AUDIT REPORT

CAO Audit of IFC

CAO Compliance

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CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries

Office of the Compliance Advisor Ombudsman (CAO)

for the

International Finance Corporation (IFC)

Multilateral Investment Guarantee Agency (MIGA)

Members of the World Bank Group

About the CAO

The CAO's mission is to serve as a fair, trusted, and effective

independent recourse mechanism

and to improve the environmental and social accountability of IFC and MIGA.

The CAO (Office of the Compliance Advisor Ombudsman) is an independent post that reports directly to the President of the World Bank Group. The CAO reviews complaints from communities affected by development projects undertaken by the two private sector lending arms of the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

For more information about the CAO, please visit www.cao-ombudsman.org

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Definitions

Term	Definition
additionality	"The benefit or value addition [IFC] brings to a client that the client would not otherwise have and which cannot be filled by the client or any commercial financier" (IFC Primer on Additionality).
Asset Management Company (IFC)	A wholly owned subsidiary of IFC set up in 2009 to mobilize capital to address the effects of the global financial crisis and serve longer-term development needs around the world.
the Board	Within this document, refers to IFC's Board of Directors.
client (IFC's client)	The organization in which IFC invested.
commitment date	Formal date when the investment is irreversible, except for failure of covenants or conditions precedent
conditions precedent	Conditions that are set out in an agreement that must be met before the agreement is fully in force. Failure to meet the conditions by the time specified can result in the agreement being annulled.
the Corporation	Within this document, refers to IFC, the International Finance Corporation.
covenants	Conditions in an agreement that must be met to comply with the agreement. Failure can result in recovery of the investment or additional measures being implemented, as defined in the agreement.
development financial institution	Publicly owned financial institution with a development mandate.
Exclusion List	IFC list of activities that IFC does not fund.
financial intermediaries	Third-party financial entities such as banks, insurance companies, leasing companies, microfinance institutions, and private equity funds.
financial sector	IFC's client sector that consists of financial intermediaries.
Global Trade Finance Program (GTFP)	Guarantee to support import and export transactions that extend to political and commercial payment risks (though excludes documentation risk), pursuant to the terms of the specific trade facilitation instrument associated with the transaction (e.g., Letter of Credit, Promissory Note, etc.). Product sub-type is only valid for the IFC Global Trade Finance Program (GTFP) Facility.

Term	Definition
Global Trade Liquidity Program	A coordinated global initiative that brings together governments, development finance institutions, and private sector banks to support trade in developing markets and address the shortage of trade finance resulting from the global financial crisis. GTLP began operations in May 2009. IFC has committed $1 billion to the program.
Performance Standards	IFC standards for environmental and social performance.
subclients	The organization(s) in which IFC clients invested.
third-party entity	In the context of this report, the end user of the funds: an entity other than IFC and the real sector project.

Abbreviations

Abbreviation	Definition
AEPR	Annual Environmental Performance Report
AMC	Asset Management Company (IFC)
CAO	Office of the Compliance Advisor Ombudsman (IFC and MIGA)
CAS	Country Assistance Strategy
CES	IFC Environment, Social, and Governance Department
DEG	Deutsche Investitions-und Entwicklungsgesellshaft (Germany)
DFI	development finance institution
DOTS	Development Outcomes Tracking System (IFC)
EBRD	European Bank for Reconstruction and Development
EDFI	European Development Finance Institutions
EPs	Equator Principles
E&S	environmental and social
ESMS	Environmental and Social Management System (as per the 2012 IFC Sustainability Framework, the 2006 version of the Framework referred as SEMS)
ESRP	Environmental and Social Review Procedures
ESRR	Environmental and Social Risk Rating
FI	financial intermediary/financial intermediaries
FM	financial market(s)
FMO	NederlandseFinancierings-MaatschappijvoorOntwikkelingslanden N.V. (the Netherlands)
GFM	Global Financial Markets (department within IFC; renamed Financial Markets Group during the period of this audit)
GTFP	Global Trade Finance Program
GTLP	Global Trade Liquidity Program
GRI	Global Reporting Initiative
IEG	Independent Evaluation Group (World Bank Group)

Abbreviation	Definition
IFC	International Finance Corporation (World Bank Group)
IFI	international finance institution
MFI	microfinance institution
MIGA	Multilateral Investment Guarantee Agency (World Bank Group)
MSEs	micro/small enterprises
MSMEs	micro/small and medium enterprises
PPAH	Pollution Prevention and Abatement Handbook
PR	Performance Requirements (of the EBRD, numbered 1–9)
PS	Performance Standard(s) (of the IFC, numbered 1–8)
SEMS	Social and Environmental Management System (as per the 2006 IFC Sustainability Framework, the 2012 version of the Framework referred as ESMS)
SMEs	small and medium enterprises
ToR	terms of reference

All monetary amounts are in U.S. dollars unless otherwise specified.

1. Background to the Audit

1.1 Background and Concerns that Led to the CAO Audit

A large and growing portion of IFC financing is provided to private sector projects in developing countries and emerging markets through third-party entities: so-called financial intermediaries (FIs) such as banks, insurance companies, leasing companies, microfinance institutions, and private equity funds. These intermediaries provide finance to subclients through a range of financial products. IFC defines these third-party investments as being in its "financial sector" or "financial market" (FM), as opposed to IFC's more direct investments in projects and/or the project operators, which IFC defines as being in its "real sector."

The CAO's experience over the past 11 years[1] with IFC projects has related predominantly to IFC's investments in the real sector. Affected parties are less likely to file a complaint with the CAO about financial sector projects for several reasons, including the following:

- Client confidentiality provisions typically applied in the financial markets in which IFC operates result in less information about the end use of IFC funds by an IFC client's subclient, compared to IFC investments in the real sector. Thus potential complainants may not know about IFC's relationship to the subclient transaction—or about the CAO as an available recourse mechanism.
- As IFC reacts to market demands and introduces new or innovative products through financial intermediaries, affected parties might not have the resources to understand these products and how they relate to the subclients.

These FM activities constitute over 40 percent of IFC's portfolio, and the proportion has been growing.

Since 2008, and especially in light of increased public scrutiny of the financial sector following the financial crisis, a number of reports and inquiries outside the World Bank Group have questioned how IFC's environmental and social standards are applied and monitored in financial sector investments.

Two sectoral studies relevant to the FM portfolio have been conducted by the Independent Evaluation Group (IEG), which functions across the World Bank Group.[2] A 2006 review of all FI investments made up to 2005 investigated one aspect of IFC's investments in the financial sector: IFC's support to micro, small and medium enterprises (MSMEs) through financial intermediaries.[3] The report concluded that IFC's support in this context was relevant and broadly effective in terms of delivering on development impact. In 2010, IEG published a World Bank-wide review of Safeguard and Sustainability Policies as the policy had been carried out by IFC and MIGA, as well as the International Bank for Reconstruction and Development (IBRD).[4] In accordance with World Bank Group practice, IFC responded formally to the recommendations and incorporated those with which it agreed (the majority) into its 2012 revision of its standard for environmental and social performance, the Performance Standards.

[1] 1999–2010 [IFC fiscal year (FY) 2000 – fiscal year 2011].

[2] With respect to IFC FI Investments, IEG performs selective in-depth evaluations of investments after close out; these include assessments of the environmental and social (E&S) performance of the IFC investment process.

[3] IEG, 2006, "Financing Micro, Small, and Medium Enterprises."

[4] IEG, 2010, "Safeguard and Sustainability Policies in a Changing World–An Independent Evaluation of World Bank Group Policies."

In May 2010, in a contribution to IFC's policy review and update, the CAO disclosed its Advisory Note that analyzed 18 real sector and 8 financial intermediary investments, and concluded that there were significant gaps between IFC's E&S requirements and their practical application for FI clients.[5]

The findings of the CAO's appraisal indicated that IFC's activities in the financial sector are creating a potentially increasing risk for IFC to the extent that its FM funding may result in environmental and/or social harm. They might also constitute missed opportunities for learning and improving the environmental and social performance of IFC, its clients, and subclients. The compliance appraisal report, issued in June 2011, concluded that there were sufficient grounds to proceed to a CAO audit of IFC's FM investments.[6]

1.2 IFC's Financial Markets Investments

The decision to undertake this audit was taken in light of the growth of IFC's financial markets (FM) portfolio from 2007[7] to 2011. During this time, IFC's FI nontrade and private equity portfolio commitments grew from $2.85 billion to $3.14 billion, and trade portfolio commitments grew from $0.77 billion to $5.04 billion (see figure 1.1).[8]

The actual investment amounts may be higher or lower than the amount of the commitments, for several reasons. Given that IFC's short-term trade facility can have durations of between 90 days and 360 days, these contracts may roll over several times within the same financial year and therefore be counted more than once. For example, while IFC committed $4.64 billion for FY2011 to Global Trade Finance Program (GTFP), its exposure at any one time could not exceed $3.0 billion.[9] Other investments, such as those in a private equity fund, might be committed in one fiscal year but partly called upon in others, and thus also affect the relationship between the size of the reported committed portfolio and the exposure.

IFC's Global Financial Markets (GFM)[10] department uses a variety of investment product types; it lists more than 30 different investment products on its website.[11] It also has a variety of clients, ranging from microfinance funds to commercial banks, and these clients may be global, national, or regional. IFC may be the only investor or one of many. In order to achieve its strategic goals, the IFC GFM department identifies key clients (currently there are around 600), builds client relationships, and aims to execute repeat investments. Information about investment products, client types, and sectors is presented in Appendix A.

[5] CAO, May 2011, "CAO Advisory Note: Review of IFC's Policy and Performance Standards on Social and Environmental Sustainability and Policy on Disclosure of Information" http://www.cao-ombudsman.org/documents/CAOAdvisoryNoteforIFCPolicyReview_May2010.pdf

[6] CAO, June 27, 2011, "CAO Appraisal for Audit of IFC's Investment Projects in the Financial Sector."

[7] IFC's Financial Year runs from July to June, IFC FY 2007 therefore started July 1, 2006, and ended June 30, 2007.

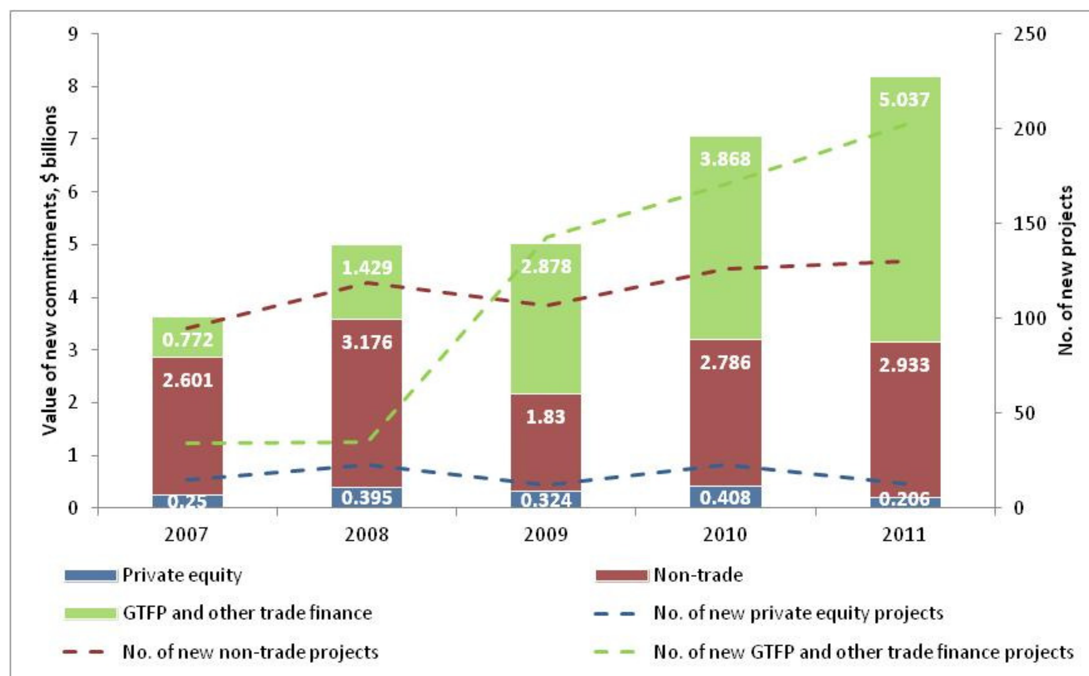
[8] See IFC Annual Reports, 2006–11.

[9] IFC, March 11, 2011, "Procedures: Global Trade Finance Program (GTFP) Operating Manual Short-Term Finance Department," Catalogue: IO461.

[10] The Global Financial Markets (GFM) department within IFC changed its name to Financial Markets Group during the period of this audit. The CAO retained the name "GFM Department" for purposes of consistency within this audit, but refer to IFC's investments in the financial sector/financial market as FM investments.

[11] IFC, 2011, "Corporate Product Hierarchy."

Figure 1.1 Total New Commitments by Year, GFM Department, FY2007–11



Source: CAO compilations, based on IFC data

1.3 The CAO Audit

This audit was conducted in accordance with the CAO's mission to enhance the environmental and social outcomes of IFC's work, thereby improving the development impact and sustainability of IFC-supported business activities. The CAO's audit mandate did not include the broader development outcomes beyond environmental and social performance.

The terms of reference (ToR) for this audit directed the CAO to focus on a sample of IFC's financial sector projects and seek to assess:

- Whether the actual social or environmental outcomes of these projects are consistent with or contrary to the desired effect of the policy provisions; and
- Whether there were any failures to address social or environmental issues as part of the review process—and if so, whether these failures resulted in outcomes that are contrary to the desired effect of the policy provisions.

Pursuing this line of inquiry involved answering the following questions:

- How did IFC determine which environmental and social provisions were applicable to a particular investment?
- What was the primary purpose of applying these provisions to the particular investment?
- To what extent did IFC assure itself that the selected provisions were implemented and had the desired effect?

To assist in conducting the work, the CAO engaged a panel of three independent professionals with relevant experience and background to assist with the audit process. They were joined by an independent consultant, who provided quality assurance and verified the

consistency of the audit approach (see Appendix B). These four independent experts, together with CAO staff, comprised the audit team.

The team based its audit on a review of IFC documents, interviews with a variety of IFC staff and client staff, staff of other development finance institutions (DFIs) with which IFC co-invests, and visits and interviews with subclients. IFC managed all communications between the CAO and IFC clients, and IFC was invited to participate in all contacts with IFC clients.

The CAO audit team travelled to 54 locations in 25 countries to conduct face-to-face interviews with IFC clients and staff.

The panel provided findings for each investment audited and region visited, and offered conclusions in response to the questions posed in the ToR for the CAO audit.

1.4 The Sample Identification Process

During the preparatory analysis, the CAO identified 911 financial intermediary investments with a commitment date between July 2006—shortly after the IFC Sustainability Framework that governs its environmental and social (E&S) requirements became effective—and April 2011.

Of these 911 investments:

- 830 investments were undertaken by the GFM department.
- 14 were undertaken by an industry department (not counting joint GFM department and industry department investments).
- 67 were undertaken jointly by the GFM department and an industry department (counted as part of the GFM department in order to avoid double counting).

Accordingly, the CAO identified 844 (830 + 14) separate investments processed during this period.

The CAO reviewed the respective Board Papers of these projects, took a 10 percent random sample, and then refined the sample to result in an initial sample size of 63 investments. Details about the selection process can be found in Appendix C.

1.5 The CAO Audit Methodology

The CAO undertook a detailed desk review of the 63 investments. The majority of these investments were repeat investments with the same client, or IFC had multiple parallel investments with the same client. In many cases, the investment that had been the lead investment—and thus had been subject to IFC's appraisal—was not the one the CAO selected. This led the CAO to expand the detailed desk review to include all investments IFC had with the 63 clients in the first sample. In the end, the CAO undertook a detailed desk review of 188 investments that related to the 63 clients in the initial investment sample.

