

A NEW FRAMEWORK FOR SOUTH AFRICA: FINANCIAL INSTITUTIONS, HUMAN RIGHTS AND INTERNATIONAL BEST PRACTICES

REPORT OF THE SEMINAR AND PROPOSED JOHANNESBURG PRINCIPLES

INTRODUCTION

On 24 November 2011, the Mandela Institute and the Wits School of Law jointly hosted a roundtable seminar entitled *A New Framework for South Africa: Financial Institutions, Human Rights and International Best Practices*. The purpose of the seminar was to build on discussions undertaken in the first *Financial Institutions, Human Rights and International Best Practices* conference, on 19 July 2011, with the aim of enumerating specific and workable principles for banks operating in the South African context.

The seminars came at a time when analysis of the role of multi-national corporations in the violation and protection of human rights has been increasingly prominent, with a number of developments proposed and undertaken at global, regional and national forums. Financial institutions have often fallen outside of these discussions.

Each of these seminars brought together representatives from three different sectors: human rights activists; human rights and finance academics; and those working in both the public and private banking sectors. Each participant in the seminar brought a unique insight and breadth of knowledge, and allowed the group to develop an approach that took account of the difficulties encountered by the banking sector while ensuring that it met the concerns of human rights activists.

It was important to the participants to develop a framework that took account of the unique situation in which South Africa finds itself. South Africa's financial market is one of the largest and most powerful in Africa, playing an important role in lending to other countries in the region. Furthermore, financial institutions in the South African environment face different constraints to banks in Europe and the United States. As such, the seminar sought to allow South Africa to lead the way in ensuring appropriate standards for lending in its own context.

The discussions focused on the project finance activities of financial institutions and, particularly, on lenders' obligations prior to concluding a contract and in the implementation of the contract.

The focus led to a discussion of principles around project finance, as human rights issues and responsibilities in transactions come out most clearly in project financing roles. However, participants emphasised the need to recognise the many different complex transactions undertaken by banks, and the need for further discussion in that regard. The discussion covered project finance in all institutions, including both public and private banks.

The following report sets out a summary of the discussions undertaken at the seminar on 24 November 2011, highlighting key points from the discussion, before presenting the *Johannesburg Principles* that emerged from the delegates' discussions.

DISCUSSION

A. Introduction: Acknowledging Progress

It was recognised by all involved in the seminar that financial institutions (FIs), especially those in South Africa, have taken considerable steps to ensure that their transactions and their borrowers' operations comply with human rights standards. FIs continue to seek to innovate in this area despite incurring significant costs from this commitment.

There are several reasons for this. FIs have a financial, moral and reputational interest in ensuring that human rights are secured when project finance is provided. This was recognised unanimously by participants.

The discussions focused on four subjects:

- i. The pre-contractual obligations of FIs in respect of human rights assessment;
- ii. Complying with human rights during the life of a project (the 'in-contract' obligations of FIs);
- iii. Responsibility for human rights compliance in projects outside South Africa;
- iv. The consequences of borrowers' non-compliance with national, regional and international human rights standards.

B. The Pre-Contractual Obligations of FIs

A Long-Term, Holistic Analysis

An underlying issue that arose in discussions across the different sessions was the need to ensure that FIs look at issues around project finance in a holistic manner. A human rights assessment would require an analysis, not only of a contract's short-term financial impact, but also its long-term environmental, social and cultural impact. Although this might be contrary to the historic trend of looking at the short-term profits to be gained from a project, this dual approach has advantages, not only for the protection of human and environmental rights, but also to manage and mitigate the financial risks of human rights violations.

The Consultation / Assessment Process

The pre-contractual consultation process is the most important stage in determining whether or not a proposed project will have harmful social or environmental consequences. Notwithstanding the importance of consultation, there is little certainty around best standards, handling this information and dealing with the conclusion of the consultation.

In due diligence assessments, there is a need not merely to include materiality concerns, but also a human rights approach to development, satisfying principles of accountability, participation, non-discrimination and empowerment.

