

HSBC's Application of the Equator Principles

Reporting Guidance 2011

Introduction

This Guidance describes the way in which HSBC Holdings plc ("HSBC"):

- a) applies the Equator Principles ("the Principles"); and
- b) reports on that application in its annual Sustainability Report.

HSBC has commissioned an independent assurer to review its application and reporting of the Principles. This Guidance supports the assurance by providing a summary of the procedures which HSBC uses in respect of the applying the Principles.

The Principles are a framework to help financial institutions to address potential environmental and social risks when providing project finance loans or project finance advisory services. They consist of 10 principles – the first nine refer to the process to determine and manage environmental and social risk, while the final one requires institutions to report publicly on their application of the Principles. HSBC adopted the Principles on 4 September 2003. For the purposes of reporting 1 January 2004 has been used as the start date. It is the responsibility of HSBC's management to ensure that appropriate procedures are in place to ensure compliance with the Principles. HSBC's adoption of the Principles applies to its subsidiaries.

The Principles were originally issued in 2003 and were updated in 2006. HSBC uses the applicable version¹ in its application and reporting. The Sustainability Report is based on the reporting period of 1 January to 31 December. HSBC's application and reporting of the Principles includes loans and advisory services approved during the year, plus the ongoing monitoring of loans approved in previous years and still outstanding.

Basis of this Guidance

In preparing this Guidance, HSBC has endeavoured to ensure that the information on the Principles in both the Sustainability Report and this Guidance is: relevant to the stakeholders who use the Sustainability Report; reliable for its purpose, including both its completeness and its accuracy; consistent with reporting in previous years; and written in understandable terms.

Scope of this Guidance and HSBC's Reporting

HSBC's formal commitment under the Principles is to apply them in two ways: firstly, where it approves project finance² loans and, secondly, when it receives a mandate to provide advisory services for a potential project finance loan. HSBC also voluntarily applies the Principles to export credit loan³ business that is beyond the current requirements of the Principles. The ways in which HSBC demonstrates the application of the Principles are documented in the two sections below:

- Project finance loans
- Export credit loans (extended transactions)

HSBC's internal procedures for applying the Principles are contained within its Functional Instruction Manual for Credit. This Manual sets out HSBC's policies for credit risk, including environmental and social risk. It contains a chapter entitled "Project Finance and Equator Principles" which, in turn, sets out our approach to the Principles. That approach is based on the format of the Principles themselves and is provided below, where the use of italics indicates terminology summarised from the Principles.

1) HSBC's procedures for the application of the Principles to project finance loans

Scope

The Principles apply to all new project financings globally with total project capital costs of US\$10 million or more, and across all industry sectors. In addition, while the Principles are not intended to be applied retroactively, HSBC applies them to all project financings covering expansion or upgrade of an existing facility where changes in scale or scope may create significant environmental and/or social impacts, or significantly change the nature or degree of an existing impact. The Principles also extend to project finance advisory activities. In these cases, HSBC commits to make the client aware of the content, application and benefits of applying the Principles to the anticipated project, and requests that the client communicates to HSBC its intention to adhere to the requirements of the Principles when subsequently seeking financing.

The following procedures support the Scope:

- a. HSBC considers the implications of the Principles when reviewing a potential project finance loan where the total project capital costs are US\$10 million or more.
- b. If it proceeds with the loan, HSBC documents the implications under the Principles on its credit and/or other internal systems.

¹ The original Principles were introduced for project finance loans on 4 June 2003 and superseded on 6 July 2006 by the current version, which includes project finance advisory services. A transitional period from 6 July 2006 to 6 January 2007 allowed financial institutions to use either version for new transactions. Since 7 January 2007, only the current version may be used for new transactions. Ongoing loans are implemented on the basis of the version of the Principles under which they were originally approved.

² Project finance - a method of funding where the lender looks primarily to the revenues generated from the project as its source of repayment and its security – for example, when developing a new power plant.

³ Export credit loan – a method of funding for projects where the lender's exposure is supported by an export credit agency.