The CAO panel then went to the field and visited IFC staff, clients, and a small number of subclients. The panel discussed 50 of these 63 clients with IFC staff either during visits to 18 IFC offices, or by teleconference. The panel then visited 37 of IFC's FM clients in 23 countries, and visited a limited number of subclients.[12]

[12] The CAO visited IFC clients in 23 countries. Including other DFIs, the CAO visited 25 countries

The purpose of these meetings was to discuss the IFC approach and what effect IFC's involvement has had on the environmental and social performance of the client. The panel also discussed the content and details of IFC's procedures and policies as they are carried out at headquarters, in local offices, and in the field, in order to understand more fully IFC's approach to E&S requirements and performance at both the departmental and corporate levels. The observations from these meetings are noted and discussed in chapter 3 of this report.

To protect client confidentiality, this report aggregates data gathered during the audit and presents summary data. All information was given to the CAO in confidence. The CAO will not disclose either the identity of the randomly selected investments or attribute any observation to a particular region or sector, as specified in the ToR of this audit.

1.6 The Audit Sample

The sample distribution broken down by client type, region, and investment type, and the year of IFC's initial investment with a sample client is presented in tables 1.2, 1.3, 1.4, and 1.5.

Table 1.2 Sample Distribution by Client Type (number of clients)

Bank	35
Private equity	13
Microfinance institution (MFI)	6
Insurance company	3
Other	6

Source: CAO compilations.

Table 1.3 Sample Distribution by Region (number of clients)

East Asia and Pacific	8
Europe and Central Asia	16
Latin America and Caribbean	14
South Asia	5
Sub-Saharan Africa	12
Middle East, North Africa, and Southern Europe	5
World (not specific to a particular region)	3

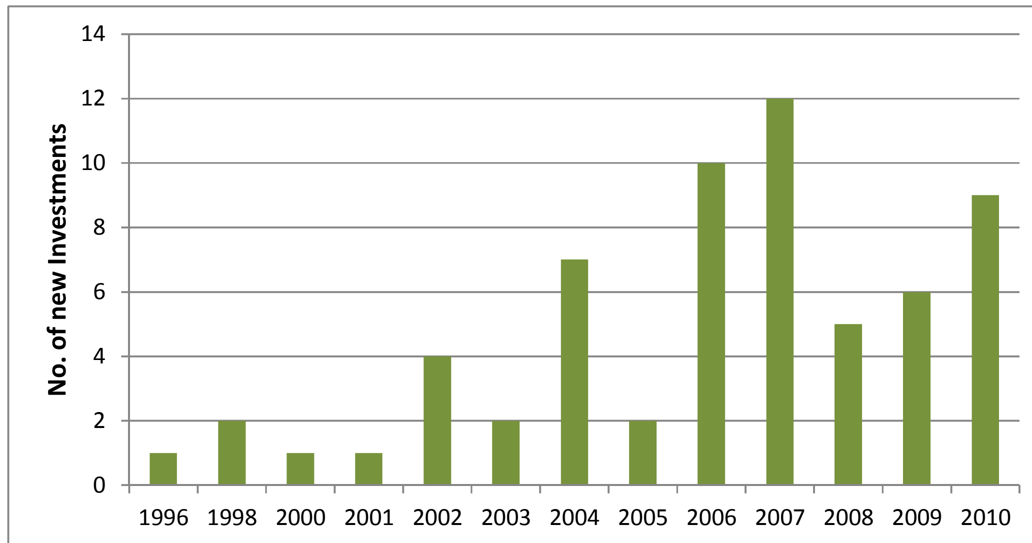
Source: CAO compilations.

Table 1.4 Sample Distribution by Investment Type (includes all 188 investments)

Equity	81
Loan	59
Loan and equity	21
Syndication loan	3
Guarantee	19
Other	5

Source: CAO compilations.

Table 1.5. Sample Distribution by Year of Initial IFC investment with Sample Client



Source: CAO compilations.

The CAO does not claim that the sample or the conclusions drawn from the audit of the sample are statistically representative of the entire population of IFC's FM investments. The sample might reflect part of the IFC portfolio, but is in no way statistically representative. Nonetheless, the CAO believes that its audit was sufficiently independent and rigorous to yield robust insights into IFC's FM investments and their environmental and social outcomes. The CAO's conclusions may also be relevant for some aspects of IFC's real sector portfolio; however, the terms of this audit were limited to IFC's FM activities.

2. An Overview of IFC's Policy Framework and Approach to E&S Management for Financial Markets Clients

The CAO devoted considerable effort to analyzing how IFC's E&S objectives fit within the context of IFC's mandate, relevant policies, and operating strategies, as well as how the objectives are realized in the investment process. As an understanding of this context is critical background for the CAO's observations, findings and conclusions, chapter 2 describes both the policy framework for IFC's financial market E&S activities, as well as the process for assessing E&S risk in new investments and monitoring E&S risk post-investment.

2.1 IFC's Mandate and Relevant Strategies, Policies, and Standards

2.1.1 *IFC's Mandate*

IFC's Articles of Association state that IFC is mandated to further economic development by encouraging the growth of productive private enterprise, particularly in less developed areas, by "assisting in financing productive private enterprises that would contribute to the development of its member countries by making investments."[13]

IFC's mandate, as specified in its Articles of Association, states that IFC shall not assume responsibility for managing any enterprise in which it has invested and shall not exercise voting rights for such purpose that is within the scope of managerial control, nor shall IFC interfere in the political affairs of any member or let anything but economic considerations be relevant to its decisions.

IFC complements this high-level mandate with strategies, policies, and standards that define the focus of IFC and its various departments with respect to its activities and the various countries where it operates. These include the IFC Road Map, which details how IFC intends to achieve its strategic priorities and establishes focus areas and growth targets;[14] Country Assistance Strategies (CAS), which establish country-level priorities; and department-level strategies, including the strategy of the GFM department.

2.1.2 *IFC's Sustainability Framework*

IFC's Sustainability Framework articulates IFC's strategic commitment to sustainable development. The discussion that follows is based on the 2006 edition of the Sustainability Framework, which applies to the cases in this audit (that is, projects that went through IFC's initial review process between April 2006 and December 31, 2011).[15] The 2006 Framework consists of IFC's Policy and Performance Standards on Environmental and Social Sustainability, and IFC's Policy on Disclosure of Information. A summary of the 2012 Sustainability Framework is presented in section 2.1.4.

[13] IFC, 1993, "IFC Articles of Agreement."
http://www1.ifc.org/wps/wcm/connect/1c95b500484cb68d9f3dbf5f4fc3f18b/articles.pdf?MOD=AJPERES. Accessed May 3, 2012.
[14] IFC, 2011, "Road Map FY12–14."
http://www1.ifc.org/wps/wcm/connect/87c9800046b649beaa04abb254bfb7d4/IFC%2BRoad%2BMap%2BFY12%2B14.pdf?MOD=AJPERES. Accessed April 17, 2012.
[15] The 2012 Sustainability Framework applies to subsequent projects.

2.1.3 *IFC's Policy and Performance Standards on Environmental and Social Sustainability*

IFC's Policy and Performance Standards on Environmental and Social Sustainability require that clients be assessed for the potential environmental and/or social harm created by their activities on the basis of IFC's Environmental and Social Review Procedures (ESRP).[16] For financial market (FM) clients, based on that assessment, IFC establishes up to three requirements: implement IFC's Exclusion List (which lists activities that IFC does not fund); confirm compliance with national E&S laws; and implement IFC's Performance Standards.[17] Implementing these requirements for an FM client means that it manages its subclients according to these requirements.

The minimum requirement is the IFC Exclusion List (which has been applied to all investments effective 2007). The maximum requirement is all three. IFC describes the purpose of the Performance Standards, the final and most demanding step in IFC's E&S requirements, as being to "anticipate and avoid adverse impacts on workers, communities, and the environment, or if avoidance is not possible, to reduce, mitigate or compensate for the impact, as appropriate."[18] One of IFC's E&S objectives can therefore be summarized as "avoid adverse impacts," or "do no harm."[19] In the 2012 revision of the Performance Standards, IFC describe this framework as the "mitigation hierarchy."[20]

The clients in the CAO's sample were typically required to apply those IFC E&S requirements that were effective as of the date of the investment, although in some cases the specialist in IFC's Environment, Social and Governance Department (CES) had taken the initiative to encourage the clients to update their application of the requirements. The requirements are applied to the FM client's portfolio according to an E&S risk-based approach in which the risk is assessed on the basis of the product and the nature of the client's business. Trade finance, for example, is considered to be a product with low E&S risk. Microfinance banks are an example of a client type that is considered to have relatively low E&S risk, because microfinance borrowers do not typically engage in activities with high E&S risk. By contrast, a loan for financing project finance would be considered a higher risk product, and a bank with a high proportion of project finance lending would be considered a higher risk client.

The tool IFC usually requires the client to use to manage compliance with IFC's E&S requirements is a Social and Environmental Management System (SEMS).[21] The purpose of the SEMS for FM clients is to manage and monitor the compliance of the client's subclients

[16]See IFC Environmental and Social Review Procedures. http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/. Accessed April 17, 2012.
[17]Before the introduction of the Performance Standards in 2006, the IFC required the Safeguard Policies (1998–2006), which were described in the Pollution Prevention and Abatement Handbook (PPAH).
[18] IFC, 2006, IFC Policy on Social and Environmental Sustainability. http://www1.ifc.org/wps/wcm/connect/5159190048855a4f85b4d76a6515bb18/SustainabilityPolicy.pdf?MOD=AJPERES&CACHEID=5159190048855a4f85b4d76a6515bb18. Accessed May 9, 2012.
[19] *ibid*
[20] For more details see IFC Performance Standards, 2012. http://www1.ifc.org/wps/wcm/connect/115482804a0255db96fbffd1a5d13d27/PS_English_2012_Full-Document.pdf?MOD=AJPERES. Accessed April 17, 2012.
[21] IFC's "First for Sustainability" web portal provides guidance to clients about E&S management. http://firstforsustainability.org

with the E&S requirements. According to the investment Board Papers for the clients in this audit sample, IFC's anticipated E&S outcome is the successful implementation of a SEMS.[22]

IFC Exclusion Lists

The IFC Exclusion Lists consist of activities that IFC and its FM clients are prohibited from financing (see Appendix D). These activities include those that harm the environment, such as the production and trade of certain classes of pesticides and herbicides, as well as activities that are considered ethically unacceptable, such as those related to gambling, weapons, alcohol, and tobacco. IFC has a separate Exclusion List for microfinance institution (MFI) clients; both lists, as well as those of other development financial institutions, are summarized in Appendix table D1.

The Exclusion List prohibition does not apply to clients that are not "substantially involved" in the excluded activities, which is understood by IFC to mean that the activity is ancillary to the main activity of the client or subclient. For example, a chain of retail stores that sells cigarettes as one of many product offerings would not typically be considered by IFC to have substantial involvement in the tobacco business. In some instances, IFC FM clients have an Exclusion List covenant that allows them to finance a small proportion, such as 5 percent, of Exclusion List activities, often with the condition or understanding that this proportion will decrease over time.

Compliance with National E&S Laws

The second level of E&S requirements is for the IFC client/subclient to confirm compliance with national E&S laws.[23]

IFC Performance Standards

IFC's eight Performance Standards (PS), which were introduced in 2006, are used to define clients' responsibilities for managing their environmental and social risks.[24] The Performance Standards were originally developed for IFC's real sector clients. FI clients are required to comply with PS1 and PS2, which IFC addresses during its due diligence. Where the intermediary's lending activities are deemed to be high risk (such as project financing or corporate financing) it is required to apply PS3 through 8 during its own due diligence.[25, 26] As noted, the Performance Standards are the core of IFC's E&S objective of "doing no harm" because they are the final and most demanding step in the escalating chain of E&S

[22] References in this report to "implementation" of a SEMS include the creation of a SEMS policy approved by IFC, appointment of E&S specialists, and appropriate staff training.
[23] IFC, 2006, ESRP 2006. http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/Sustainability+Framework+-+2006/Performance+Standards+and+Guidance+Notes/, Accessed April 17, 2012,
[24] IFC, 2006, IFC Policy on Social and Environmental Sustainability. http://www1.ifc.org/wps/wcm/connect/5159190048855a4f85b4d76a6515bb18/SustainabilityPolicy.pdf?MOD=AJPERES&CACHEID=5159190048855a4f85b4d76a6515bb18. Accessed May 9, 2012.
[25] IFC, September 23, 2010, ESRP 2010.
[26] The PS1 requirement to establish an SEMS has been applied to FI clients since before the 2006 introduction of the PS. IFC began screening its FI clients for PS2 compliance in FY2009 and applied this requirement to all FI clients beginning in FY2010. This requirement was formalized in the 2012 revision of the PS.

requirements.[27]

PS1 requires the client to create a SEMS. PS2 through 8 establish conditions applying to the following issues:

2: Labor and Working Conditions

3: Pollution Prevention and Abatement

4: Community Health, Safety and Security

5: Land Acquisition and Involuntary Resettlement

6: Biodiversity Conservation and Sustainable Natural Resource Management

7: Indigenous Peoples

8: Cultural Heritage.

The PS initially propagated by IFC have evolved into a global market standard.[28] The PS are the basis of the Equator Principles (EPs), for example, which are an independently managed financial industry benchmark for assessing and managing E&S risk in project finance.[29] IFC played a facilitating role in the development of the EPs.

"The [Performance] Standards have allowed us to do more business because they provide us with a risk management tool."

--- IFC Vice President Lars Thunell[30]

2.1.4 *Revisions to the Sustainability Framework in 2012*

Following extensive internal and external consultation, IFC has issued a revised Sustainability Framework, including revised Performance Standards and Access to Information Policy, that are effective for investments processed after January 2012.[31] The 2012 Sustainability Framework had not been issued when the CAO launched this audit, and none of the investments in the CAO sample was processed using the 2012 Sustainability Framework. Nevertheless, the CAO will refer to changes in the Framework when relevant for context.

The most significant change for FI investments is the addition of the objective of achieving positive development outcomes. This is a step beyond the previous objective of "do no harm." The revised Sustainability Framework clarifies and/or strengthens the due diligence process for FIs, as well as the risk categorization process. PS1 reinforces the requirement to

[27] IFC, 2006, IFC Policy on Social and Environmental Sustainability, http://www1.ifc.org/wps/wcm/connect/5159190048855a4f85b4d76a6515bb18/SustainabilityPolicy.pdf?MOD=AJPERES&CACHEID=5159190048855a4f85b4d76a6515bb18. Accessed May 9, 2012.
[28] IFC, 2011, "Road Map FY12–14.
[29]For more on the Equator Principles see http://www.equator-principles.com/
[30] The *Financial Times*, June 15, 2011, "Interview: IFC's Lars Thunell on Standards and Expansion."
[31] IFC, 2011, IFC Sustainability Framework–Effective January 1, 2012. http://www1.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+sustainability/publications/publications_handbook_sustainabilityframework. Accessed May 9, 2012,

develop and operate an ESMS[32] (formerly to implement a SEMS). Likewise, the need for FIs to apply PS2 on labor and working conditions to their internal operations is made more explicit. Both PS1 and PS2 relate to the goal of “do no harm.” The Access to Information Policy stipulates increased disclosure for IFC’s FI investments, including disclosing development impact indicators. The revised Sustainability Framework also notes that the Performance Standards “help clients to manage their E&S risks and impacts and improve their performance.”[33]

2.1.5 *IFC’s Additionality in Financial Markets Investments*

IFC’s Articles of Agreement specify additionality, broadly defined as not displacing the private sector, as one of IFC’s three guiding principles.[34] IFC’s Primer on its role and additionality describes the concept more fully as “the benefit or value addition it [IFC] brings to a client that the client would not otherwise have and which cannot be filled by the client or any commercial financier.”[35]

IFC’s Road Map FY12–14 (paragraph 3.15) states that additionality is “in effect, IFC’s competitive advantage.” The Road Map specifies that IFC provides additional value to its clients in four main areas: risk mitigation (financial risk and nonfinancial risk, such as mobilizing resources by “providing comfort” to other investors); knowledge and innovation; standard-setting (E&S is specifically mentioned); and policy work. The Board Papers for the majority of the FM investments in the CAO sample cited increased financial intermediation as an important element of additionality. This intermediation is sometimes seen as particularly important for efficiently expanding IFC’s reach in important products and client-types, such as climate change products, trade finance, microfinance borrowers, and SMEs. Specific E&S additionality is not typically cited in the Board Papers unless the financing is focused on climate change. The E&S section of the Board Papers (separate from the additionality section) typically refers to the creation of a SEMS as the expected E&S outcome.