The following issues arose:

1. Who is consulted?
 - a. While it may be clear that a certain community may be affected by a project, it is not clear who in that community should be consulted. Communities are not uniform or homogeneous entities. As such, community members may have different views on a proposed project.

- b. The consultation process should ensure that the views of the various sub-groups within the community are heard. Particular attention should be paid to the views of women and minority groups (who are often excluded from official representative bodies).
 - c. Therefore, the community should not be seen as a singular entity but rather a collective of individuals.
 - d. The consultation process needs to be undertaken on a basis of 'equality of arms' i.e. ensuring the community has legal representation, knowledge of their rights and technical information about the consequences of the project.
2. Who conducts the consultation?
- A key concern expressed by representatives of the banking sector is the role of the consultants who undertake the human rights and environmental impact assessments. Consultants are costly (and banks, for the most part, are required to burden this additional cost) and often do not produce reports that are rigorous and sufficiently in-depth.
3. What is being asked in the consultation process?
- a. Is the consultation process about negotiation or about consent?
 - b. Do international standards of free, prior and informed consent apply?
 - c. What happens when the community rejects the project but the government approves it?
4. How transparent can and should the consultation be?
- a. Transparency was emphasised.
 - b. It is critically important to capture the lessons that are learned from each experience, not merely internally but also through external examination.
 - c. There is a problem, however, where the consultation process yields market-value information. The protection of this information as a commodity imposes confidentiality constraints that mitigate the ease of transparency.
 - d. It was agreed that market sensitivity, while important, must be critically analysed rather than merely asserted. Furthermore, community participation cannot be sidestepped on this basis.
5. How do we deal with the unknowable?
- a. There are certain eventualities or outcomes which are unpredictable and unknowable.
 - b. To the extent that this information cannot be assessed, FIs should be clear about what they do not know.

Consultation is therefore a critical aspect of transactions, both from communities' perspectives and from the view of the project sponsor and FIs. Effective and meaningful participation in the project at an early stage ensures an understanding of the goals of the project. This is necessary for respecting communities' dignity and right to choose but also secures community buy-in if consultation is successful, which is essential for ensuring the implementation and long-term success of a project. The issues of free, prior and informed consent to consultation are complicated and uniform standards are required. While uniform consent is an unrealistic aspiration, a proper participation process is necessary, including one that takes into account the divergent needs of different groups within the community, noting that a community is not homogenous and often includes groups with varying degrees of power and vulnerabilities.

C. The In-Contractual Obligations of FIs

Human Rights Standards as Terms and Conditions of the Loan Agreement

The delegates expressed the view that clear contractual terms and conditions are an effective method of enforcing human rights obligations by the borrower. If a borrower violates a condition of the loan

agreement relating to human rights standards, it would be in default of the loan agreement (either in part or in whole).

Current contractual conditions include, as a matter of practice, prohibitions against illegal conduct. However, it was considered by participants that it is necessary to go beyond merely what is illegal (such as child pornography) to ensure that contracts do not violate human rights (such as unlawful displacement and impoverishment, which are not expressly illegal under many national jurisdictions).

To ensure that these conditions are truly effective, the pre-contractual due diligence must be sufficiently thorough. As stated above, FIs must assess projects in a holistic fashion, taking into account environmental, social, cultural and financial issues at the start of the process. There must therefore be an adequate risk assessment before the contract is signed. This risk assessment must also take into account the human rights costs of *not* financing the project.

Degree of Monitoring and Intervention

During the currency of a contract, banks are reluctant to become involved in the monitoring of human rights compliance, not least because such involvement in the day to day practice of the borrower's project may expose banks to liability.

D. Responsibility for human rights compliance in projects outside South Africa

The participants discussed the issue of dealing with projects that are based outside South Africa but funded by South African banks (extra-territoriality). In accordance with state standards for extra-territorial conduct, as well as current best practices by South African banks, it was agreed that the standards of the state will take precedence *so long as* those standards meet the basic international best practices. Therefore, if the standards required by the host state are higher than international standards, those standards must apply.

