

# Small and Medium Enterprise Finance: Loans to a Cotton Producers Cooperative in Brazil

Find out why environmental and social due diligence (ESDD) assessments can be important in small and medium enterprise (SME) financing, particularly when land or other physical assets are used as collateral.

Financing SMEs creates high developmental impact and is considered to have lower environmental and social (E&S) risks than project and corporate finance because of SMEs' smaller footprint. However, unlike larger corporations, SMEs can have limited capacity and resources to manage E&S risks, and authorities may in some cases not regulate and monitor them as closely.

Because SMEs are typically less sophisticated than larger companies, it is usually riskier to lend to them, and thus it's common to use collateral to guarantee loans and enable access to finance for these types of companies. For a financial institution supporting SMEs, ESDD isn't as important a focus as it is for corporate finance, but as this case illustrates, E&S risks are still present and can be exacerbated by using physical assets as collateral.

## THE LOAN AND WHAT HAPPENED

A Brazilian bank supported a cooperative of cotton producers with a \$15 million package, providing the SME loans backed by a land guarantee. The E&S issues associated with financing SMEs in the agribusiness sector may include pollution and worker health and safety issues from the improper use of pesticides, poor working conditions, and in frontier regions, deforestation and impacts on Indigenous Peoples. The risks vary, depending on the company size and its capacity to manage E&S risks and on industry sector and location.

In this case, when weather events caused the crops to fail, many of the cooperative's members couldn't repay their loans. Some of them had crop insurance, but the amount covered was still insufficient. To address the outstanding balances and responsibly manage its position, the bank made use of its collateral rights and assumed stewardship of a portion of the land.

The bank had checked that the producers had proper licenses and title to the property, but it didn't conduct a proper ESDD covering the key E&S risks related



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**ESDD assessments can help financial institutions and their clients and investees avoid potential E&S issues and adverse events that could jeopardize financial and operational viability.**

Conducting ESDD on transactions is a critical component of a financial institution's E&S management system. The ESDD's scope and level of detail depends on the transaction's E&S risk category and will vary by transaction type. The assessment systematically identifies, quantifies, and evaluates any potential E&S risks associated with a potential client or investee's business activities to confirm that the transaction won't present liabilities and risks to the institution. If the process finds E&S risks, it helps identify mitigation measures to reduce those risks, in many cases bringing value to borrowers. Thus, its outcome is important to the decision-making process for proceeding with a transaction because E&S risks could present a credit, liability, or reputational risk to financial institutions.

to this sector and missed the fact that excessive and improper use of pesticides caused severe land and groundwater contamination. Although the local municipality and neighboring landowners were aware of this issue, none of them had taken any action because of the inability of the cooperative's small farmers to provide compensation. Once the bank took possession of the land, however, the affected stakeholders now had a responsible party with the financial resources to provide remedy, so both the local municipality and the neighboring landowners sued the bank. The bank's failure to assess the E&S risks associated with its loan package resulted in the loss of the amount loaned to the cooperative plus liability to provide compensation and cleanup.

**In this case, failure to identify and manage potential E&S issues through an ESDD caused significant financial losses for the bank.**

The bank took possession of the land when the loans defaulted but didn't anticipate the E&S liabilities from soil and groundwater contamination or damages to third parties. Contaminated areas are those where planned, accidental, or natural pollution from the disposal, accumulation, storage, or infiltration of substances or wastes have been proved to harm protected property. When contamination is confirmed, the property owner is responsible for remediation, even if the owner is not at fault. In this case, an ESDD should have identified the water contamination, which was already known to other landowners and the municipality.

Liability for soil and groundwater contamination requires careful management to avoid civil, administrative, and criminal penalties, especially because liability does not expire in markets without a statute of limitations on environmental claims). The bank could face future claims and faced reputational damage for its association with the pollution.

Some banks perform a preliminary environmental assessment to check if the property could become contaminated, especially in countries with strict liability rules. In Brazil, for example, the National Environmental Policy imposes strict liability on property owners to address environmental impacts, regardless of fault.

Remediation is often costly and can involve removing contamination sources, treating contaminated material, and transferring waste to licensed disposal facilities. It can also require multiple studies and assessments that add to costs and delays.

This case underscores the importance of integrating ESDD into SME lending decisions. Even when borrowers are small or less regulated, lenders may still face significant liability and financial loss if risks are not assessed properly. When financing SMEs, especially in sectors with known E&S risks, lenders should go beyond license checks and consider additional environmental assessments. This case illustrates how failing to identify existing environmental damage can create liabilities and financial losses that outweigh the original loan.

## Managing E&S risks is good corporate responsibility and enhances business value.

Financial institutions that manage E&S risks as part of their risk management systems and pursue environmental business opportunities to enhance overall performance signal good corporate responsibility and improve their reputations.

The bank in this case learned a hard lesson from the losses associated with this loan package. It has since improved its E&S risk management and implemented specific policies to not only review whether its clients have proper licenses and permits but also to check for additional E&S risks associated with the activities it finances. Additionally, it developed a new policy for reviewing the E&S risks and liabilities of any collateral taken as part of a loan guarantee.



See an [example E&S checklist for SME projects](#).