2.1.6 *IFC’s Legal Context and Disclosure*

IFC’s Policy on Disclosure of Information, which is part of the 2006 Sustainability Framework, states that “IFC makes available information concerning its activities that would enable its clients, partners and stakeholders (including affected communities), and other interested members of the public, to understand better, and to engage in informed discussion about, IFC’s business activities, the overall development and other impacts of its activities, and its contribution to development” (paragraph 8).

Paragraph 9 of the Policy states that “there is a presumption in favor of disclosure,” but that “consistent with the practice of commercial banks and of most public sector financial institutions (for their private sector investments), IFC does not disclose to the public financial, business, proprietary or other nonpublic information provided to IFC by its clients or other

[32] In this report, the CAO will refer to an Environmental and Social Management System—or a Social and Environmental Management System—as a SEMS, when it is does not refer directly to the 2012 Framework.
[33] IFC 2012 Sustainability Framework–Policy on Environmental and Social Sustainability, Chapter 1, para 7.
[34]This guiding principle is articulated in Article One as follows: “In association with private investors, assist in financing the establishment, improvement and expansion of productive private enterprises which would contribute to the development of its member countries by making investments, without guarantee of repayment by the member government concerned, in cases where sufficient private capital is not available on reasonable terms.”
[35] IFC, 2009, “IFC’s Role and Additionality: A Primer.” http://www1.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc. Accessed April 17, 2012.

third parties. To do so would be contrary to the legitimate expectations of its clients, who need to be able to disclose to IFC detailed information without fear of compromising the confidentiality of their projects or other proprietary information in a highly competitive marketplace."

IFC disclosures are also restricted by applicable laws, such as restrictions imposed by securities or banking laws, or any contraventions of its Articles of Agreement. National law is often referred to as preventing IFC from disclosing information about subclients.

2.1.7 *IFC's Corporate Message*

IFC's corporate message positions IFC as a global leader in E&S issues. In updating the PS, IFC stated that it will "continue to be a global standard-setter in E&S development for private companies and financial institutions, as demonstrated by the update of its Performance Standards."[36] IFC is also an active promoter of what it identifies as the sustainable banking sector. The Sustainable Finance Awards, which have been awarded by IFC and the *Financial Times* since 2006, are "the world's leading awards for banks and other financial institutions that demonstrate leadership and innovation in integrating environmental, social and corporate governance considerations into their business."[37]

The corporate message also implies that IFC's E&S requirements have an impact beyond doing no harm. The 2006 Policy and Performance Standards state, for example, that "Socially and environmentally responsible businesses can enhance clients' competitive advantage and create value for all parties involved" (paragraph 7). Another example is provided by Executive Vice President Thunell's statement in an interview that, "We see clearly that, for the companies that are not focusing on environmental and social standards, we have high credit losses and significantly lower return on our equity investments."[38] The revised 2012 Sustainability Framework, as noted, has expanded IFC's specific E&S objectives beyond doing no harm to having a positive development outcome.

2.2 E&S Assessment, Management, and Impact Measurement for FM Clients

IFC's investment cycle includes a number of processes that are directly or indirectly related to E&S performance.[39] These include the assessment of governance issues, risk, and IFC's additionality; post-investment E&S assistance and support; and monitoring and impact assessment.

2.2.1 *IFC's Assessment of Governance Issues*

IFC assesses five key elements of corporate governance: board practices, structure, and composition; control environment and processes; disclosure and transparency; protection of

[36] IFC, 2011, "FY12–14 IFC Road Map," paragraph 4.32.
[37] IFC, 2012, "Website Press Release: *Financial Times* and IFC Launch the 2012 Sustainable Finance Awards." http://www1.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/industries/financial+markets/news/financial+times+and+ifc+launch+the+2012+sustainable+finance+awards?presentationtemplate=ifc_ext_design/AlternatePresentationTemplate. Accessed May 3, 2012.
[38]The *Financial Times*, June 15, 2011, "Interview: IFC's Lars Thunell on Standards and Expansion."
[39] For details on IFC's investment cycle, see http://www1.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/ifc+projects+database/projects/aips+added+value/project+cycle. Accessed April 17, 2012.

(minority) shareholder rights; and commitment to corporate governance reforms.[40] The level of scrutiny is driven by an analysis of the indicative credit risk rating of the client and the size of the financial investment. E&S issues are not reviewed as part of the governance assessment; that is done as part of IFC's E&S review.[41]

2.2.2 *IFC's Risk Assessment*

IFC's risk assessment encompasses two types of E&S risk: the risk of doing harm, and credit-related risk.

The risk of doing harm, or creating adverse impacts, is described in the Sustainability Policy, as was discussed in section 2.1.3. This approach is reinforced by IFC's Integrated Risk Management Framework, which identifies seven types of risk: strategic; credit; financial; operational; environmental and social; legal; and reputational.[42] Environmental and social risk is described in this Framework as the risk of IFC's Sustainability Policy and Performance Standards not achieving their objectives, which are to "do no harm."

The other aspect of E&S risk can be summarized as the credit risk associated with an E&S event, such as fines, loss of licenses, loss of reputation, and events of default that can lead to the worsening of a client's financial condition.[43]

2.2.3 *Additionality*

As has been discussed, IFC's E&S additionality is not typically defined, unless the financing is focused on climate change. E&S additionality is implicitly achieved by improving the E&S risk management culture at the FM client, which is then further propagated through the intermediation provided by those FM clients.

2.2.4 *IFC's E&S Early Review and Appraisal*

The E&S early review and appraisal are guided by IFC's Environmental and Social Review Procedures (ESRP), as discussed.[44]

Post-Investment E&S Assistance and Support

During appraisal and post-investment, clients are assisted, as needed and as internal resources allow, with the process of creating their SEMS and a functioning E&S

[40] In some cases, IFC has the right to nominate directors to serve on boards of its equity investment client to add value, to further IFC's development mandate, and to support improvement of the client's environmental and social policies. Directors nominated by IFC serve as independent board members; therefore, IFC cannot require them to seek to enforce the implementation of IFC's E&S (or any other) agenda. IFC's board nominees can nevertheless influence the board's understanding of E&S issues and their place within management of the client's business.
[41] See IFC corporate governance website for more details.
http://www.ifc.org/ifcext/corporategovernance.nsf//Content/Home.
[42] For more details, see IFC Integrated Risk Management Framework, 2010.
http://ifcnet.ifc.org/intranet/irm.nsf/AttachmentsByTitle/IRFPDF/$FILE/IRM+to+AC_vF1.pdf. Accessed April 17, 2012.
[43] These are discussed in detail on IFC's First for Sustainability website. firstforsustainability.org/risk-management/environmental-and-social-risk-for-financial-institutions.php. Accessed June 8, 2012.
[44] For more information, see IFC Environmental and Social Review Procedures.
http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/. Accessed April 17, 2012. Also see the Environmental and Social Review Procedures Manual.
www1.ifc.org/wps/wcm/connect/190d25804886582fb47ef66a6515bb18/ESRP_Manual.pdf?MOD=AJPERES. Accessed June 8, 2012.

management and monitoring system. The legal agreements with the clients typically allow a specific period of time post-investment for these procedures to be put in place. Assistance can include one-on-one coaching with the E&S specialist; technical assistance; completion of IFC's online Sustainability Training and E-Learning Program (STEP) by the client's designated E&S officers; use of materials provided on the recently developed FIRST for Sustainability website;[45] and other measures.

Monitoring and Impact Assessment

Clients are required to provide CES a standard format Annual Environmental Performance Report (AEPR) at the end of the client's calendar year.[46] CES provides feedback to the client and the IFC investment officer about any shortcomings in the report; requests additional information when relevant, such as confirmation that IFC's client E&S specialists have completed their training and questions about specific transactions or even due diligence documentation on some initial transactions; and follows up as relevant, either directly with the client or through the IFC investment officer.

Each client is assigned an annual Environmental and Social Risk Rating (ESRR), based on the AEPR and experience with the client during the year, including on-site visits when relevant. The ESRR is used to manage the portfolio as a whole and to focus on clients that are having difficulties with compliance. This post-disbursement process for managing the E&S commitments of clients is the second prong of the E&S risk-based approach that was noted earlier: prior to disbursement, E&S requirements are based on an assessment of E&S risk (the product and the client's business); post-disbursement, client management is based on the degree of E&S noncompliance.

The CAO panel was advised that clients are visited on-site at least every two years, but that clients with the two weakest categories of ESRR scores are visited at least annually. The ESRR is based on five factors: policy and management commitment; process and implementation; capacity and quality; reporting and feedback; and AEPR reporting. The ESRRs reviewed for this audit were based primarily on the client's implementation of the SEMS.

E&S performance is one of four areas that IFC measures in assessing the achievement of its mandate. This assessment is done by means of the Development Outcome Tracking System (DOTS) (see Appendix E). This system, which has been applied since 2007, maps indicators into four performance areas: financial performance; economic performance; environmental and social performance; and private sector development. There are 10 E&S indicators used for FM projects, including financing underserved markets and community development, as well as product-specific indicators such as energy-efficiency components and projects designed to address gender issues. The only FM DOTS indicator related to E&S requirements more broadly concerns improvements in environmental/social management, which are measured on a Yes/No basis. DOTS does not measure the impact of E&S requirements more broadly, including the impact on subclients.

[45] For further details see www.firstforsustainability.org Accessed June 8, 2012.

[46] Details can be found at www.firstforsustainability.org/risk-management/reporting-for-banking-institutions.php. Accessed June 8, 2012.

3. CAO Audit Panel Analysis and Observations

In the process of reaching the findings and conclusions presented in chapters 4 and 5 of this report, the panel undertook extensive discussion and analysis of the interview results; IFC's mandate, and relevant policies and procedures; and developments in IFC's operating environment, such as the 2008 financial crisis and the evolution of the E&S practices of other market participants. These topics interact in complex ways. The panel decided to summarize its discussion and analysis of these areas here, to provide context for the findings and conclusions presented in chapters 4 and 5. In addition, some topics that the panel reviewed in detail were ultimately not included in the findings or conclusions of this report, but are presented here because they provide context.

3.1 Results and Breakdown of the CAO Sample

The CAO audit panel undertook a desk review of each of the sample investments and conducted extensive interviews with IFC staff, clients, subclients (where possible), and IFC co-investors. The panel then examined the outputs of these desk reviews and interviews to identify and explore common themes and critical issues. This section summarizes that analysis.

Table 3.1, 3.2 and 3.3 present the results of the CAO's specific audits. The CAO does not suggest that these results are necessarily representative of the broader portfolio, but used them to frame and inform its analysis, observations, and findings.

Table 3.1 Interview Summary and Panel Reviews Based on Client Visits (Question 1)

			Responses
Client Level	**Question 1.** Consistency with IFC Policy and Procedural Requirements	Fully consistent	30
		Substantively compliant - This designation to be used where parts of the system have yet to be developed or where the system is designed but yet to be fully implemented	9
		Noncompliant	5
		Unable to determine based on the information available (this designation to be used where commercial or other issues meant that the audit could not be completed)	3

Source: CAO audit panel compilations.

Thirty of the 47 clients (over 60 percent) summarized in table 3.1 were considered by the CAO panel to be fully consistent with IFC's policy and procedural requirements (see table 3.1). A further 10 percent of the sample investments were regarded as noncompliant by the CAO panel.[47] This indicates that, despite the increased allocation of resources by IFC, a number of investments remain intractable to resolution and IFC's leverage in all its forms (legal, commercial, and other) has not yet been able to bring them into compliance.

[47] For definition of noncompliant, see the panel's questions in table 3.1.

Table 3.2 Interview Summary and Panel Reviews Based on Client Visits (Question 2)

			Yes	No	n.a.
Client Level	**Question 2**	Has the application of the requirements improved environmental and/or social performance outcomes at the client level?	30	14	3

Source: CAO audit panel compilations.
n.a. not applicable.

As outlined in table 3.2, around 30 percent of investments in CAO's sample were not regarded by the CAO panel as to have "improved" outcomes as a result of the application of IFC's E&S requirements at the client level. Why this is the case was an area of further discussion and analysis. Was it because the E&S performance of the clients was already strong or perhaps because the IFC approach, while meeting IFC's own needs, did not improve client performance?

Table 3.3 Interview Summary and Panel Reviews Based on Client Visits (Question 3 & 4)

			Yes	No	n.a.
Subclient Level	**Question 3**	Did other factors (non IFC) improve environmental and/or social performance or outcomes at the subclient level?	23	21	3
	Question 4	Did application of the IFC requirements improve environmental and/or social performance or outcomes at the subclient level?	18	25	4

Source: CAO audit panel compilations.
n.a. not applicable.

As outlined in table 3.3 some 50 percent of sample investments were regarded as having "improved" E&S performance at the subclient level due to factors not related to IFC (although IFC might have also had a positive impact). The panel therefore discussed factors such as clients' predisposition, market conditions, institutional framework, legislative environment, sectoral issues, and other topics that had an important influence on E&S performance. The proportion of cases of non-improved performance was around 60 percent at the subclient level, which is where IFC seeks to really have an impact.

3.2 IFC Strategy and Standard-Setting

IFC positions itself as a leader in sustainable banking and in other areas such as E&S standard-setting for the private sector. The elevation of the IFC Performance Standards to those of a global public good via the EPs recognizes this positioning, even though as a development institution IFC has a significantly different mandate than the commercial and investment banks that apply the Principles. IFC is essentially a hybrid organization, part commercial bank, part politically governed development institution, part management consultancy (through its Advisory Services), and part regulator (establishing the policy framework and standards that it applies to itself and its clients, and then measuring its own performance in ensuring that its clients meet those requirements).[48]

The different roles within such a hybrid organization pose challenges for clarity of mission and operations, especially where differing roles and functions may conflict. During the CAO's interviews, for example, some IFC staff identified a tension (and sometimes a conflict) between trying to increase investment and imposing the appropriate E&S provisions. Other examples include the fact that IFC cannot, for political governance reasons, proactively address and show leadership in some of the most difficult issues confronting commercial banks and investors, such as human rights and climate change.

These challenges are particularly complex when IFC invests indirectly through financial intermediaries, effectively enhancing IFC's different roles and thereby further increasing the need for clarity. As an example, IFC applies two different concepts of E&S risk: the risk of doing harm, which could be considered a development institution consideration; and credit risk, which is a commercial consideration, although also critical for development institutions. The panel found it difficult to understand, however, the rationale for how IFC applied its E&S risk-based approach to specific products. Trade finance, for example, is considered low risk, yet trade in some products could entail high E&S risk. Another example is an equity investment in a commercial bank, which generates the requirement for all of the E&S requirements to apply to the bank's corporate loan portfolio. Applying the concept of E&S risk as the risk of harm, it was not clear to the panel why an equity investment is considered to create a higher degree of E&S risk.

The panel also noted the need for greater clarity in applying the two risk concepts at the client level. For example, some clients in the sample utilized the E&S requirements as a credit screening tool, with little or no attention paid to the risk of doing harm. (In one region the potential implications of this were explored further; an IFC client staff acknowledged that a polluting subclient could be considered an acceptable credit risk because it has provided good collateral or because the loan is short term and the pollution will occur later in the client's production cycle.) This lack of clarity about which risk concept applies creates the possibility that E&S harm is not being minimized, in addition to creating differing expectations on the part of stakeholders.