- c. When applying the Principles to expansions or upgrades, HSBC's definition of "significant" is tailored specifically to the circumstances of the project.
- d. When applying the Principles to project finance advisory activities, HSBC has a process and form of wording in its mandate letter (a) to make the client aware of the content, application and benefits of applying the Principles to the anticipated project and (b) to ensure that the client communicates its intention to adhere to the requirements of the Principles when subsequently seeking financing.

Principle 1 – Review and Categorisation

When a project is proposed for financing, HSBC, as part of its internal social and environmental review and due diligence, categorises such a project based on the magnitude of its potential impacts and risks in accordance with the environmental and social screening criteria of the International Finance Corporation (IFC), which are:

- **Category A** – *Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented.*
- **Category B** – *Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures.*
- **Category C** – *Projects with minimal or no social or environmental impacts.*

The following procedures support Principle 1:

- a. HSBC categorises each project finance loan as Category A, B or C according to the potential environmental and social impacts, as described in the Social and Environmental Assessment, an Independent Report or an internal report, using this categorisation to inform its business approval and credit approval processes.

Principle 2 - Social and Environmental Assessment

For each project assessed as being either Category A or Category B, HSBC ensures that the borrower has completed a Social and Environmental Assessment ("SEA") process to address social and environmental risks and impacts of the proposed project. The SEA should also propose mitigation and management measures relevant and appropriate to the nature and scale of the proposed project.

The following procedures support Principle 2:

- a. HSBC applies this Principle to all Category A and B projects.
- b. Upon receiving the SEA from the borrower, HSBC undertakes a review to confirm whether the project meets the Equator Principles and the SEA includes appropriate mitigation and management measures for the risks and impacts identified for the proposed project.
- c. Where the information in the SEA is not sufficient or the proposed mitigation and management measures are not satisfactory, HSBC has processes to request further information/action from the borrower. HSBC documents the outcomes.
- d. Where the SEA is received subsequent to the Review and Categorisation described under Principle 1, HSBC reviews the SEA to decide on the appropriate categorisation. The new

categorisation will apply for internal approval purposes and all Category A projects require additional clearance by HSBC's Group Corporate Sustainability department.

Principle 3 - Applicable Social and Environmental Standards

For each project assessed as being either Category A or Category B – where the project is not located in a High Income OECD Country⁴ - the SEA refers to the then applicable Performance Standards and the then applicable industry-specific Environmental Health and Safety ("EH&S") Guidelines of the International Finance Corporation ("IFC") and local regulations, where relevant.

For each project assessed as being either Category A or Category B – where the project is located in a High Income OECD Country - the SEA should confirm that the project complies with relevant host country laws, regulations and permits for social and environmental matters.

The following procedures support Principle 3:

- a. HSBC applies this Principle to all Category A and B projects.
- b. HSBC checks whether the project location is in a High Income OECD Country in order to determine which standards and which Principles apply.
- c. Where the project is not located in a High Income OECD Country, HSBC reviews the SEA to determine whether the project meets the Performance Standards and EH&S Guidelines.
- d. If the project does not meet the Performance Standards and EH&S Guidelines, HSBC determines whether a deviation can be justified by the circumstances of the project. In making such a judgement, HSBC takes into account the nature and scale of the deviation, the borrower's response, as well as the projected benefits of the project, and documents the basis of its decision.
- e. Where a deviation is not justified, HSBC has processes to engage with the borrower in order to seek an improvement in the project, so that it meets the Performance Standards and EH&S Guidelines, failing which HSBC declines to finance the project.
- f. Where a deviation is justified, HSBC documents any mitigating action with the borrower.
- g. Where the project is located in a High Income OECD Country, HSBC reviews the SEA to determine that the project complies with appropriate local and national laws.

Principle 4 – Action Plan and Management System

For each project assessed as being either Category A or Category B – where the project is not located in a High Income OECD Country - the borrower has prepared an Action Plan ("AP") which addresses the relevant findings, and draws on the conclusions of the SEA. The AP describes and prioritises the actions needed to implement mitigation measures, corrective actions and monitoring measures necessary to manage the impacts and risks identified in the SEA. Borrowers will build on, maintain or establish a Social and Environmental Management System that addresses the management of these impacts, risks, and corrective actions required to comply with applicable host country social and environmental laws and regulations, and requirements of the applicable Performance Standards and EH&S Guidelines, as defined in the AP.

