Nordea Asset Management
Protecting shareholder value & securing the license to operate; managing community risk

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Nordea Asset Management 2015
MISSION

Nordea Asset Management’s commitment to Responsible Investment was formalized in 2007, when Nordea Asset Management among the first Nordic banks signed the Principles for Responsible Investments. It is Nordea Asset Management mission to create Returns with responsibility.

This is achieved through analysis, dialogue and engagements in selected companies and integration of key environmental, social and governance issues into our investment processes.
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PURPOSE
This purpose of this report is to build the case for improved risk management by those companies with operations that have high environmental and social impacts on local communities, particularly in high risk geographies and capital heavy industries.

We believe that companies which adopt good practice in managing community impacts in their operations are best positioned to protect shareholder value and meet stakeholder expectations. This paper serves as guidance for us as an investor as well as recommendations to companies.

THIS REPORT HIGHLIGHTS
• Key impacts that many large-scale extractives and infrastructure\(^1\) projects may have on local communities and which may elicit community opposition;
• The material business risks that community opposition can present to companies operating these projects; and
• Our research on good practice in managing these risks as a result of field visits and discussions with a number of companies and NGOs.
INTRODUCTION

Studies\(^2\) have highlighted that local communities are increasingly opposing the development of extractives and infrastructure projects, particularly in developing and emerging markets characterised with social and ecological vulnerabilities.

These studies also show that the risks that community opposition (e.g. through protests and disputes) present to shareholder value and license to operate can be material and are often disregarded. Many companies do not fully capture the related costs of community opposition across their portfolios of projects and are therefore underestimating the value of community engagement\(^3\), i.e. fostering positive, long-term, relationships with local communities.

This is particularly evident at the early stages of project development but also throughout the project lifecycle.

Investors (as well as lenders and insurers) are increasingly concerned about how the failure to adequately manage community relationships erodes value, through increased financial, operational and regulatory risks, but also how poor management of community issues conflict with their long-term, shared interest in promoting responsible and sustainable development.

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1. This report is focused on extractives and infrastructure (e.g. utilities) projects due to the nature of risks posed to local communities as a result of their operations. However, this paper is not limited to these types of projects in its application.
3. In this context, we refer to community engagement as a process by which companies establish ongoing, permanent relationships with local organisations and individuals to address issues that impact their well-being and with the purpose working collaboratively to benefit community needs. This includes credible and transparent reporting as well as collaborative decision-making.
SOURCES OF COMMUNITY RISK
Many extractives and infrastructure projects, if executed responsibly, can provide socio-economic development opportunities and benefits to local communities, particularly related to employment, infrastructure, healthcare and education.

However, we have encountered several cases where community engagement and mitigation of negative environmental and social impacts have been overlooked and under prioritised; leading to conflict and disputes that ultimately lead to the suspension or abandonment of projects.

Community impacts related to projects that can elicit opposition, particularly in ecologically and socially vulnerable areas can include but are not limited to:

INADEQUATE CONSULTATION, COMMUNICATION & LACK OF CONSENT, PARTICULARLY AT AN EARLY STAGE
Many developers face cost pressures and tight deadlines when executing projects – criteria often required to win contracts.

These pressures have conflicted with the priority and time given to fostering positive relationships with communities and ensuring quality impact assessments and consultation processes at an early stage to garner community support.

INDIGENOUS COMMUNITIES
These are specific rights at risk. As the International Finance Corporation (IFC) Environmental and Social performance standards state, indigenous peoples economic, social and legal status limits their capacity to defend their rights to and interest in land and natural and cultural resources and may restrict their ability to participate in and benefit from development. Indigenous peoples are particularly vulnerable where their lands and resources are transformed, encroached upon or significantly degraded.

ENVIRONMENTAL/ACCESS TO NATURAL RESOURCES
Extractives and infrastructure projects can impact local communities access to or use of natural resources. This can include resources such as land, water, minerals, forests, biodiversity, etc. – resources that may be vital to the livelihoods of local communities. Projects can also result in environmental pollution, impacting air and water quality and affecting community health.

DISTRIBUTION OF PROJECT REVENUES
Profit flows, royalties, taxes and other benefits from projects may overlook local communities and flow directly to other stakeholders. Corruption is also highlighted as exacerbating the misallocation of revenues away from local communities.

RESETTLEMENT, REHABILITATION, COMPENSATION
Projects can involve involuntary resettlement where local communities must be physically and economically displaced. We have seen cases where compensation and remediation for local communities has been delayed to later stages of the project lifecycle, triggering community tensions.

LAND RIGHTS & PROPERTY DISPUTES
Property disputes can arise, particularly if companies are dealing with legacy issues where government acquired land through a questionable process where local communities do not feel adequately compensated.

SOCIAL & CULTURAL INTRUSION
Local communities often experience an influx of outsiders or migrant workers and have experienced social challenges related to violence, crime, prostitution, and security issues raising human rights violations.

EMPLOYMENT
Projects are known to create employment opportunities for local communities, however there have been cases where poor treatment of the local labour force has led to strikes and protests. In addition, labour needs can also diminish in later stages of the project lifecycle putting local communities out of work. In particular geographies, there can be skilled labour shortages increasing the need for local capacity building to create long-term employment opportunities.
BUSINESS CASE FOR IMPROVED COMMUNITY RISK MANAGEMENT

REPUTATIONAL RISKS
Large multinational companies often have portfolios of projects spread across different geographies where they are part of consortiums or joint ventures with other players executing the projects. Even though community controversies surrounding one particular project may only account for a small percentage of the company revenues, community opposition on a project level can impact the company’s reputation.