Some provisions in the Maastricht Principles on Extraterritorial Obligations of States in the area of Economic, Social and Cultural Rights, adopted in September 2011, were highlighted, that could be of relevance to FIs.

This discussion also raised issues of state responsibility. Often excessive emphasis is placed on FIs to perform regulatory duties that should be allocated to the state. It is not the role of FIs to act as a policing body in terms of regulation; however, they do have a role, in the absence of state regulation, to ensure compliance with human rights standards and to avoid making profits from harmful projects.

E. The Consequences of Borrowers Committing Human Rights Violations During the Contract

Non-compliance with human rights standards is common and therefore a key outcome of the discussion was how to deal with them. The following proposals were discussed with agreement:

1. *Breach of contract*: If human rights protection is a provision of the loan agreement, non-compliance will constitute a breach of the loan agreement. Depending on the terms of the agreement, FIs may have a degree of flexibility in addressing the violation.
2. *Meaningful engagement*: In keeping with the Equator Principles, most equator banks adopt a policy of 'meaningful engagement' with the borrower to construct solutions to the violation and avoid repetition. One

rationale for this approach is to ensure that a responsible bank works with the offending borrower to remedy the violation rather than creating space for a bank which does not operate in accordance with human rights standards.

3. *Suspension/ Termination*: Suspension and termination of the contract were considered to be extreme options, utilised only as a final step. It was also recognised that suspension and termination may have detrimental effects on the community and therefore unintended consequences of exiting from the project should be considered.
4. *Leverage*: The leverage of banks should not be overstated. It was recognised that financial imperatives for FIs make it extremely difficult for banks to effect these solutions. In particular, FIs will have little or no leverage where the entire loan has been paid. Staggered loans were therefore seen to be preferable, as subsequent portions of the loans can be used as leverage to enforce contractual conditions.
5. *Standard of liability*: It was recognised that there does have to be accountability for FIs when violations of human rights standards occur. Such liability will depend on a number of factors. When FIs are close to the violation, or have power over the operation of the contract, they should be held liable. Furthermore, the more significant the injury on the affected parties, the more likely liability will be found. A negligence standard was considered as a way of ensuring these variables could be taken into account. If a FI is negligent, and does not comply with the reasonableness standard in due diligence and monitoring of the contract, then liability can be considered.

The views of the delegates were harnessed and summarised into the following points of action, entitled the *Johannesburg Principles*. A draft of these principles is below. These principles constitute a summary of the key issues raised and represent a proposal of the way forward in the development of a framework for the protection of human rights by FIs.

THE PROPOSED JOHANNESBURG PRINCIPLES

A NEW FRAMEWORK FOR SOUTH AFRICA: FINANCIAL INSTITUTIONS, HUMAN RIGHTS AND INTERNATIONAL BEST PRACTICES

A. THE BACKGROUND TO AND PURPOSE OF THE JOHANNESBURG PRINCIPLES

The *Johannesburg Principles* constitute a set of proposed, guiding principles emanating from two high-level multi-sectoral meetings held in July and November 2011 in Johannesburg. The delegates of the 2nd seminar on *Financial Institutions, Human Rights and International Best Practices*, based on the proceedings of the 1st seminar, discussed key principles which must be addressed in the development of a South African Framework for Financial Institutions and Human Rights.

B. THEMES UNDERPINNING THE PRINCIPLES

Key themes underpinning the principles:

- Banks have human rights obligations to their staff, their clients and the people affected by the transactions in which they invest;
- The human rights obligations of financial institutions are often regulated by governments but this regulation is not always enforced or robust;
- The international principle in the UN Framework on Business and Human Rights confirm that business entities, *including* financial institutions, have a 'responsibility to respect human rights', to refrain from doing harm and to exercise due diligence in all their business activities;
- Financial institutions' transactions and their role in funded projects are complex;
- While financial transactions come in many forms, this document focuses on the role of banks; project finance; and, loan agreements;
- There are global standards which articulate the need for business entities, including financial institutions, to protect human rights, including the UN Framework on Business and Human Rights, the International Finance Corporation Performance Standards, the OECD Guidelines on Multinational Enterprises, the UN Global Compact; and the Equator Principles;
- There is a need for adherence to policy regulations and further positive mechanisms to support compliance with human rights;
- It is in financial institutions' interests to comply with human rights obligations: there is a profit risk in non-compliance with human rights obligations; there is a reputational risk in non-compliance with human rights standards; there is a risk of damage to relationships with international banks and the global financial industry as a result of non-compliance with international rules and standards;
- Compliance with human rights obligations is necessary for peace, security and development, which in turn are necessary for profit and financial gain;
- Financial institutions in South Africa are in many ways ahead of international trends; operate in a different context to many European and American banks; and are in need of nuanced and contextual guidance.

C. THE PRINCIPLES

1. Pre-Contractual Assessment and Participation

- a. The pre-contractual phase of project finance is the most important stage to ensure that projects do not cause unjustifiable and disproportionate human rights violations;
- b. When making a decision to invest in a project, financial institutions should ensure effective and meaningful participation of primary and secondary stakeholders;
- c. Community members, civil society and other relevant actors must be given a say in the outcome of projects. Such participation must be meaningful and engage diverse members of the community, with specific reference to gender-specific needs and diversity;
- d. This assessment can and should be undertaken notwithstanding the market-sensitivity of certain project concepts;
- e. Where external consultants are engaged, detailed and substantiated reports should be produced;
- f. The pre-contractual assessment should be informed by consideration of the entire life-cycle of projects in an inclusionary and holistic manner, rather than solely considering the short term financial benefits.

2. Project Finance Contracts

Project finance contracts should:

- a. Include, as a condition of the agreement that borrowers will comply with national, regional and international human rights standards. Such standards should go beyond an enumeration of illegal activities to ensure positive compliance with national, regional and international human rights standards;
- b. Take account of the principles of accountability, participation, non-discrimination and empowerment;
- c. Where possible, be financed by staggered loans to ensure leverage in cases of non-compliance.

3. Reasonable care and Due Diligence

Financial institutions shall take reasonable care to ensure effective due diligence in and monitoring of project finance contracts.

4. Consequences of Human Rights Violations by the Borrower

Where a borrower, either directly or indirectly commits or is complicit in the commission of a human rights violation, financial institutions should take the following steps:

- a. In accordance with international standards such as Principle 8 of the Equator Principles and Principle 22 of the UN Guidelines on Business and Human Rights, *engage* with the borrower to stop the violation, ensure its non-recurrence and commit to remediation;
- b. Where a borrower fails to re-establish compliance, financial institutions may *delay, suspend or cancel* the loan, where possible;
- c. Always *consider* the unintended consequences of any remedial action, such as the loss of income to the local community if the contract is cancelled.

5. Liability for Human Rights Violations

- a. When determining whether a financial institution is responsible for a human rights violation or could have prevented a human rights violation, it would be appropriate to use a standard of negligence i.e. how would a reasonable financial institution in the circumstances have acted and were there steps that could have been taken to avoid or mitigate the harm?
- b. This standard would consider:
 - i. The power of financial institutions in comparison to the borrower;
 - ii. The extent of control the financial institution had over the borrower, and the extent of control that could have been achieved through proper contracts;
 - iii. The impact of the violation on affected communities.

6. *Contracts outside South Africa*

Where a borrower's project operates outside South Africa, the same standards must be applied, unless the legislation of that state carries a higher or more onerous standard for protecting human rights.

7. *Integration of Human Rights and Environmental Specialists*

- a. The fulfilment of these Principles requires the integration of human rights and environmental specialists into all operations of financial institutions;
- b. Management, shareholders and depositors should be encouraged to support these endeavours.

Held on Thursday 24 November 2011, 08h00 – 17h00 at Chalsty Teaching and Conference Centre, Wits
School of Law, Johannesburg