⁴ Certain countries are designated as High Income OECD Countries under the World Bank Development Indicators Database.

For each project assessed as being either Category A or Category B – where the project is located in a High Income OECD Country - HSBC may require development of an AP based on relevant permitting and regulatory requirements, and as defined by host-country law.

The following procedures support Principle 4:

- a. HSBC applies this Principle to all Category A and B projects.
- b. HSBC reviews the AP to check it addresses the findings and conclusions in the SEA.
- c. Where the AP does not immediately address the findings in the SEA, HSBC engages with the borrower to rectify the AP.
- d. HSBC has processes to confirm that the borrower has or will develop a Social and Environmental Management System that will help to ensure that the project complies with the applicable social and environmental standards.
- e. Where the Social and Environmental Management System is considered inadequate, HSBC has processes to request and confirm that changes are made to that system.
- f. Where the project is located in a High Income OECD Country and HSBC determines, from its review of the SEA, that an AP is appropriate, HSBC documents that process both internally and with the borrower.

Principle 5 – Consultation and Disclosure

For each project assessed as being either Category A and, as appropriate, Category B – where the project is not located in a High Income OECD Country – HSBC ensures that the government, borrower or third party expert consults with project-affected communities in a structured and culturally appropriate manner.

The following procedures support Principle 5:

- a. HSBC applies this Principle to all Category A projects and, based on its analysis of the SEA and AP, to relevant Category B projects, documenting the rationale.
- b. Where consultation is required, HSBC obtains and reviews documentation to confirm that:
 - i. Consultation with project-affected communities is undertaken in a structured and culturally appropriate manner.
 - ii. The process ensures their free, prior and informed consultation and facilitates their informed participation as a means to establish, to the satisfaction of HSBC, whether a project has adequately incorporated affected communities' concerns.
 - iii. The SEA and AP, or non-technical summaries thereof, are made available to the public by the borrower for a reasonable minimum period in the relevant local language and in a culturally appropriate manner.
 - iv. The borrower documents the process and results of the consultation, including any actions agreed resulting from the consultation.
 - v. Disclosure occurs early in the SEA process and in any event before the project construction commences, and on an ongoing basis.
- c. Where the consultation process needs amendment, HSBC has processes to confirm amendments are made.

Principle 6 – Grievance Mechanism

For each project assessed as being either Category A and, as appropriate, Category B – where the project is not located in a High Income OECD Country – HSBC ensures that the borrower will, scaled to the risks and adverse impacts of the project, establish a grievance mechanism as part of the management system.

The following procedures support Principle 6:

- a. HSBC applies this Principle to all Category A projects and, based on its analysis of the SEA and AP, to relevant Category B projects, documenting the rationale.
- b. Where a grievance mechanism is required, HSBC obtains and reviews relevant documentation to confirm that:
 - i. Consultation, disclosure and community engagement continues throughout the construction and operation of the project.
 - ii. The borrower receives and facilitates resolution of concerns and grievances about the project's social and environmental performance raised by individuals or groups from among project-affected communities.
 - iii. The borrower informs the affected communities about the mechanism in the course of its community engagement process and ensures that the mechanism addresses concerns promptly and transparently, in a culturally appropriate manner, and is readily accessible to all segments of the affected communities.
- c. Where the grievance mechanism needs amendment, HSBC has processes to confirm amendments are made.

Principle 7 – Independent Review

For each project assessed as being either Category A and, as appropriate, Category B, HSBC ensures that an independent social or environmental expert not directly associated with the borrower reviews the SEA, AP and consultation process documentation in order to assist HSBC's due diligence, and assess compliance with the Equator Principles.

The following procedures support Principle 7:

- a. HSBC applies this Principle to all Category A projects and, based on its analysis of the SEA and AP, to relevant Category B projects, documenting the rationale.
- b. HSBC has processes to establish that the social or environmental expert is independent from the borrower.
- c. HSBC analyses the Independent Review to determine the borrower's adherence to the Principles and whether the categorisation remains appropriate.
- d. The findings from the review are documented and, where appropriate, raised with the borrower.

Principle 8 - Covenants

For each project assessed as being either Category A or Category B, HSBC ensures that loan covenants are agreed with the borrower to address compliance with the Principles.