These differing expectations are further exacerbated by the fact that the stated E&S objective of the 2006 Sustainability Framework—which is to do no harm—is not actually measured in IFC's work with FIs. IFC addresses E&S impact issues three ways: in its use of the concept of additionality; in its requirements for SEMS implementation; and in its DOTS assessment

[48] The panel considers IFC to have a partly regulatory role because typically a regulator would establish the standards for an industry as a whole and then enforce and measure compliance, while in the case of the E&S requirements, IFC establishes the requirements for itself and then assesses how well it does in achieving them.

system. During its supervision activity, IFC also selectively visits sub-projects to validate implementation of the SEMS. As is discussed below, however, none of these approaches systematically tracks or measures E&S impact at the subclient level. They also do not measure the expanded objectives of the 2012 Sustainability Framework, which are to move beyond doing no harm to having a positive development outcome.

- *The concept of additionality.* This is an important consideration for IFC in its FM investments. Board Papers often link additionality to the effects of increasing the level of business for IFC clients. The implicit general E&S additionality is the potential subsequent effects of the increase of business for certain types of clients as a consequence of access to finance. Particularly strong arguments are made by IFC that funding FM clients will subsequently increase business activities of micro, small, and medium enterprises (MSMEs) in the subclient portfolio of the financial intermediary (see Appendix F for detail). Specific types of E&S additionality are framed in terms of concrete issues such as reduction of greenhouse gas emissions. IFC does not currently have the tools to measure E&S additionality other than for these types of focused E&S products.

- *Requirements for SEMS implementation*. Many of the Board Papers for the projects in the audit sample refer to the implementation of a SEMS as an E&S "outcome." Although the implementation of a SEMS can be measured as an outcome, this is not the same as measuring impact.

- *The DOTS assessment system*. The DOTS system, as noted, maps indicators into four key performance evaluation areas: financial performance; economic performance; environmental and social performance; and private sector development impacts. The only measurement of E&S issues that applies to IFC's overall E&S approach is a Yes/No question about whether E&S management has improved. There is measurement of E&S outcomes related to specific E&S products, such as climate change products, but no assessment of whether the E&S requirements are successful in doing no harm.

The result of this lack of systematic measurement tools is that IFC knows very little about potential environmental or social impacts of its FM lending. The CAO panel does not underestimate the difficulties associated with measuring and understanding those outcomes and the challenges it presents to IFC. The panel observed, however, that developing these tools would be consistent with the intent of IFC's Sustainability Framework, its strategic positioning, and the expectations that these create among stakeholders. Changes to this approach are essential if IFC is to demonstrate the link made in its 2012 Sustainability Framework between enhanced E&S outcomes and the application of the Performance Standards.

IFC's Policy on Disclosure of Information is the second element of the 2006 Sustainability Framework. Disclosure of investment information is a central tenet of the accountability of publicly funded multilateral finance institutions, and poses a particular challenge when working through intermediaries in the private sector. External observers raise a legitimate concern that the constraints posed on disclosure effectively mean there is no information publicly available about the end use of IFC's funds. IFC discloses information about the primary activity it funds. In the case of intermediary financing, this is the IFC client (the financial intermediary). In the CAO's sample, depending on the type of client and investment, there were parts of the sample portfolio where IFC itself did not have the information on the end use of funds available, other than on an aggregated level collected by the client, and

mainly based on the size of the loan provided to subclients (the clients of IFC's FM client). In the investments in the sample, IFC had not explored the evolving industry practice of requiring the client to engage third-party verification of end use of funds. The CAO panel recognizes the significant challenge that any enhanced disclosure would constitute. However, the fact that the end use of such a significant proportion of IFC funding remains opaque is a matter of some concern. Reconciliation of legitimate concerns over transparency and operational constraints pose a significant challenge.

These issues are further developed elsewhere in this analysis. Based on its review of IFC's strategy, in chapter 4, the CAO panel has made specific findings relating to:

- The relationship between the IFC corporate message and its approach to FM investments (Finding 4.1)
- The definition of environmental and social risk (Finding 4.2)
- The clarity of E&S objectives (Finding 4.3).

3.3 The Operating Environment and Alignment of E&S Standards

Robust performance by IFC requires alignment between IFC's operating environment, its mandate and strategy, and the instruments that it uses.

The market conditions in which IFC's GFM department operates changed considerably during the period covered in these audits (2006–11). The most significant change was caused by the global financial crisis that started in 2008. The impact of the crisis on commercial banks in particular reduced their ability and willingness to finance certain businesses, especially higher risk opportunities in developing countries. The role of IFC during and after 2008 is discussed in Appendix G.

The CAO panel observed that these changing market conditions contributed to the expansion of IFC's FM portfolio and the expanded use of products such as trade finance and private equity funds. The panel was advised by some IFC E&S staff that this expansion posed increasing challenges to determining how to apply E&S requirements to new or revised products. The CAO panel sought to assess the impact of these new developments on E&S outcomes by adding an example from IFC's Asset Management Company (AMC) and the Global Trade Finance Program (GTFP) to its sample.

The regulatory environment in some countries also changed during this period. Stricter regulations and effective enforcement, such as displayed in the CAO's sample in European Union (EU) countries, clearly had a significant impact on E&S performance. National government legislation and governing practices related to environmental and social issues, including employment practices, naturally influenced the clients' affinity for E&S issues, and thereby their understanding of those issues and their E&S performance. Similarly, the degree to which the market in which IFC clients operated was receptive to E&S issues, and whether E&S performance could be used by clients to differentiate their products to the market, clearly also drove clients' interest and performance.

The strength of local and/or regional nongovernmental advocacy groups/civil society organizations also influenced client interest and their E&S performance. Interviewees attributed this influence to increased reputational risk, but also to general increased awareness.

A further significant development over the period has been the growth and influence of market-based standards, such as the EPs and the Principles for Responsible Investment.[49] IFC's early involvement in the facilitation of the EPS in 2003 elevated its Safeguard Policies and subsequent Performance Standards to the status of a common global good, with an enhanced level of attention and accountability for their quality.

Another important change has been in corporate reporting through the Global Reporting Initiative (GRI) framework. A financial services supplement has been in place since 2002 and was updated in 2008, using GRI's multi-stakeholder processes, with IFC involvement.[50] As of 2011, approximately 350 financial institutions were reporting according to the GRI Framework and Sector Supplement. There are numerous examples of emerging market financial institutions reporting to GRI standards, some of which are existing IFC clients. From its core in Western Europe and North America, the initiative has gained traction, particularly in Latin America and increasingly in Asia (including China). In Africa, there is limited reporting beyond South Africa, but the potential for expansion is significant.

GRI also encourages third-party assurance, so as to independently test the public reporting. It is relevant to note that the 2010 report by the World Bank's Independent Evaluation Group recommended that IFC adopt third-party verification more broadly in its oversight practice. The Committee on Development Effectiveness (CODE) and World Bank Institute (WBI) External Advisory Panel supported this recommendation.[51] A requirement for FM clients to disclose a third-party verified report consistent with the GRI could enhance the transparency of the end use of IFC funds.

The CAO panel also discussed E&S requirements with some of the other development finance institutions (DFIs) that undertake FI investments and that were co-investors with IFC in the CAO's sample investments. These DFIs include Deutsche Investitions-und Entwicklungsgesellshaft (DEG), the European Bank for Reconstruction and Development (EBRD), and Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO).[52] In addition, the CAO panel discussed the issue of alignment of DFI E&S requirements with a number of IFC clients that also have other DFIs among their investors.

Other DFIs and IFC clients commonly expressed the need to align multilateral and bilateral DFI requirements to minimize diverse, inconsistent, and duplicate commitments. Although the panel was advised by IFC that it has put considerable effort into harmonizing DFI requirements, including via the "Rome Consensus" of 2009 and 2011, the panel observed that the impact has not been experienced at the level of the clients in this sample. In fact, this issue was commonly raised by IFC clients, often with some vehemence and frustration. For some investments, DFIs have adopted IFC's E&S Performance Standards, policies, and guidelines. This has had a positive outcome in advancing E&S performance of those clients by aligning the requirements. Other DFIs indicated their willingness to waive their reporting

[49] For further details, see the Principles for Responsible Investment website. http://www.unpri.org/. Accessed June 19, 2012.
[50] Global Reporting Initiative. https://www.globalreporting.org/reporting/sector-guidance/financial-services/Pages/default.aspx. Accessed June 19, 2012.
[51] IEG, 2010, "Safeguard and Sustainability Policies in a Changing World–An Independent Evaluation of World Bank Group Policies."
[52] For further details see the DFI's websites. DEG: http://www.deginvest.de EBRD: http://www.ebrd.com/ FMO: http://www.fmo.nl/

requirement and accept IFC reporting formats and requirements when co-investing.[53] The DFIs, however, also observed that IFC was not usually prepared to waive its own requirements in favor of those of another DFI, even where that DFI was an existing investor in a proposed IFC investment. IFC confirmed that where there are other DFI requirements and they are not to the same standard as IFC, then it is not acceptable to IFC to waive its requirements. Irrespective of this, the key issue is that there is room for much greater alignment, and failure to achieve this is not in the best interests of clients or development generally.

The CAO panel also noted efforts of other DFIs to encourage adoption of improved environmental and social management practices through incentives rather than purely through systems implementation linked to legal covenants. Early examples of financial incentives based on adjusted interest rate spreads justified by reduced risk seemed to be having positive results.

It seems both counterintuitive and inefficient that the E&S requirements of the major development finance institutions are not more effectively aligned, when such alignment is clearly in the interests of both clients and the development finance institutions. The development of market-wide reporting standards and use of independent verification could be an effective approach to this issue.

Based on this analysis, the CAO panel makes specific findings in chapter 4 in relation to:

- Coordination with development finance institutions. (Finding 4.4)
- Alignment of IFC instruments with broader international standards (Finding 4.5)
- Weaknesses in standardized implementation (Finding 4.9).

3.4 The IFC E&S Implementation Toolkit

The capacity of IFC financial markets clients to understand, internalize, and implement a process of environmental and social analysis in their operations is variable. It is influenced by numerous factors, particularly the institutional setting and the business drivers. The IFC approach must adapt to that variability.

In the most difficult and extreme cases, the IFC client operates in an institutional setting where there are no environmental and social market drivers, no civil society organizations advocating change, and no legislative or institutional drivers that might integrate E&S issues into business thinking. To focus on E&S issues in these circumstances is essentially countercultural. This scenario is perhaps most commonly encountered in national or subnational commercial banks servicing various commercial and industrial sectors with many clients but limited exposure to international financing.

A second influential variable is the business drivers for each type of client, such as a bank, private equity fund, or microfinance institution: these can also affect the client's willingness

[53] Members of the Association of European Development Finance Institutions (EDFI), which include DEG, FMO, and Proparco, in particular have agreed that they will accept and "follow" the lead institution's E&S standards and analysis.

and capacity to develop its E&S processes. Commercial banks, for example, tend to be complex organizations with relatively long histories and established systems and approaches to doing business. It is therefore particularly challenging for them to change their approach to comply with IFC's E&S requirements.

At the other extreme, private equity and venture capital funds recognize almost without exception the business value of E&S management and internalize the issues at an early stage. These funds typically support a limited number of projects over a relatively short period of time. The focus on business value added is intense, leading to an exit point based on acquisition, Management Buy Out (MBO), Initial Public Offerings (IPOs), or full listing where the value added is monetized. In the CAO sample, the funds tended to be more receptive to E&S requirements than commercial banks because of the potential financial value to having a good governance system.[54] IFC typically invests in a private equity fund as the fund is being created, and interacts directly with the founders and senior management, thereby securing buy-in at the most senior level for issues that IFC raises.

Microfinance institutions are receptive to E&S concerns by nature, and indeed place them central to their success criteria. The origins of MFIs are often in social entrepreneurship, cooperative movements, or civil society organizations (CSOs) or nongovernmental organizations (NGOs), and they were commonly founded to achieve a "double bottom line," embracing social objectives as well as commercial success. Many MFIs receive substantial investments from DFIs, which sometimes also act as the originator of the concept/business case for the specific MFI. In the CAO sample, these MFIs often had proprietary systems for the monitoring of environmental and social impacts at the subclient level. Relevant to the impact measurement issue discussed earlier, the microfinance sector is highly engaged in the monitoring and capture of development outcomes from its lending (and the common reporting) of those outcomes, in a way that is largely absent from the commercial banking community.

The influence of these differences in institutional settings and business drivers on the willingness and/or capacity of IFC's clients to implement effective E&S systems can be profound. This is particularly evident in the use of the SEMS. Clients that were already actively engaged with E&S issues or that were predisposed to do so often utilized the SEMS as part of an integrated approach to manage—and in some cases, to try to improve—the E&S outcomes of their financing activities. In the cases in which clients did not understand or did not have a strong interest in E&S issues, the SEMS itself tended to become the E&S product; it was not seen as a tool that played a role in an broader, ongoing process. The effectiveness of the SEMS was sometimes further compromised by lack of clarity about what set of risks (credit risk, and the risk of doing no harm) the client was expected to control. Viewing the SEMS as a product was reinforced by IFC's legal requirement that a SEMS be produced and that the client report annually on the basis of the SEMS. Clients can therefore comply with the letter of IFC's legal requirements, but not with the spirit. While IFC does visit some subprojects during its supervision process, the absence of any systematic measurement of impacts or outcomes at the subclient level means that IFC is unable to measure the actual effectiveness of the SEMS requirement.

[54] Reports by internationally respected consultancy groups were frequently quoted by some IFC clients as stating that as much as 40 percent of assessed value at the time of an initial public offering might be influenced by governance structure. Interestingly, they all included handling E&S issues as part of good governance.

Clearly, the more difficult clients require more attention and assistance from IFC in order to understand the importance of E&S issues and grasp what institutional changes are required to implement IFC's requirements effectively. These clients often require a change management process in which the creation of a SEMS is an important but relatively technical exercise compared to the cultural and institutional changes required to make the system work effectively. Such clients in the CAO's sample benefited from early contacts with E&S specialists at the appropriately senior level (such as the CEO) within the client's organization. Experienced IFC staff are also the best qualified to assess whether difficult clients are genuinely committed to undertake the steps necessary to develop an effective E&S system.

The panel concluded that IFC's approach to its clients is based primarily on the nature of their business and their products. This has precluded IFC from creating a systematic approach to identifying potentially challenging clients in terms of E&S performance at the outset of the relationship and deliberately allocating the additional relationship and possibly financial resources needed. While the panel observed a number of examples of successful one-off efforts to provide tailored assistance to individual clients, particularly during the post-disbursement monitoring process, the panel believes that a more systematic approach to recognizing and responding to different institutional settings and business drivers at the beginning of the relationship, and the use of appropriate tools for these different circumstances, could be a more effective and efficient way to optimize the results.[55]

In a reflection of these different circumstances, some clients expressed frustration with lack of access to guidance and assistance in order to implement IFC's E&S requirements, especially in cases where local E&S consulting capacity was lacking. In particular, they cited the fact that E&S training material is often not available in an appropriate local language and expressed frustration with the number of different IFC staff they have to deal with throughout the investment cycle and lack of clarity about who is their main contact. This feedback was highly variable by region, with other clients very satisfied with the support provided by IFC.

IFC's E&S requirements were originally designed for IFC direct project finance in the real sector, with the Safeguard Policies and now the Performance Standards providing the underlying technical standards. This approach has remained essentially the same, albeit applied with increasing sophistication, since the time when FM investments were a minor part of the IFC investment portfolio. Requirements for FM investments have sought to use these standards, plus others (local law, Exclusion Lists) through increasingly complex procedural requirements. The requirements made of a client also change as the nature of the IFC products change; there are many examples of clients moving up through the hierarchy of E&S requirements as they obtain products with more demanding E&S requirements. Examples of these relationships are provided in Appendix H.

