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APPRAISAL REPORT

CAO Appraisal for Audit of IFC

CAO Compliance

C-R1-Y11-F135

June 27, 2011

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**IFC's Investment Projects in the Financial Sector  
Multiregional/ World**

***Summary***

A large portion of IFC financing is currently channeled to private sector projects in developing countries and emerging markets through third party entities. The CAO's experience over the past 11 years in working to resolve complaints related to IFC projects shows that grievances raised by affected communities have related predominantly to IFC's real sector investments. The CAO's analysis indicates that this is a consequence of a combination of factors. Most basically, according to its eligibility criteria, the CAO may accept only those complaints alleging direct or perceived harm. Moreover, financial sector projects are less known to and less understood by affected communities because disclosure provisions required in the financial markets in which IFC operate are less transparent, and the structures and instruments used by IFC to support private sector development through financial intermediaries and other instruments are complex.

The CAO's findings from analyzing its data indicate there is a likelihood of occurrence of similar risks and harm, and possible grievances, as seen in the real sector stemming from the financial sector business activities of IFC. As a result of the difficulties for external parties of bringing these grievances directly to the CAO's attention, these less visible activities are creating an increasing risk for the institution, and might constitute missed opportunities for learning and improving the environmental and social performance of IFC.

In light of the above, the CAO Vice President initiated an appraisal for audit of IFC's financial sector activities. This work is being conducted in accordance with the CAO's mission to enhance the development impact and sustainability of IFC supported business activities by improving social and environmental outcomes of IFC's work, thereby fostering a higher level of accountability.

The CAO elected to focus its appraisal on IFC's financial intermediaries (FIs) investments after the introduction of the 2006 Policy and Performance Standards on Social and Environmental Sustainability. The CAO found 844 projects that were specifically categorized as FI investments,<sup>1</sup>

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<sup>1</sup> See "IFC's Environmental and Social Review Procedures" at [www.ifc.org](http://www.ifc.org) for details concerning the use of Category A, B, C, and FI in the context of due diligence review.

or were in relation to investments in financial intermediaries. In addition, these 844 investments had a commitment date between July 2006 and April 2011.

The CAO concludes that this appraisal highlights the need for CAO audits of IFC's different financial sector projects to assess whether:

- The actual social or environmental outcomes are consistent with or contrary to the desired effect of the policy provisions.
- The failure to address social or environmental issues as part of the review process resulted in outcomes that are contrary to the desired effect of the policy provisions.

Upon completion of the CAO appraisal selection process, the CAO decided on a sample consisting of 63 IFC FI projects. How the CAO made this determination is described in full detail in Chapter 2 of this report.

The CAO concludes that this case merits an audit of IFC. In accordance with the CAO's Operational Guidelines, the CAO will develop Terms of Reference based on this determination and thereafter conduct audits of the projects identified to form the sample.

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](http://www.cao-ombudsman.org)

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## 1. Overview of the CAO Compliance Appraisal Process

A compliance audit can be initiated by request from the President of the World Bank Group, the senior management of IFC or MIGA, or the CAO Vice President.

A CAO compliance appraisal is a preliminary investigation to determine whether the CAO should proceed to a compliance audit of IFC/MIGA. Through CAO compliance appraisals, the CAO ensures that compliance audits of IFC/MIGA are initiated only for those cases that may raise substantial concerns regarding social or environmental outcomes.

A compliance audit is concerned with assessing the application of relevant policy provisions and related guidelines and procedures to determine whether IFC/MIGA are in compliance. The primary focus of compliance auditing is on IFC/MIGA, but the role of the sponsor may also be considered.

A compliance audit appraisal, and any audit that ensues, must remain within the scope of the original request. It/they cannot go beyond the confines of the request to address other issues. In such cases, the requestor should consider a new request.

The CAO compliance appraisal will consider how IFC/MIGA assured itself/themselves of compliance with national law, reflecting international legal commitments, along with other audit criteria. The CAO has no authority with respect to judicial processes. The CAO is not an appeals court or a legal enforcement mechanism, nor is the CAO a substitute for international court systems or court systems in host countries.