The following procedures apply to Principle 8:

- a. The proposed covenants are checked against HSBC's standard financial covenant template and to ensure that borrower agrees to:
 - i. Comply with all relevant host country social and environmental laws, regulations and permits in all material respects.

- ii. Comply with the AP during the construction and operation of the project in all material respects.
 - iii. Provide periodic reports in a format agreed with HSBC (with the frequency of these reports proportionate to the severity of impacts, or as required by law, but not less than annually), prepared by in-house staff or third party experts, that a) document compliance with the AP (where applicable), and b) provide representation of compliance with relevant local, state and host country social and environmental laws, regulations and permits.
 - iv. Decommission the facilities, where applicable and appropriate, in accordance with an agreed decommissioning plan. HSBC will add specific covenants to the loan documentation to support the borrower's compliance with the Principles.
- b. Where the borrower is not in compliance with its social and environmental covenants, HSBC works with the borrower to bring it back into compliance reflecting HSBC's role in the transaction, documenting the process.
 - c. If the borrower fails to re-establish compliance within an agreed grace period, HSBC reserves the right to exercise appropriate remedies, documenting the process.

Principle 9 – Independent Monitoring and Reporting

For each project assessed as being either Category A and, as appropriate, Category B, HSBC requires the appointment of an independent environmental and/or social expert - or requires that the borrower retain qualified and experienced external experts - to verify its monitoring information which would be shared with HSBC.

The following procedures support Principle 9:

- a. HSBC applies this Principle to all Category A projects and, based on its analysis of the SEA and AP, to Category B projects where appropriate, documenting the rationale where that is the case.
- b. HSBC has procedures in place to ensure that reports are received over the life of the loan.
- c. HSBC reviews the monitoring reports to check that the project is operating in accordance with the AP.
- d. Where the project is not operating in accordance with the AP, HSBC has processes to discuss such issues with the borrower and to address them in accordance with the covenants.

Principle 10 – HSBC Reporting

HSBC commits to report publicly at least annually about its Equator Principles application processes and experience, taking into account appropriate confidentiality considerations

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The following procedures support Principle 10:

- a. HSBC compiles an inventory of all new project and export finance loans which were analysed, plus all new advisory services provided in respect of projects, during each financial year.
- b. HSBC has procedures in place to check the accuracy and completeness of the inventory, including advisory activities.
- c. HSBC includes a summary of the inventory in its annual Sustainability Report, plus comments on application of the Principles.
- d. Where HSBC changes the assumptions behind its reporting, or becomes aware of any inconsistency which would be material or misleading, it comments accordingly in its annual Sustainability Report.

2) HSBC's procedures for the application of the Principles to export credit loans (extended transactions)

Scope

HSBC applies the Principles to export credit loans provided to customers (project owner/operator or material⁵ supplier) where the Group knows the proceeds will finance a project with capital costs of US\$10m or more.

The following procedures support the Scope:

Principle 1: The procedures as noted above for a project finance loan are applied.

Principle 2: HSBC identifies the main impacts, risks and mitigating actions of the project by using relevant documentation (e.g. the SEA) or correspondence with the customer, export credit agency, or the lead financial institution.

Principle 3: HSBC identifies the standards to which the project must conform depending on the customer and nature of the project. Applicable standards can be the IFC Performance Standards, World Bank Safeguards, or local law.

Principle 4: HSBC confirms that an AP is in place where the project is not located in a High Income OECD country.

Principles 5 and 6: For Category A projects not located in a High Income OECD country, HSBC confirms that affected communities have been consulted and a grievance mechanisms exists.

Principle 7: For Category A projects and where HSBC's customer is the project owner/operator or a supplier supplying at least 50% of a project's capital costs, HSBC has processes to establish that an independent expert has reviewed relevant project documentation and confirmed compliance with the applicable standards.

Principles 8 and 9: For Category A projects and where HSBC's customer is the project owner/operator, HSBC's loan documentation contains covenants to comply with the AP and provide annual update reports. HSBC confirms that an independent expert verifies compliance with the applicable standards on an annual basis over the life of the loan.

Principle 10: The procedures as noted above for a project finance loan are applied.

⁵ Material – where the supplier provides equipment or services representing at least 25% of a project's capital costs.