The CAO panel questioned whether this approach, designed for another type of client, is really suited to the broad base of financial markets transactions and whether, if one were designing a green-field approach targeting the financial sector, one would choose to start with requirements designed for the real sector. The panel noted that EBRD has chosen to develop an approach to FIs that is a independent (from its real sector investments) approach to FIs.

[55] As was noted in 2.2.1, E&S issues are not reviewed as part of IFC's assessment of a client's corporate governance.

The ‘fit for purpose’ question is also raised indirectly by the experience of the private sector in applying the EPs, which are based upon the application of the Performance Standards to project and corporate finance. Some commercial banks that have adopted the EPs have tried to extend them to other types of financial products and transactions, but have found this difficult. This may indicate that the Performance Standards could be too complex a tool to apply across a broad base of financial instruments. Furthermore, the difference in E&S terms between trying to apply the Exclusion List and the Performance Standards is a very difficult chasm for clients to cross and raises the question of whether a more graduated set of requirements would be appropriate.

Clients interviewed by CAO’s panel often questioned the Exclusion List, which is seen to impinge on activities that are perfectly legal within the country of application and commonly constitute a minority of a bank’s or a client’s portfolio of activity. It is not uncommon for IFC to agree that only a specific percentage of an organizations portfolio could be within the “excluded” activities. A number of clients noted that a more dynamic “at risk” list that identified not only internationally embargoed products and practices but that identified investment sectors, activities, and countries that were for a period designated as high risk would be a more valuable tool from a commercial and E&S perspective.

In response to its interview questions, the panel found that the inclusion by IFC of a legal E&S requirement to comply with national laws is often seen as a positive reinforcement of commitment by IFC and the client to E&S performance and helps focus on the importance of this issue.

The legal agreement between IFC and its client is regarded as an important tool in ensuring compliance and central to overall management and governance of the investment. Significant resources are therefore clearly expended in preparing these agreements. Specific commitments to meet IFC E&S requirements are often incorporated as legal covenants in the body of the overall agreement. The IFC Exclusion List is also defined in the agreement and commonly included as an annex to any agreement. There is significant variation, however. For example, of the sample 37 investments in which Performance Standards were required, 16 of the legal agreements utilized a similar format and wording to incorporate the requirements in the agreement, but 21 altered the text, so that it was more open for interpretation. A particularly notable example is the fact that some clients are required to apply “reasonable” efforts to implement the E&S requirements, while other clients are required to apply “commercially reasonable” efforts (see Appendix I for details.) In a number of instances, IFC utilized legal side agreements to incorporate E&S requirements, rather than the principal legal agreement. Although the panel was advised that IFC’s legal department considers these different formulations equally demanding and enforceable, it was not clear to the panel why there was a need for so many different types of formulations, even acknowledging the changing requirements over time.

The CAO panel also found the intent of the legal requirements to be somewhat opaque. Most notably, CAO panel members were surprised to find a number of examples where failure to comply with E&S covenants in legal agreements did not cause IFC to refuse additional IFC financing, although IFC staff advised that it was not accepted practice to do this. Several portfolio managers voiced the opinion that exiting a facility based exclusively on a default on the legal provisions related to the E&S requirement could be challenging, based on the formulations used in the legal agreement. This opinion appears to be borne out by the fact that there were no examples in the CAO sample of IFC directly using the provisions to exit a facility, even though in a few cases, a client’s noncompliance had proved intractable. In one instance, national authorities removed a FM subclient’s license to operate due to a major

pollution incident, but the IFC client had failed to undertake the required due diligence or to report the matter to IFC.

The panel also observed that using legal covenants to enforce E&S requirements reinforced the context of system compliance and drove the focus toward production of documents, rather than implementation of processes and measurement of outcomes.

Overall, the panel observed that the "toolkit" available to IFC staff to address E&S issues has not evolved in response to significant changes in the operating environment. Based on this analysis, the panel has made specific findings in chapter 4 in the following areas:

- The focus on Social and Environmental Management Systems and E&S requirements in legal agreements (Finding 4.6)
- Adaptation to FM investments (Finding 4.7)
- The assessment of client capacity and commitment (Finding 4.8)
- Weaknesses in standardized implementation (Finding 4.9).

3.5 Resources Allocated to E&S Due Diligence in Financial Market Investments

The overall quality of the CES staff with whom the CAO panel met was very high. Among investment staff with whom the panel met, the understanding of E&S issues varied from region to region, and depended on the relative level of support given to E&S issues and the promotion of an integrated approach by the Regional Director and Financial Market managers. The panel observed both very good and poor practice. It was clear that the quality of individual staff—both investment and CES staff—and the IFC staff's understanding of E&S issues in a financial market context have directly influenced the quality of E&S performance by IFC clients. In particular, the CAO panel noted that the understanding of E&S issues by clients in a number of investments was significantly higher when IFC E&S staff interacted directly with clients and investment staff throughout the entire investment process, rather than engaging later in the IFC investment handling process. Relationships in which there was less IFC staff turnover also tended to have better E&S results.

The CAO panel noted in several regions an inherent tension around the level of resources allocated to E&S due diligence and portfolio management. As outlined in table 3.4, it is clear that there has been a significant increase in IFC's Full-Time Equivalent (FTE) E&S staff allocated to FM investments in recent years.[56]

[56] According to IEG, CES staff resources increased from 1 in FY2005 to 2 in FY2006 to 3 in FY2007 and FY2008, to 5 in FY2009 (IEG, 2010, *Safeguard and Sustainable Policies in a Changing World*).

Table 3.4 Full-Time Equivalent IFC E&S specialists for FI investments

	2006	2007	2008	2009	2010	2011	2012
STC FTE		0	1.4	4.1	4.1	5	5.5
STAFF FTE	2.5	3	4	4.5	5.5	9	13.5
STAFF + STC FTE	2.5	3	5.4	8.6	9.6	14	19

Source: IFC

The increase occurred initially in the period after the 2007 revisions to the ESRP, and more recently during IFC's decentralization process.[57]

In any event, the additional resources and the decentralization process appear to be bearing fruit. For investments in the CAO's sample, there was a common perspective among clients and IFC staff that the clients' understanding of E&S issues, and their E&S performance, benefited when their CES counterpart was based in-country or in the local regional office. Particularly important was being based in the same time zone and geographic region, being co-located with the relevant investment staff, and being familiar with the local business climate and culture.

It is equally clear, however, that resources have at times been stretched to the limit, imposing significant pressures on the staff involved. Some of this pressure relates to supervising projects processed in earlier years that are noncompliant or problematic; there are a number of legacy cases.

"Getting an investment classified as FI was a free card on E&S requirements."

—IFC Investment Officer,
commenting on the Environmental and Social Review Procedure before 2007

In about 10 percent of cases in the sample, there has been a substantial period of E&S noncompliance that has become a major relationship issue between IFC and the client. The CAO observed that, in a number of these cases, it had been difficult for the field staff to escalate the issue to a management level in IFC where it could be resolved. This was in some ways not surprising because in many cases, the E&S noncompliance was an indicator or symptom of a wider management or relationship issue that might be resolvable only by a complete exit from the relationship. Nonetheless, field staff must know that they will receive ultimate support when every avenue of collaborative engagement with the client has been exhausted.

Although the panel was advised that IFC tracks historical E&S costs per client, the panel did not observe any specific application of this cost data, such as cost-benefit analyses or a deliberate allocation of more resources to specific clients, other than on the basis of the E&S risk-based approach that has been described.[58] Managers have developed their own

[57] However, the information available on IFC E&S staff resources to FIs (IEG's 2010 data) does not address the precise level of full-time equivalents of E&S specialists working on FM investments.
[58] A three-year review of the Sustainability Framework, dated July 29, 2009 and entitled "IFC's Policy and Performance Standards on Social and Environmental Sustainability and Policy on Disclosure of Information: Report on the First Three Years of Application," discusses cost issues in general terms, and presents a survey of the E&S costs to clients, but does not provide detailed information.

methodologies for allocating staff time based on availability of people and geography, but this varies by region.

For IFC's clients, there does not seem to be any formal process to discuss the costs and benefits of compliance with IFC's requirements at the time of appraisal or due diligence. By developing comparative cost/benefit data across clients, it is possible that a more compelling case could be made to reluctant clients to help them understanding the overall benefit of fully adopting the requirements. It would also help clients understand that adopting the requirements is often part of an extensive change management process, with the attendant costs, and not merely a technical exercise.

IFC sometimes uses in-country or regionally based commercial consultancy services to provide E&S training and systems development support to clients. Other development finance institutions, which have significantly lower levels of specialist resources than IFC, have used this approach extensively, particularly in achieving early high-level engagement with FM clients and driving culture change and system development at an early stage. The DFIs interviewed by the CAO panel regarded this as an efficient use of resources that provided outcomes—and in particular, a focused engagement with the client. (The CAO panel noted, however, that, like IFC, other DFIs do not apply cost-benefit analysis to assess the effectiveness of their E&S processes.) The CAO panel believes that IFC should consider whether its current operating model enables it to deploy its staff at the optimum time and in the optimum way to influence the client. The use of tried and tested consulting support in interaction with FM clients at the early stages of the project would appear from the experience of others to achieve improved outcomes and might result in a more manageable workload for field-based E&S staff. It might also potentially support the building of local consulting capacity, which was regarded by many clients and other DFIs as an important factor for improving client E&S performance.

The overall quality of E&S due diligence on FM investments has clearly improved significantly in recent years and is now of a high quality and generally consistent with IFC's policy and procedural commitments. However, this has not always been the case, and problematic noncompliant legacy projects remain and are difficult for IFC to resolve.

Based on this analysis, the CAO makes findings in chapter 4 related to:

- Trends in the quality of E&S analysis (Finding 4.10)
- Allocation of E&S resources (Finding 4.11).

4 CAO Summary and Findings

This section presents the specific findings of the CAO. Each finding is preceded by a summary of the observations that resulted in those findings.

Findings Related to IFC Strategy

4.1 IFC's E&S processes and results do not fully correspond to IFC's corporate message

Observations: The IFC's corporate message implies, and has been interpreted by external stakeholders to mean, that IFC's approach to its financial markets clients has a positive E&S performance impact at the subclient level and end use of funds, both in terms of doing no harm and also in the broader sense of having a positive proactive impact on how IFC's clients understand and manage environmental and social issues. The revised Sustainability Framework states specifically that the Performance Standards are intended to create a positive development outcome.

Finding: The CAO finds that IFC's E&S processes and results do not fully correspond to IFC's overall corporate message. The IFC approach, which is based on achieving change through the application of a management system, does not generate information about actual E&S results at the subclient level.

4.2 IFC applies two different concepts of E&S risk: do no harm and credit risk

Observations: IFC applies two different concepts of risk in its approach to E&S issues. One concept is the risk of environmental and/or social harm. The other concept is the credit risk to IFC or the IFC client created by an environmental or social event that threatens the financial condition of an IFC client or subclient. (Credit risk also includes an element of reputational risk, because a weakened reputation can lead to increased credit risk.) While both these approaches to identifying risk are fully appropriate, there is a lack of clarity about when which concept applies.

Finding: The CAO finds that the lack of clarity about when IFC's two different concepts of E&S risk apply creates the possibility that IFC's systems do not effectively minimize environmental or social harm that may result from the action of clients or subclients.

4.3 IFC has three different types of E&S objectives

Observations: IFC appears to have three different types of E&S objectives for its financial markets activities. The narrow, more technical objective, which is typically described as an "E&S outcome" in investment Board Papers, is to ensure that IFC's clients implement a Social and Environmental Management System (SEMS) to manage their E&S commitments. The individual Board Papers do not specify any broader influence on the end use of funds by subclients, other than the implicit possible effects generated by a client's having implemented a SEMS. Implementing a SEMS could be described as a "tool" rather than as an "objective," but the term "objective" seems appropriate because of the centrality of the SEMS to IFC's E&S approach.

The second, broader objective, which is stated in IFC's Sustainability Framework, is to ensure that the end use of funds by subclients does no harm.

The third objective is a more general and far-reaching one that corresponds with IFC's role as a market leader in E&S issues. Historically, IFC has implied that its E&S requirements have gone beyond doing harm and have had a positive impact; as of 2012, the Sustainability Framework states this specifically.

Although there is an assumption that the technical objective of creating a SEMS will lead to the two broader objectives, there is no explicit link between them, and no data or methodology for measuring whether those two broader objectives have been achieved. IFC does not have the tools to measure E&S performance at the subclient level to confirm that there has been no harm, in accordance with the second objective. Moreover, as discussed in Finding 4.6, the focus on SEMS implementation can conflict with the third objective of having a positive impact—which in any case is not measured.

Finding: The CAO finds that there is a lack of clarity about IFC's actual E&S objectives. In addition, there is not a systematic approach to assessing whether the two broader objectives are being achieved. The current approach is focused on confirming that clients have implemented a SEMS.

Findings Related to Standards

4.4 Despite interaction between IFC and other Development Finance Institutions, differing standards are a burden for clients

Observations: In a number of cases in the CAO sample, various development finance institutions, as co-investors, imposed different but overlapping E&S requirements on IFC's clients. Many of these clients expressed frustration with the efforts required to comply with these varying requirements, which the clients did not feel generated commensurately enhanced impact. In a few cases, clients raised questions about the relationship between the Equator Principles and IFC's E&S requirements, and questioned why both were necessary. Although there were some instances of effective cooperation between IFC and other DFIs, these were created on a case-by-case basis due to the initiative of individual DFI or IFC staff members. The CAO was advised that the DFIs are attempting to coordinate their approaches, but these efforts have not had a practical impact at the level of the clients in this sample.

Finding: The CAO finds that the differing E&S requirements of the various development finance institutions places a burden on IFC's clients and fails to take advantage of potential opportunities to increase the efficiency and leverage of the DFIs, individually and collectively, effectively wasting development resources.

4.5 IFC has further opportunities to encourage the adoption of a shared vision and industry standards

Observations: The CAO observed that the Equator Principles have successfully established industry standards that financial institutions voluntarily adopt. Such industry standards streamline the efforts of both the funders and the investees and create a shared vision of acceptable behavior. In recent years, the UN Principles for Responsible Investing have been developed, while reporting frameworks that also encourage third-party assurance have been developed through multi-stakeholder processes—notably, the UN Global Compact and the Global Reporting Initiative.

Finding: The CAO finds that there are potential opportunities for IFC to encourage the adoption of a widely shared vision of industry standards for acceptable E&S practices, behavior, and results. Requiring clients to report and disclose E&S performance and to engage third-party assurers to provide an independent check would further contribute to the propagation of global norms, while improving disclosure. Separately, these steps could free up IFC resources to play a more strategic role, such as focusing on results and outcomes (see below), working with new clients, working in countries where capacity is weak, and identifying and sharing good practice across regions/countries.

<u>Findings Related to the IFC Toolkit</u>

4.6 IFC's focus on the SEMS does not necessarily achieve a broader management and cultural change process

Observations: The focus of IFC's E&S activities is ensuring that its clients institute a SEMS. The standard legal agreements typically require that the SEMS be implemented within an agreed time frame, and the client ESRR ratings in the sample are based on the implementation of the SEMS. The formal limit of the requirements placed on the client are the allocation of internal resources, completion of an acceptable SEMS, and subsequent reporting.

The focus on the SEMS and the related reporting creates the risk that producing system documentation, rather than the E&S outcomes, becomes the end product. Client reporting in these cases can become mechanistic. For example, the client may confirm that its subclients comply with the Performance Standards because the subclients are required to provide written confirmation of this in the subloan agreements. However, the client does not necessarily engage with the subclients to see whether they actually comply with the Performance Standards, and/or whether there are other potential applications of the Performance Standards to which the subclients should be sensitive (such as with suppliers). In such cases, the SEMS system is used for formal reporting by the client instead of as a tool for implementing the kind of organizational change that makes E&S awareness a self-sustaining behavior, regardless of formal requirements. Indeed, in those cases where IFC and its clients approached the design and implementation of a SEMS though a medium- to long-term change management process, the result appears to be a more effective system, and ultimately a greater probability of enhancing E&S outcomes.