The appraisal criteria are set forth in CAO's Operational Guidelines. The criteria are framed as a series of questions to test the value of undertaking a compliance audit of IFC or MIGA. The criteria are as follows:

- Is there evidence (or perceived risk) of adverse social and environmental outcomes that indicates that policy provisions (or other audit criteria) may not have been adhered to or properly applied?
- Is there evidence of risk of significant adverse social and environmental outcomes that indicates that policy provisions, whether or not complied with, have failed to provide an adequate level of protection?
- Is there evidence (or perceived risk) of significant adverse social and environmental outcomes where policy provisions, standards, or other audit criteria were not thought to be applicable but perhaps should have been applied?
- Is there evidence that the application of some aspect of a policy, standard, guideline, or procedure resulted in adverse social and environmental outcomes?
- Can the cause of adverse social and environmental outcomes not be readily identified and corrected through the intervention of the project team without a detailed investigation of the underlying causes or circumstances?
- Could a compliance audit yield information or findings that might better inform the application of policies (or other audit criteria) to future projects?



After a compliance appraisal has been completed, the CAO can choose only one of two options: to close the case, or to initiate a compliance audit of IFC/MIGA.

The CAO will report and disclose the findings and decision of the CAO compliance appraisal in an appraisal report in order to inform the President of the World Bank Group, the Boards of the World Bank Group, senior management of IFC/MIGA, and the public in writing about its decision.

If the CAO decides to initiate compliance audits as a result of the compliance appraisal, the CAO will draw up Terms of Reference for the audits in accordance with the CAO's Operational Guidelines.

## **2. Background and Concerns that Led to the Appraisal**

A large portion of IFC financing is currently channeled to private sector projects in developing countries and emerging markets through third party entities. IFC defines these investments as its "financial sector," as opposed to IFC's more direct investments in projects and project operators, defined by IFC as its "real sector."

The CAO's experience over the past 11 years in working to resolve complaints related to IFC projects shows that grievances raised by affected communities have related predominantly to IFC's real sector investments. The CAO's analysis indicates that this is a consequence of a combination of factors. Most basically, according to its eligibility criteria, the CAO may accept only those complaints alleging direct or perceived harm. Moreover, financial sector projects are less known to and less understood by affected communities because disclosure provisions required in the financial markets in which IFC operate are less transparent, and the structures and instruments used by IFC to support private sector development through financial intermediaries and other instruments are very complex.

An IEG report in 2006 concluded that IFC's support to MSME's through financial intermediaries was relevant and broadly effective in terms of delivering on development impact. However, in light of increased public scrutiny of the financial sector following the 2008 crisis, there have been a number of external reports and inquiries questioning how IFC's environmental and social standards are applied and monitored in financial sector investments.

The CAO's findings from analyzing its data indicate there is a likelihood of occurrence of similar risks and harm, and possible grievances, as seen in the real sector stemming from the financial sector business activities of IFC. As a result of the difficulties for external parties of bringing these directly to the CAO's attention, these less visible activities are creating an increasing risk for the institution, and might constitute missed opportunities for learning and improving the environmental and social performance of IFC.

In light of the above, the CAO Vice President initiated an appraisal for audit of IFC's financial sector activities. This work is being conducted in accordance with the CAO's mission to enhance the development impact and sustainability of IFC supported business activities by improving social and environmental outcomes of IFC's work, thereby fostering a higher level of accountability.



## *The CAO Appraisal Process*

The CAO elected to focus its appraisal on financial intermediary investments that IFC has made since July 2006, when IFC introduced its new Policy and Performance Standards on Social and Environmental Sustainability.

The CAO found 844 projects that were specifically categorized as FI investments,<sup>2</sup> or were related to investments in financial intermediaries. In addition, these 844 projects had a commitment date between July 2006 and April 2011.

Eighty-one FI projects were listed within the industry departments. Of these, 67 were cross listed with projects listed under the Global Financial Markets (GFM) department. Therefore, the CAO counted these 67 toward the GFM portfolio only, which left 14 FI investments housed within the industry departments, and 830 within the Global Financial Markets (GFM) department.