In addition, the reputational risks for being involved in a controversial project could hurt future revenue streams for projects in other parts of the world — hurting access to new projects.

OPERATIONAL RISKS
Community opposition can also present significant operational and financial risks. Community disputes in the form of protests or physical damage to assets, property or infrastructure, can result in lost productivity due to project shutdowns and delays in construction.

We have also seen many cases where licensing disputes have been held up in the legal system repeatedly and over a period of time spanning several years.
A recent report\(^4\) states the UN Guiding Principles on Business and Human Rights estimates that, on average, mining companies suffer an estimated USD20 to 30 million per week when a site is shut down due to non-technical reasons, and that a Harvard study on the cost of company-community conflict in the extractive sector states that 30% of extractives projects facing community confrontations are either suspended or abandoned. In addition, community issues are increasingly diverting senior management time to managing conflicts.

**ACCESS TO CAPITAL RISKS**

Lenders are increasingly looking at companies’ commitment, capacity (policies and processes) and track record to prevent and address environmental and social risks. Failure in systems to manage community risk could mean an increase in the cost of capital as the cost of financing increases. Currently, there are 80 Equator Principles Financial Institutions (EPFIs) in 34 countries that have officially adopted the Equator Principles\(^5\), covering over 70 percent of international Project Finance debt in emerging markets.

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5. The equator principles are a risk management framework for determining, assessing and managing environmental and social risk in projects, and is primarily intended to provide a minimum standard for due diligence by financial institutions to support responsible risk decision-making.
ELEMENTS OF GOOD PRACTICE IN COMMUNITY RISK MANAGEMENT

Given that there are several points of contention that can fuel community opposition related to extractives or infrastructure projects, a single good practice approach to mitigate potential community risks is difficult to outline.

COMPANY SYSTEMS & PROCESSES

There are several international best practice guidelines that have been published to assist companies in developing proactive and meaningful approaches to community engagement and managing community relations, including implementation of quality, third party impact assessments and audits, stakeholder and human rights risk monitoring, grievance mechanisms, local capacity building and support for SMEs, community programmes and reporting practices.

These include but are not limited to the UN Guiding Principles on Business and Human Rights and the IFC Performance Standards on Environmental and Social Sustainability or industry-specific guidelines such as the ICMM Sustainable Development framework or Hydro Power Sustainability Assessment Protocol.

The application of Free, Prior and Informed Consent (FPIC) particularly where indigenous communities are concerned, has been widely highlighted. However, we recognise that for companies, the ‘consent’ element of FPIC can be contentious, in the sense that indigenous peoples could in practice withhold their consent. And although best practice companies commit publicly to FPIC, in practice this tends to be ‘strive to achieve’.

However, there are a number of clear themes that we highlight as a result of our research and discussions with companies where we see a more successful mitigation approach.

Nevertheless, we believe that best practice guidelines must be supported with processes for meaningful community consultation and engagement throughout the project lifecycle to secure community support.

For companies with large portfolios of projects we see the importance of having oversight of stakeholder and human rights-related risks across the entire portfolio as part of basic risk mapping processes and in formal risk registers. When incidents occur, they should be followed up with processes to determine the root causes so that lessons learned can be integrated into the company practices in other projects. In general, focusing on prevention instead of investment when something has gone wrong is a defining factor in successfully managing community risk.

Proactive community risk mitigation strategies are important and should be integrated with operational policies and processes across the project portfolio (and in the specific projects themselves), rather than solely relying on separate standalone community investment approaches or community projects to mitigate community risks.
“FRONT-END” COMMITMENTS TO EARLY STAGE COMMUNITY CONSULTATION, ENGAGEMENT & REMEDIATION

One of our key learnings is the importance of commitments (in time and resources) to early stage and quality consultation and engagement, taking proper account of community dynamics.

The resulting mitigation and compensation measures outlined as a result of due diligence/impact assessment processes that comprehensively cover environmental and human rights issues (and subsequent transparency of this) at the feasibility and construction stage — where most conflicts can lead to the suspension or abandonment of projects — are critical to implement and should not be delayed to later stages in the project. While we recognise that project timelines can be in conflict and companies with a low cash flow at the beginning of a project may face difficulties in achieving this, “front–end” commitments can avoid even higher costs in trying to buy support later.

GOVERNMENT PROCESSES
Impact studies and consultation processes are often required as part of obtaining regulatory licenses and approvals, and in many geographies, we recognise that government agencies play a critical role in carrying this out.

We have noted cases where alleged inadequate studies and consultation processes, largely led by government agencies, have hindered consent from local stakeholders and resulted in community protests and licensing disputes — ultimately suspending the projects that companies are involved in.

Companies are under increasing pressure to supplement the gaps in processes led by government agencies, as insufficient attention to this stage of the process has resulted in significant costs in later stages of the project lifecycle where significant time and resources are dedicated to conflict resolution, especially by senior management.

Companies that develop an interest to build government capacity to conduct consultation and consent processes properly, and that supplement gaps in government processes, can better mitigate the risks of community conflict.

ON THE GROUND PRESENCE
We find it important to have staff with the skills to prevent and address community opposition who are on the ground before construction starts and who coordinate with commercial and technical teams. On the ground staff should also foster positive relationships with local suppliers and contractors.

A successful approach to mitigating community risk must also allow for a time frame for decision-making that is realistic for the local situation and provide a high degree of transparency — providing ongoing details of how negative environmental and social impacts are being mitigated. On the ground information should also be integrated into company risk management systems.

DISCLOSURE
We see a need for increased transparency of the community risks related to projects and how they are being managed with greater detail. This can be provided as a part of company annual reporting processes.