Finding: The CAO finds that IFC's focus on establishing a SEMS as a legally required product—instead of as part of a more fundamental change management process—creates the risk of a reporting and compliance orientation on the part of the client. This focus, in turn, reduces the potential impact of the E&S requirements because the emphasis is on the input (the SEMS) rather than on the output (do no harm). The SEMS can become merely an end in itself (a box-ticking exercise), rather than a means of enhancing E&S performance outcomes on the ground.

4.7 IFC's E&S requirements have not been adapted for FM clients

Observations: IFC's E&S requirements were originally developed for its clients in the real sector and subsequently applied to FM clients, as well. Although IFC staff have applied considerable effort to make these requirements relevant for FM clients, the fit is not ideal. The Exclusion List, which is the first significant requirement applied, can be confusing to clients because it is not solely focused on E&S issues. Of the eight Performance Standards, only the first two are typically relevant for FM clients. The result of this mismatch between the

requirements and the actual operations of many FM clients is that the requirements can seem theoretical and largely irrelevant. There is also a missed opportunity to apply requirements that would be more relevant for the clients' businesses and therefore have a more significant impact.

Finding: The CAO finds that the current E&S requirements are not optimally designed to assist FM clients in improving the E&S performance of their subclients.

4.8 IFC's approach to E&S requirements has precluded a structured approach to assessing two key elements of a successful E&S program: client capacity and commitment

Observations: IFC has historically applied an E&S risk-based approach to structure its focus on FM clients, according to which clients with high E&S risk products and businesses are subject to more demanding E&S requirements. However, regardless of the product, two of the most significant factors in achieving successful E&S outcomes are commitment to E&S issues at the level of senior management of IFC's clients, and the client's organizational capacity to manage those issues. Cases in which an inexperienced junior-level staff member was nominated as the E&S specialist, without the full support of at least one member of the senior management team to further develop the institution's E&S management capacity, tended to produce superficial results in which E&S reports were generated but no impact was created.

While experienced IFC staff can often gauge where and when E&S implementation challenges will arise, IFC has no formal procedures to identify and address these challenges at the outset. Examples of such proactive measures include involving senior-level IFC staff in the early discussions, and making a realistic assessment of the client's capacity and the potential assistance that may be required. (A further complicating factor occurs in countries in which affordable local E&S consulting and training support are not available.)

Finding: The CAO finds that IFC does not have a structured approach to assess and address two key elements of a successful E&S program: client commitment at the highest levels of the organization; and client capacity to implement an effective E&S management system using internal and/or external resources.

4.9 Standardized implementation requirements do not accommodate different levels of E&S development

Observations: Client capacity and commitment to E&S concerns also varies considerably, based on the types of IFC clients and the countries in which they operate. Some types of clients have business drivers that are naturally aligned with E&S considerations, such as private equity funds that will gain financially if their investees meet international standards. Some clients, regardless of type, take a proactive approach to E&S management for a variety of reasons, including their corporate culture, the prior influence of another DFI, and/or an E&S-related loss that has forced them to recognize the importance of E&S. (Nonetheless, even clients that are actively interested in E&S issues may have capacity constraints in actually addressing them.) Certain countries and regions provide institutional settings that are also more supportive of E&S requirements, such as European Union countries with strict E&S laws and enforcement. The resulting range of differences in client understanding of IFC's E&S requirements, and their readiness and ability to implement these requirements, have a significant impact on the resources and time required by IFC to achieve positive E&S results.

However, IFC's approach to E&S implementation is relatively standardized (based on product) in terms of compliance requirements, resources provided, implementation time lines, and assessment of the results.

In the CAO's view, the approach does not adequately address the wide range of capacity that exists between different types of IFC clients due to their business model or operational context.

Consequentially, IFC does not apply a graduated set of requirements that reflect these differences. Such an approach would potentially open up linking E&S requirements to financial incentives, which acknowledge the level of environmental and social risk in the transaction (as with any other kind of risk).

IFC's standardized approach also prevents IFC from maximizing the efficient allocation of resources, such as by anticipating that more E&S staff time and training resources will be required for clients whose business model or operational context is not naturally aligned with E&S considerations. It can also create unrealistic expectations for the time and effort required for clients to understand and implement IFC's E&S requirements.

Finding: The CAO finds that the current approach to the application of E&S issues to financial markets transactions does not adequately reflect the significant differences in client capacity and the business, institutional, and cultural setting in which they operate. This can lead to unrealistic expectations about client implementation of the E&S requirements, and reduces IFC's ability to maximize the effective allocation of its resources.

Findings Related to Resources

4.10 The quality of E&S assessment has improved

Observations: The SEMS-based approach to E&S management, although limited in its impact on the end-use of funds, has for the most part been implemented professionally and conscientiously by IFC staff. The cases showed a clear trend toward better managed E&S relationships after 2008, as a result of increased staffing and decentralization. The CAO also found cases in which IFC staff were able to use the SEMS requirements to help their clients achieve the kind of institutional change necessary to improve E&S outcomes at the subclient level—despite the fact that, in the CAO's opinion, the institutional approach to SEMS requirements is not optimally designed to achieve that objective. The CAO also observed noteworthy efforts to address challenging legacy cases that were created during the earlier period of lower staffing and less experience. In addition, although there were some cases in which GFM staff did not consider E&S issues to fall within their relationship management responsibilities, there were a number of cases in which GFM and E&S staff had jointly developed close and successful working relationships with their clients.

Finding: The CAO finds that the deployment of high quality E&S staff to work on FM investments in recent years has had a material impact on the quality of support provided to clients. The commitment of IFC's E&S and GFM staff to working with their clients on E&S issues has improved substantially. However, this has yet to address the underlying limitations of the SEMS-based approach to E&S management.

4.11 The allocation of E&S resources is not cost-based

Observations: Although IFC tracks historical E&S costs, it does not have a formal system in place to determine whether resources are being used efficiently and whether, for example,

certain functions could be outsourced. The E&S risk-based approach focus resources on higher risk products and clients, but its actual effectiveness is not assessed. Likewise, there is no explicit process to work with clients to help them understand the long-term costs and benefits of complying with IFC's requirements.

Finding: The CAO finds that the lack of a cost-based approach to allocate E&S resources makes it impossible to assess the efficiency and effectiveness of IFC's E&S activities.

5. CAO Conclusions

The CAO concludes the following:

IFC has processed the majority of its investments in the audit sample in compliance with the applicable environmental and social policy and procedural requirements. However, clients have failed to comply with IFC requirements in approximately 10 percent of the cases in the CAO sample. These cases remain a problematic legacy despite attempts by IFC to rectify them.

The additional staff resources allocated beginning in 2008 to manage the environmental and social requirements in IFC's financial sector portfolio, as well as the increased presence of E&S staff in local and regional offices, have had a significant positive effect on the level and quality of client engagement and compliance.

However, although IFC has used an E&S risk-based approach in its efforts to ensure environmental and social compliance, it has not undertaken a cost-benefit analysis to assess how best to maximize the effective use of resources.

IFC has played a leading role in developing and enforcing standards for environmental and social sustainability, although it has not assumed a leadership role in coordinating its standards with other lenders. There is an opportunity for IFC to utilize evolving tools developed through multi-stakeholder processes for corporate reporting and verification that could help to further the development of global E&S norms, as well as facilitate more effective utilization of IFC resources by establishing disclosure of E&S impact as a direct responsibility of their clients.

The SEMS procedures applied by IFC to its clients for screening subclients for compliance with the environmental and social requirements are aligned and in compliance with IFC's mandate, intentions stated in Board Papers for individual clients, and the Global Finance Markets Department strategies and Country Assistance Strategies focused on increasing financial penetration by investing in intermediaries.

However, IFC does not have a systematic methodology for determining whether the implementation of a SEMS actually achieves the objective of doing no harm or the objective of improving E&S outcomes at the subclient level.

In some cases, the creation and implementation of SEMS and related reporting has become an end in itself, rather than means to improved E&S outcomes on the ground.

Lack of clarity in the application of the two different approaches to environmental and social risk (credit risk and the risk of harm) further complicates the effort to assess the effectiveness of IFC's approach. As a result, it is not possible to reach a conclusion about whether the compliance failures noted above have resulted in outcomes that are contrary to the desired effect of the environmental and social policy provisions.

The IFC E&S procedures and impact assessment measurements are not optimally designed to support the broader environmental and social outcomes that are commensurate with IFC's prominent leadership role as a promoter of environmental and social responsibility.

Achieving those broader objectives would require IFC to expand its approach. IFC would need to focus on facilitating a self-sustaining cultural change within client organizations, raising their level of understanding and management of environmental and social risk. This implies a more sophisticated approach to the analysis of client commitment, and

interventions that align E&S issues with relevant business and socioeconomic drivers of change, rather than focusing on systems compliance. It would also require a systematic methodology for measuring impact at the subclient level. This approach would be more aligned to the aspirational objectives within IFC's Sustainability Framework, as well as the expectations of stakeholders.

Appendixes

Appendix A. Investment Products, Client Types, and Sectors

Investment Products

IFC can make a variety of financial investments, although investments cannot exceed 20 percent of the value of the company. The investments fall into two general categories: loans and equity investments. Within each of these two categories are multiple subtypes, resulting in over 30 different types of investment identified by IFC (table A.1). Equity investments may confer a variety of rights for IFC in relation to the investee, including board representation voting rights at shareholder meetings. The main differences between the two types of investment are summarized in table A.2.

Table A.1 Global Financial Markets Department Product Offerings

Senior debt	Structured finance	Mezzanine finance	Equity	Trade finance	Advisory services	Sustainable finance
Credit lines/loans	Partial credit guarantees	Convertible debt	Common shares	Guarantees to issuing and confirming banks	Corporate governance	Carbon finance
Liquidity management	Securitization	Subordinated debt	Preferred shares	Risk-sharing facilities	Risk management	Sustainable energy
Acquisition financing	Bond anchor investor	Other Tier-2 instruments	Investments in PE funds	Liquidity pools	SME banking	Supply chain financing
Warehousing facilities					Microfinance	Energy efficiency financing
International syndications					Housing finance	

Source: IFC.

Table A.2 Similarities and Differences in the Main Investment Types

Product type/ characteristics	Guarantee	Syndicate loan	Senior loan	Subordinat-ed loan	Quasi-Equity	Fund investment product	Equity
Time	Fixed	Fixed	Fixed	Fixed	Fixed, variable if exercised	Variable	Variable
Return of capital	Fixed	Fixed	Fixed	Fixed	Fixed, variable if exercised	Variable	Variable
Repayment order in default	Junior	Senior	Senior	Junior	Medium	Junior	Junior
Return on investment	Fixed return	Fixed return	Fixed return	Fixed return	Fixed/ variable	Variable	Variable
Ability to increase existing investment	No, new agreement required	No, new agreement required	No, new agreement required	No, new agreement required	Possible via rights issue	Yes	Rights issue
Board position	No	Unlikely	Unlikely	No	Possible	Likely	Likely
Legal leverage	Before funds disbursed	Through-out	Through-out	Through-out	Through-out if not equity	At each capital call	Before funds disbursed
Purpose	Specific product	Usually entire portfolio	Specific product or entire portfolio	Specific product or entire portfolio	Entire portfolio	Usually entire portfolio	Entire portfolio

Source: CAO compilations based on publicly available information from IFC.

Client Types and Sectors

IFC invests in over 300 sector areas, with over 70 related to the Global Financial Markets department. The main financial intermediary sectors that IFC invests in are discussed below. It is possible for some of these intermediaries or IFC to cross-invest. For example, IFC can invest in a private equity fund, which invests in a microfinance institution/commercial bank in which IFC has a pre-existing investment.[59]

[59] With the exception of the definitions of insurance company, factoring transactions, and AMC, all definitions are from http://firstforsustainability.org/risk-management/client-investee-exposure-to-environmental-and-social-risk.php

Banking Institutions/Commercial Banks

A banking institution can range from a large financial institution with a highly visible brand name and an international presence to a small organization with a local presence. Banking institutions finance activities generally involve various types of lending, such as corporate finance, factoring transactions (finance company), mortgage lending, project finance, retail, short-term finance, small and medium enterprises (SMEs), and trade finance (such as GTFP). Alternatively, the focus of a banking institution may be only on specific transactions with clients that meet certain requirements and within certain industry sectors.

Insurance Companies

Insurance companies provide individuals or corporations with financial protection or reimbursement against a defined risk. They offer various policies that transfer the risk of loss from a corporation or individual to the insurance company.

Leasing Companies

Leasing companies provide a physical asset or service for use by a commercial client or individual for an established period of time (sometimes with provisions to purchase the asset at the end of the contract) in return for regular payments; this is known as financial leasing. The lessee is the receiver of the assets or services under the lease contract, and the lessor is the owner of the assets or provider of services. Leasing assets include passenger vehicles, light duty trucks, furniture, office equipment, appliances, and heavy equipment, such as earth movers, large machines, industrial equipment, ships, heavy duty trucks, and airplanes. In some cases, a leasing company both owns and services the leased physical asset and is responsible for installing and operating the asset; this is known as operational leasing.

Microfinance Institutions (MFIs)

Microfinance institutions are organizations that provide loans to low-income clients, including micro-companies and the self-employed, who traditionally lack access to mainstream sources of finance from banking institutions. The loans are typically for small amounts targeting borrowers in developing countries and usually for a short term. The loans are sometimes not secured by collateral, as would typically be the case for loans from banking institutions.

Private Equity Funds

Private equity funds make long-term equity investments in companies or projects (although sometimes other financial instruments may be used), with the goal of selling the equity stake at a profit at the time of exit.

A private equity fund usually consists of a partnership with investors who are limited partners in the fund, which is controlled by a general partner. Limited partners commit to provide funding when the general partner has identified an opportunity for investment, such as acquiring a controlling stake of a company. A fund will typically make separate investments in several companies or projects over the life of the partnership. Investee companies or projects can encompass microfinance institutions, small and medium enterprises, and corporations and large-scale projects.

IFC's Asset Management Company (AMC)

In response to the financial crisis in 2008, IFC set up the Asset Management Company (AMC) to assist in stabilizing vulnerable financial systems. AMC is a wholly owned subsidiary of IFC that is incorporated in the state of Delaware in the United States. It mobilizes IFC's and large third-party institutional investor's capital in emerging markets. AMC may engage only in activities in which IFC is permitted to engage.

As of June 2011, AMC managed three funds: the IFC Capitalization Fund; the IFC African, Latin American, and Caribbean (ALAC) Fund; and the African Capitalization Fund. IFC has made capital investments with other institutional investors in the IFC Capitalization Fund and the ALAC Fund; however, IFC has not invested in the African Capitalization Fund.

Appendix B. Letter on Quality Assurance

August 14, 2012

Office of the Compliance Advisor Ombudsman
International Finance Corporation
2121 Pennsylvania Avenue NW
Washington DC 20433

Attention: Mr. Henrik Linders

Dear Mr. Linders:
Summary Report on Quality Control:
Independent Panel Work on the Financial Intermediary Audit

As required by our terms of reference, our consultant Mr. J Graham Joscelyne confirms that control of the quality was consistently considered by the Panel (and the IFC CAO staff) before, during and after this Report was finalized.

We confirm the following:

1. We are satisfied that the Panel's overall project planning specifically included identifying, assessing, and addressing risks associated with a project of this magnitude and complexity, and adapted its views on the risks throughout the duration of the its work;
2. We tracked progress by:
   a. Attending meetings in person and on calls;
   b. Discussing the methodology and sampling technique to be used, rereading and reviewing all Panel analyses, findings, supporting documentation to understand the Panel's initial views and then how this matured over time;
   c. Understanding what Panel initial views were and how these were impacted when new information came to light; and
   d. Checking that the Panel's final views were substantiated and were the views of the whole Panel and not a single prevailing member of it.
3. We challenged Panel members (and CAO support staff) both individually and collectively throughout the audit – on quality issues – to see if and to what extent they reacted, including if views changed as a result, and are satisfied with the outcome;
4. We are satisfied that the progression of Panel judgment overall resulted in findings, observations and conclusions that are in line with the agreed Scope of Work and are consistent with underlying data and analysis;
5. We noted the involvement of the CAO support staff input and confirm that that its views, while helpful to the progress of the audit, did not unduly influence the Panel views of its scope, its selected methodology, its judgments or its overall conclusions; and
6. We checked to ensure that the Audit Report is well enough supported - by data and analysis - to withstand a strong rebuttal from the IFC.

In conclusion, we are confident that the Panel's work leading to the FI Audit Report had quality control built into its methodology and process, that Panel judgments are sound - based on the information and evidence made available to it at the time - and that the Panel's work is within the agreed scope of its work. As a result, we are confident the CAO is on solid ground substantively and reputationally.

Yours truly,

J Graham Joscelyne
Managing Director

Joscelyne + Associates, Inc. 8506 Rehoboth Court, Vienna VA 22182, USA
(m) +1 703 919 1234 (email) graham@joscelyneplus.com

Appendix C. The CAO Sample Selection Process

During the preparatory analysis, the CAO audit panel identified 913 financial intermediary investments with a commitment date between July 2006 and April 2011 (see table C.1).[60] These 911 investments were split as follows:

- 830 investments were undertaken by the Global Financial Markets (GFM) department (including 67 also cross-listed by the industry departments); and
- 14 were solely undertaken by IFC industry departments.

Accordingly, the CAO identified 844 unique investments (830+14) during this period.

The CAO reviewed the respective Board Papers of the 830 projects in the GFM portfolio and eliminated 93 projects that were not related to client disbursements; rather, these projects sought approval to cancel or reverse a bank line or dealt with other activities not intended to result in disbursements. This elimination process left the CAO with 737 projects in addition to the original 14 industry department projects, for a total of 751 projects.

Of the subset of 737 projects undertaken by GFM, the CAO took a 10 percent sample, resulting in a sample size of 74 GFM projects. Of the subset of 14 projects assigned to the industry departments, 13 were categorized by IFC as Financial Intermediary (FI) projects and one was categorized as a Category C project (unlikely to result in adverse environmental or social impact). No projects were categorized as a Category A or B project (those with the potential to have greater/more widespread/irreversible environmental effects). Of the 13 FI projects from industry departments, the CAO selected one project at random. Since there was only one Category C FI investment from an industry department, the CAO also included this investment.

In addition, in order to adequately capture IFC's interaction with FIs through two other avenues of IFC FI investments—the IFC Asset Management Company (AMC) and the Global Trade Liquidity Program (GTLP)—the CAO added one AMC project and one GTLP project to the sample.[61]

The CAO reviewed the resultant 78 sample projects and opted to exclude 15 projects based on the following grounds:

- Three projects were presented to the IFC Board before the introduction of the Sustainability Framework in April 2006 (but the commitment date was after July 1, 2006) or funds were committed against a facility that was preapproved before 2006.
- In two cases, two projects were selected with the same client. In each case, the CAO kept the most recent investment.
- Three projects received funding from a specific debt facility separately funded by IFC; the CAO limited the sample to one randomly selected investment of the three initially selected.
- Two projects were excluded because they were no longer active.

[60] The IFC Sustainability Framework that governs its E&S requirements became effective in April 2006.
[61] For explanations of the Asset Management Company and the Global Trade Liquidity Program, see the definitions section at the front of this document.

- One project was excluded because it referred to a former jeopardy case.[62]
- Six projects were included in the Global Trade Finance Program (GTFP). Due to the nature and legal agreements of those investments was quite similar, the CAO opted to limit the selection to only one GTFP project.

Removing the investments as discussed led to a final sample size of 63 investments.[63]

Table C.1 Details of the CAO Sample

Total Financial Intermediary investments	911		
Subdivide between Global Financial Markets and Industry departments			
	GFM		**Industry**
Total FM investment	830	Total Industry investments	81
Remove double-counted projects from Indusrty	0		-67
Subtotal	830	*Subtotal*	14
Unrelated	-93		0
Subtotal	737	*Subtotal*	14
10% sample	74	10% sample	1
Add		*Add*	
Include AMC and GTLP project	2	Include one project that was categorized as "C"	1
Subtotal	76	*Subtotal (Industry)*	2
Remove			
Projects before April 2006	-3		
Projects related to the same client	-2		
Projects funded from similar debt facility	-2		
Projects no longer active	-2		
Jeopardy case	-1		
GTFP	-5		
Subtotal (GFM)	61		
Total (GFM and Industry)	63		

Source: CAO compilations.

[62]IFC designates a project as a jeopardy case when the prospects for recovery of IFC's investment are in serious doubt due to expected future loan defaults, country/industry considerations, stock market factors, or other factors as determined by IFC.

[63] After the final selection process, the panel found that two of the selected investments related to the same client. The panel audited both investments for the sake of completeness.

Appendix D. IFC's Exclusion List

The IFC has a list of activities in which it will not invest, including:

- Production or trade in weapons and munitions.
- Production or trade in alcoholic beverages (excluding beer and wine).
- Production or trade in tobacco.
- Gambling, casinos, and equivalent enterprises.

Table D.1 summarizes the IFC Exclusion List from 1998, and includes updates to the Exclusion List in 2006 and 2007. It also compares IFC's list with those of other development financial institutions (DFIs).

An important caveat is that the exclusion will not apply to project sponsors that are not substantially involved in production or trade in the excluded areas. IFC defines "not substantially involved" such that the activity concerned is ancillary to a project sponsor's primary operations.

A GFM client is sometimes allowed to invest in activities specified in the Exclusion List, provided that the total client investment in those activities constitutes less than a specific proportion of the client's portfolio, such as 5 percent of its portfolio.

Table D.1 Changes to the IFC Exclusion List from 1998 to 2011 and Current Exclusion Lists of Other DFIs

	IFC - Current	IFC - 2006	IFC - 1998	DEG	FMO	EBRD
Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans	Yes	Yes	Yes	Yes	Yes	Yes
Production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial scale usage of hazardous chemicals. Hazardous chemicals include gasoline, kerosene and other petroleum products	MFIs only	MFIs only	No	No	No	No
Production or trade in weapons and munitions	Yes*	Yes*	Yes*	Yes*	Yes*	No
Production or trade in alcoholic beverages (excluding beer and wine)	Yes*	Yes*	Yes*	Yes*	Yes*	No
Production or trade in tobacco	Yes*	Yes*	Yes*	Yes*	Yes*	No
Gambling, casinos and equivalent enterprises	Yes*	Yes*	Yes*	Yes*	Yes*	No
Production or trade in radioactive materials. This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where IFC considers the radioactive source to be trivial and/or adequately shielded.	Yes	Yes	Yes	Yes	Yes*	For FI only - Referral to EBRD
Production or trade in unbonded asbestos fibers. This does not apply to purchase and use of bonded asbestos cement sheeting where the asbestos content is less than 20%.	Yes	Yes	Yes	Yes (no 20% stipulation)	Yes (no 20% stipulation)	Yes
Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.	Yes	Yes	Yes	Yes	Yes	Yes
Commercial logging operations for use in primary tropical moist forest.	FIs only	FIs, MFIs and Trade Finance only	Yes	No	No	No
Production or trade in wood or other forestry products other than from sustainably managed forests / from unmanaged forests.	FIs only	MFIs only	MFIs only	No	No	No
Purchase of logging equipment for use in primary tropical moist forest	No	Yes	Yes	No	No	No

Any business related to pornography or prostitution	No	No	No	Yes	Yes	No
Production and distribution of racist, anti-democratic	No	No	No	Yes	Yes	No
- and/or neo-nazi media	No	No	No	Yes	No	No
Cross-border trade in waste and waste products unless compliant to the Basel Convention and the underlying regulations	Yes, but no specific mention	Yes, but no specific mention	Yes, but no specific mention	Yes	Yes	Yes
Shipment of oil or other hazardous substances in tankers which do not comply with IMO requirements	No	No	No	No	No	Yes
Trade in goods without required export or import licenses or other evidence of authorization of transit from the relevant countries of export, import and, if applicable, transit	No	No	No	No	No	Yes
Destruction of Critical Habitat	No	No	No	Yes	Yes	Yes - as per host country legislation or international convention
Significant alteration, damage, or removal of any critical cultural heritage.	No	No	No	No	Yes	Yes - as per host country legislation or signatory to international convention
Production or activities that impinge on the lands owned, or claimed under adjuction, by Indigenous Peoples, without full documented consent of such peoples	MFI's only	MFI's only	MFI's only	No	No	No
Relocation of Indigenous Peoples from traditional or customary lands	No	No	No	No	Yes	For FI only - Referral to EBRD
Production or activities involving harmful or exploitative forms of forced labor/harmful child labor.	FIs, MFIs and Trade Finance only	FIs, MFIs and Trade Finance only	Yes	Yes	Yes	No
Activities involving involuntary resettlement	No	No	No	No	No	For FI only - Referral to EBRD
Activities within, adjacent to, or upstream of designated protected areas under national law or international conventions, sites of scientific interest, habitats of rare/endangered species, fisheries of economic importance, and primary/old growth forests of ecological significance	No	No	No	No	No	For FI only - Referral to EBRD
Activities which may affect adversely sites of cultural or archaeological significance	No	No	No	No	No	For FI only - Referral to EBRD
Activities in the nuclear fuel production cycle (uranium mining, production, enrichment, storage or transport of nuclear fuels)	No	No	No	No	No	For FI only - Referral to EBRD
Energy generation using nuclear fuels (excluding electricity import/export)	No	No	No	No	No	For FI only - Referral to EBRD
Activities involving the release of GMOs into the natural environment	No	No	No	No	No	For FI only - Referral to EBRD
Construction of mini-hydro cascades	No	No	No	No	No	For FI only - Referral to EBRD
*This does not apply to project sponsors who are not substantially involved in these activities. "Not substantially involved" means that the activity concerned is ancillary to a project sponsor's primary operations.						

Source: CAO compilations based on IFC Exclusion List, EBRD Exclusion List, DEG Exclusion List, FMO Exclusion List.

Appendix E. IFC's DOTS Indicators

IFC uses a Development Outcome Tracking System (DOTS) to track development outcomes of projects against key indicators identified at the start of the investment cycle. DOTS covers all active projects in IFC's portfolio, for both investments and advisory services. See table E.1 for GFM DOTS indicators.

DOTS allows for real-time tracking of development results throughout the project cycle. At the outset of a project, IFC staff members identify clear, standardized, and verifiable indicators, with baselines and targets. They track progress throughout supervision, which allows for real-time feedback into operations, until project closure. Some types of projects are not tracked by DOTS. The most typical exclusions are projects in the early stages of the project cycle, projects that are expansions of existing ones, projects that are split into several investments, small projects that form parts of larger programs, and certain financial products such as rights issues and some swaps.

Trade finance projects historically have not been tracked; IFC expects to begin tracking trade finance projects in 2012. For most Global Financial Markets (GFM) department investments, the indicators are extrapolated from the size of investment. That is, IFC makes the assumption that increased investment in clients that invest in small and medium enterprises (SMEs) leads to an increased development outcome.

Table E.1 Global Financial Markets Department DOTS Indicators

Performance area	Indicator name	*Tracking?* Mandatory	Mandatory - where relevant
Financial Performance	Life of Project - ROE (%)		
	Annual ROE (%)		
	Portfolio quality (%NPLs)		
Economic Performance	Life of Project - EROE (%)		
	Annual EROE (%)		
	Total employment - sex disaggregated (#)		
	Outstanding portfolio (US$ millions)		In specific cases
	Outstanding portfolio (# loans)		In specific cases
	Annual disbursed (US$ millions))		In specific cases
	Annual disbursed (# loans)		In specific cases
	MBS issues ($)		(housing)
	MBS issues (#)		(housing)
	Mortgage bond issues ($)		(housing)
	Mortgage bond issues (#)		(housing)
	Refinanced/repurchased portfolios ($)		(housing)
	Refinanced/repurchased portfolios (#)		(housing)
	Financial services offered ($)		(financial services)
	Financial services offered (#)		(financial services)
	Brokerage accounts opened/serviced ($)		(financial services)
	Brokerage accounts opened/serviced (#)		(financial services)
	NPLs resolved/restructured ($)		(financial services)
	NPLs resolved/restructured (#)		(financial services)
	Assets disposed or sold ($)		(financial services)
	Assets disposed or sold (#)		(financial services)
	Mortgages disposed or sold ($)		(financial services)
	Mortgages disposed or sold (#)		(financial services)
	Insurance clients (#)		(insurance)
	Gross premiums raised (% per annum)		(insurance)
	Gross premiums raised ($)		(insurance)
	Reinsurance clients (#)		(insurance)
	Gross premiums raised (% per annum)		(insurance)
	Gross premiums raised ($)		(insurance)
	Households with improved infrastructure (#)		(property finance)
	Jobs created by PF project (#)		(property finance)
	Property development projects financed ($)		(property finance)
	Property development projects financed (#)		(property finance)
	Branches (#)		
	Branches - rural (#)		
	Taxes and other payments (US$ millions)		
	Life-of-project Lending Subsidy Indicator ($)		
	Annual Lending Subsidy Indicator ($)		
Environmental and Social Performance	Improvements in Env/Social management (incl. health and safety standards)? (Y/N)		
	Energy Efficiency/Renewable Energy component? (Y/N) - if available: (split between EE and RE, cost $)		
	Improvement in pollution management? (Y/N) - if possible: (% pollution abatement)		
	Involuntary resettlement? (Y/N) - if possible: (# of people resettled)		
	Employees trained in EE (#)		(energy efficiency)
	Employees trained in sustainability (#)		(sustainability)
	Community Development outlay ($)		
	Project design addresses gender issues? (Y/N) - specify type of gender issue		
	Financing to underserved markets: Volume of loans ($)		
	Financing to underserved markets: Loans (#)		
Private Sector Development	Institutions replicating IFC product (#)		
	FIs adopting client company best practices (#)		
	FIs created following IFC investment (#)		
	Greater Commitment/Improvement to Corporate Governance (Y/N)		
	Improvements in the Structure and Functioning of the Board of Directors (Y/N)		
	Enhancement of the Control Environment (Y/N)		
	Improved Transparency and Disclosure (Y/N)		
	Better Treatment of Shareholders (Y/N)		
	Introduction of new/improved MIS/IT systems (Y/N)		
	Introduction of risk management system (Y/N)		

Source: IFC.

Appendix F. Definition of MSMEs Used by IFC and other DFIs

IFC's Definition

IFC's definition of micro/small and medium enterprises MSMEs is summarized in table F.1.[64]

Table F.1 IFC's Definition of Micro/Small and Medium Enterprises

Firm size	Employees	Assets ($millions)	Annual sales ($millions)
Micro	< 10	< 0.1	< 0.1
Small	< 50	< 3.0	< 3.0
Medium	< 300	< 15.0	< 15.0

Source: IFC.

EBRD's Definition

The European Bank for Reconstruction and Development (EBRD) bases its definition on the loan size and size of the subborrower.[65]

Loan size: A micro loan/lease is a loan up to €30,000. A small loan/lease typically ranges between €30,000 and €125,000. In the MSE lending programs, a micro loan is a loan up to $10,000. A small loan ranges from $10,001 to $200,000.

Sub-borrower size: Microenterprises are companies with up to 9 employees (including sole proprietors). Small enterprises have 10 to 49 employees. Medium companies have 50 to 249 employees.

The European Union's Definition

The European Union defines SMEs as firms with 10 to 250 employees and annual sales of €2 million to €50 million. Micro-firms are defined as having fewer than 10 employees and less than €2 million in annual sales. Often there is no single definition within a country.

[64] For further details see http://www.ifc.org/ifcext/gfm.nsf/AttachmentsByTitle/SMEBankingGuide2010-E.pdf/$FILE/SMEBankingGuide2010-E.pdf Accessed April 17, 2012

[65] For more details, see EBRD www.ebrd.com/downloads/policies/sector/msme.pdf. Accessed April 17, 2012.

Appendix G. IFC's Role in Financial Flows to Emerging Markets

Table G.1 shows net private financial flows to emerging and developing economies beginning in 2005, along with the IFC's annual commitments. Two important caveats about this table should be noted.

First, the IFC's fiscal year ends on June 30. Therefore the IFC's activities during the crisis in the autumn of 2008 span the IFC's reporting year of 2009. The impact of the crisis can be seen more clearly in the IFC's 2009 reporting year.

Second, the geographical regions are not fully aligned.

Table G.1 Private Financial Flows to Emerging and Developing Economies and IFC's Annual Commitments, 2004–11

	Units	Scale	2004	2005	2006	2007	2008	2009	2010	2011
Private financial flows, net (a)	USD	Billions	241.39	323.46	302.53	715.11	245.64	267.45	482.26	574.66
IFC new nommitments (b)	USD	Billions	4.80	5.30	6.70	8.10	11.40	10.60	12.70	12.20
GTFP (b)	USD	Billions			.30	.80	1.40	2.40	3.50	4.60
IFC new nommitments *less GTFP*	USD	Billions	4.80	5.30	6.40	7.30	10.00	8.20	9.20	7.60
IFC new nommitments/private financial flows, net			2.0%	1.6%	2.2%	1.1%	4.6%	4.0%	2.6%	2.1%
IFC new commitments less GTFP/private financial flows, net			2.0%	1.6%	2.1%	1.0%	4.1%	3.1%	1.9%	1.3%
Annual change in private financial flows, net			N/A	34.0%	-6.5%	136.4%	-65.7%	8.9%	80.3%	19.2%
Annual change in IFC new commitments			N/A	10.4%	26.4%	20.9%	40.7%	-7.0%	19.8%	-3.9%
Annual change in IFC new commitments *less GTFP*			N/A	9.4%	17.2%	12.3%	27.0%	-22.0%	10.9%	-21.1%

Source: IMF World Economic Outlook database, IFC Annual Reports

(a) Defined as "emerging and developing economies, private financial flows, net." Regions included are Central and Eastern Europe, Commonwealth of Independent States, Developing Asia, Latin America and the Caribbean, Middle East and North Africa and Sub-Saharan Africa (www.imf.org).
(b) IFC New Commitments and GTFP are for year IFC's Financial year ending in June of each year

Even taking these caveats into account, the table clearly shows the increased role for IFC during and after the 2008 crisis. While IFC's commitments accounted for only 1.1 percent of net private financial flows to emerging and developing economies in 2007, this ratio increased to 4.6 percent in 2008. This was the result of net private financial flows dropping by 65.5 percent during 2008, while the IFC's commitments increased by 38.7 percent in light of the crisis. Even with a decline of 7.5 percent in the IFC commitment level in 2009, IFC's commitments relative to net private financial flows stayed at a relatively high level of 3.9 percent. As of 2011, this ratio had decreased to 2.1 percent, which is approximately the same level as in 2006 (2.2 percent), the year preceding the enormous 136.4 percent increase in net private financial flows.

Investments that the GFM department makes is often claimed to stimulate the market and lead other financial institutions to have the confidence to make investments in the same or similar clients. This leverage means that IFC/GFM could be influencing up to 20 percent of funding in the emerging markets.

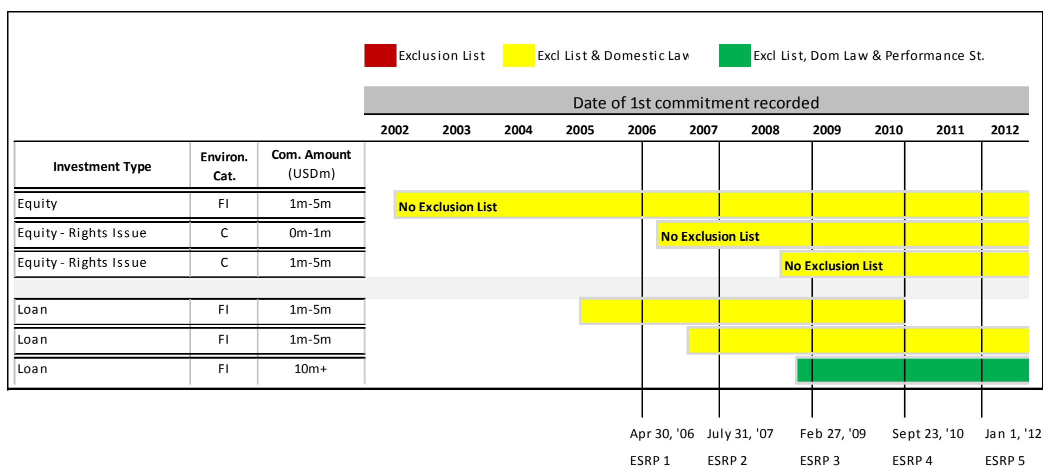
Appendix H. Sample E&S Requirements When IFC Undertakes Multiple Investments

The discussion that follows presents three examples of the sequence in E&S requirements as IFC undertakes multiple investments.

Client A

The original equity agreement failed to require the client to apply the Exclusion List (this is a rarity in the 63 investments audited). This was not corrected in subsequent equity agreements. The Exclusion List and domestic law (national E&S law) were applied to all loan agreements and the third loan agreement. In the first instance, (for Client A), 6 investments were made by mid-2011 (3 equity investments and 3 loans).They also required the Performance Standards to be applied. Table H.1 also shows when the various ESRP versions came into play and how these relate to the investment dates.

Table H.1 Client A: Changing E&S Requirements over Time



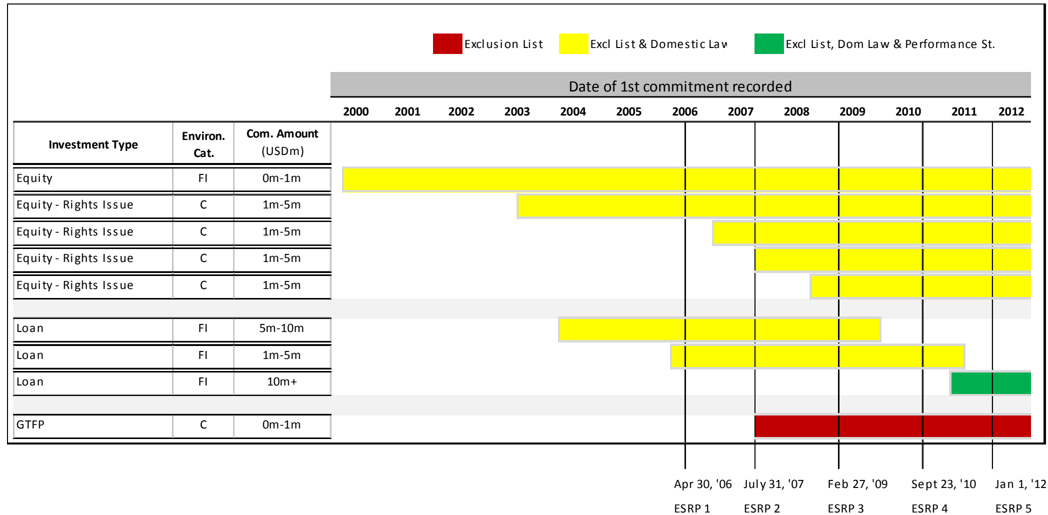
Investment Type	Environ. Cat.	Com. Amount (USDm)
Equity	FI	1m-5m
Equity - Rights Issue	C	0m-1m
Equity - Rights Issue	C	1m-5m
Loan	FI	1m-5m
Loan	FI	1m-5m
Loan	FI	10m+

Source: CAO compilations.

Client B

For Client B, 9 investments were made by mid-2011: 1 equity investment, followed by 4 rights issues, and 4 loans (including one through the GTFP). The original equity agreement required the client to apply the Exclusion List and domestic law. The final loan required compliance with the Performance Standards. However, the agreement for the loan through the GTFP required only compliance with the Exclusion List. Table H.2 shows when the various ESRP versions came into play and how these relate to the investment dates.

Table H.2 Client B: Changing E&S Requirements over Time

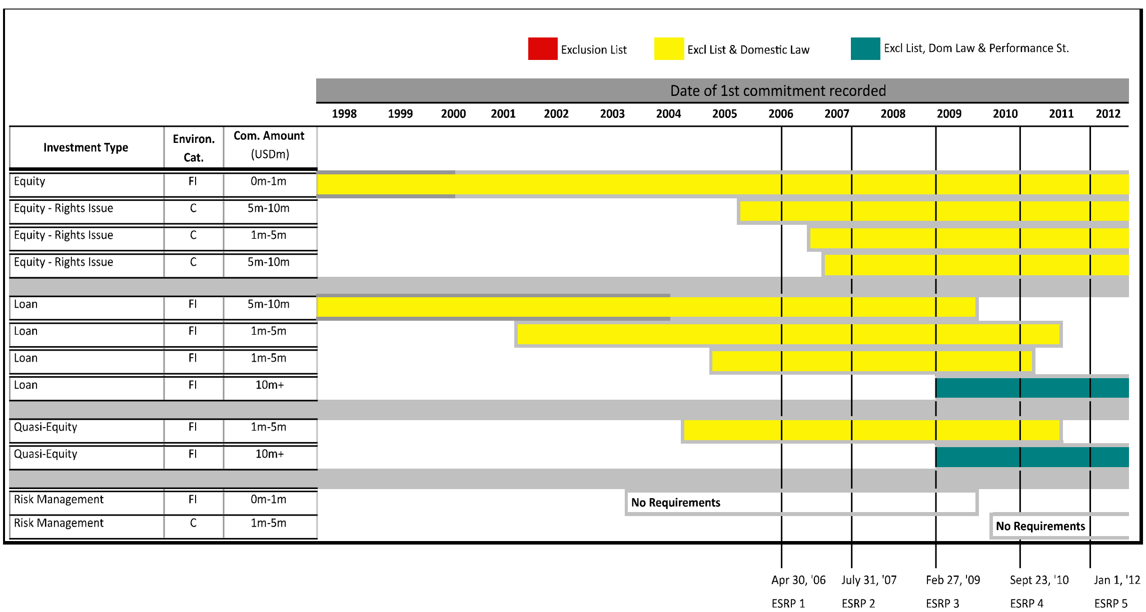


Source: CAO compilations.

Client C

For Client C, 12 investments were made by mid-2011 (1 equity investment, followed by 3 rights issues, 4 loans, 2 quasi-equity, and 2 risk management–interest rate swaps). The first loan and equity investment were made simultaneously and required the client to apply the Exclusion List and domestic law, as did all subsequent loans and equity investment. The loan and quasi-equity investment in 2009 required compliance with the Performance Standards. However, the 2 risk intermediations did not require any E&S compliance provisions. Table H.3 shows when the various ESRP versions came into play and how these relate to the investment dates. The fourth loan continues, but the other three have closed.

Table H.3 Client C: Changing E&S Requirements over Time



Source: CAO compilations.

Appendix I. Sample E&S Requirements in Legal Agreements

The applicable environmental and social requirements for IFC investments are determined before Board approval and included in IFC's legal agreements with its clients. When IFC repeats equity investments with a client through a rights issue,[66] these are normally conducted under the terms of the original agreement. Therefore, if the IFC Exclusion List was not required in the original investment, it is usually not incorporated in follow-up rights issues. Of the 36 investments in the CAO sample that require adherence only with national E&S laws of the host country and not the IFC Exclusion List, more than half (19) were based on an earlier investment (see table I.1).

Table I.1 E&S Requirements in the Legal Agreements of the CAO Sample Investments

Type of requirement	Number of investments
No E&S requirements	17
IFC Exclusion List only	30
National E&S laws only	36
IFC Exclusion List and national E&S laws	68
IFC Exclusion List, national E&S laws, and IFC Performance Standards	34
National E&S laws and IFC Performance Standards	3

Source: CAO compilations.

Break-down of the E&S Requirements in the FI Investments in the CAO Sample

Of the 188 investments that the CAO reviewed, 37 investments by 27 clients required the client to adopt the Performance Standards (a number of clients had repeat investments).

In 16 of these investments, IFC's legal agreement utilized a similar format in incorporating the requirements into the agreement. The environmental and social requirement were commonly defined in the definition section of the agreement as "S&E Requirements": "the social and environmental obligations to be undertaken by the Portfolio Companies to ensure compliance with: (i) the Exclusion List; (ii) Applicable S&E Laws; (iii) the Performance Standards; and (iv) any other requirements established by the S&E Management System."

In these 16 investments, the requirements were commonly enacted in the body of the agreement through a covenant that required the IFC client to implement a SEMS to ensure compliance with the S&E requirements. The legal covenant was commonly framed in the following way: The IFC client "shall use all reasonable efforts to ensure the continuing operation of the S&E Management System to identify, assess and manage the social and environmental performance of the Relevant Financed Operations in compliance with the S&E Requirements."

[66] A rights issue entails issuing rights to a company's existing shareholders to buy a proportional number of additional securities at a given price (usually at a discount) within a fixed period.

Legal Requirement to Implement a SEMS

Of the 188 investments in the sample, 126 were required to implement a SEMS, while 62 investments did not include this requirement. Of those remaining 126 investments, there were 38 instances where the IFC utilized a similar legal text to require the client to implement a SEMS. This legal covenant was commonly framed in the following way: The IFC client "shall use all reasonable efforts to ensure the continuing operation of the S&E Management System to identify, assess, and manage the social and environmental performance of the Relevant Financed Operations in compliance with the S&E Requirements."

IFC Performance Standards in Legal Text

Four examples of variations in the legal agreements for clients required to implement PS are presented in box I.1.

Box I.1 Four Examples of Legal Text Utilized in IFC Legal Agreements that Require IFC Performance Standards

Example 1 *Body of legal text:* The Company shall use all reasonable efforts to ensure the continuing operation of the S&E Management System to identify, assess and manage the social and environmental performance of the Company's operations in compliance with the S&E Requirements. *Definitions:* "S&E Requirements": The social and environmental obligations to be undertaken by Portfolio Companies to ensure compliance with: (i) the Exclusion List; (ii) Applicable S&E Laws; (iii) the Performance Standards; and (iv) any other requirements established by the S&E Management System.
Example 2 *Body of legal text:* The Partnership and the General Partner shall use all reasonable commercial efforts to ensure the continuing operation of the S&E Management System to identify, assess and manage the social and environmental performance of Partnership Operations in compliance with the S&E Requirements. *Definitions:* "Applicable S&E Law": All applicable statutes, laws, ordinances, rules and regulations, including, but not limited to, any license, permit or other governmental authorization imposing liability or setting standards of conduct concerning any environmental, social, labor, health and safety or security risks of the type contemplated by the Performance Standards. *Definitions: "*S&E Requirements": The social and environmental obligations to be undertaken by the Portfolio Companies to ensure compliance with: (i) the Exclusion List; (ii) Applicable S&E Laws; (iii) the Performance Standards; and (iv) any other requirements established by the S&E Management System.
Example 3 *Body of legal text:* The Fund Manager and the Investment Advisor will ensure that all projects are reviewed and evaluated against the following environmental and social requirements (Applicable Requirements): The environmental and social Exclusion List for all projects as presented in Annex X; The applicable national laws on environment, health, safety and social issues (including international conventions ratified by the host country) and any standards established therein; and The IFC Performance Standards (PS) (Details in Annex Y) and EHS Guidelines.

Example 4

Body of legal text: Environmental–The Company shall (and further ensure that its Key Subsidiaries shall) comply with all applicable environmental, health and fire and life and safety legislation and standards of the countries in which the Company operates, as well as the Performance Standards.

Source: CAO compilations.