The CAO reviewed the respective Board Papers of the 830 projects in the GFM portfolio and was able to eliminate 93 projects that were not related to client disbursements; these instead 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, which created a total of 751 projects.

In selecting sample investments, it was the CAO's intent to capture all different types of FI investments in all regions and project sizes.<sup>3</sup> The CAO found that a 10 percent sample would provide a relative composition that reflected the entire IFC FI portfolio in regard to region, size, and type. It was not the CAO's intent to provide a statistically significant representation.

From the remaining 737 projects housed within the GFM department, the CAO therefore selected 74 projects at random. In relation to the 14 financial intermediary investments housed within the industry departments, 13 were categorized as "FI" and one was categorized as "C". From the 13 investments housed within the industry departments, the CAO selected 1 project at random.

In addition, the CAO included the financial intermediary investment categorized as "C"; one investment in a fund managed by IFC's Asset Management Company (AMC); and one investment in the Global Trade Liquidity Program (GTLP), in order to adequately capture IFC's interaction with FIs through these vehicles. As a result of this process, the CAO arrived at a sample selection of 78 projects.

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

- Three projects were not required to apply the Performance Standards, either because they were presented to the Board before the introduction of the Sustainability Framework in April 2006 or funds were committed against a facility that was preapproved before 2006.

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<sup>2</sup> See IFC's *Environmental and Social Review Procedures* at [www.ifc.org](http://www.ifc.org) for details concerning the use of Category A, B, C and FI in the context of due diligence review.

<sup>3</sup> Geographical Regions: East Asia and the Pacific; Europe and Central Asia; Latin America and the Caribbean; Middle East and North Africa; Sub-Saharan Africa; South Asia; World.. Financial Regions: IDA, non-IDA. Size: less than \$5 million; \$5 million–\$50 million; \$50 million–\$150 million; more than \$ 150 million. Type: equity; loan; loan and equity; guarantee; other.. IFC Category: B; C; FI.

- In three cases, projects referred to the same client, and in each case the CAO kept only the most recent investment in the sample.
- Three projects received funding from a specific and separately IFC-funded debt facility; the CAO limited the sample to only one of the three selected.
- The CAO excluded two projects that were no longer active and another because it referred to a former jeopardy case.
- The sample included six projects in the Global Trade Finance Program (GTFP). Due to the similar nature and legal agreements of those investments, the CAO opted to limit the selection to one GTFP project only.

Upon completion of the CAO appraisal selection process, the sample consisted of 63 projects.

### **3. Scope of the Appraisal and Compliance Audit of IFC**

In the context of CAO compliance auditing of IFC, at issue is whether:

- The actual social or environmental outcomes are consistent with or contrary to the desired effect of the policy provisions.
- The failure to address social or environmental issues as part of the review process resulted in outcomes that are contrary to the desired effect of the policy provisions.

In the process of addressing the above, the CAO will seek clarification on three key questions:

- How did IFC determine which environmental and social provisions were applicable to a 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?

As stated in the CAO's Operational Guidelines, in order to assure itself of the implementation of environmental and social provisions, and to verify performance, the CAO will need to visit the field/client.

#### *IFC Standards, Guidelines, and Procedures*

The framework of IFC's due diligence is provided by IFC's Policies on Sustainable Development and by IFC's Performance Standards, in combination with relevant procedures, guidelines, and other conditions for IFC involvement. The Environmental and Social Review Procedures require IFC to review projects against the Performance Standards and good international practice standards as set out in the applicable Environment, Health and Safety (EHS) Guidelines.

In addition, an assessment typically includes a review of the track record, capacity, corporate and project-specific management systems of the client, and business and technical risk and associated risk mitigation measures.

CAO audit criteria, as stated in the CAO's Operational Guidelines, include IFC/MIGA policies, performance standards, guidelines, procedures, and requirements whose violation might lead to

adverse social or environmental consequences. Audit criteria may have their origin in, or arise from, the environmental and social assessments or plans, host country legal and regulatory requirements (including international legal obligations), and the environmental, social, health, or safety provisions of the World Bank Group, IFC/MIGA, or other conditions for IFC/MIGA involvement.

#### 4. Findings of the CAO Appraisal

The CAO finds that:

- There is perceived risk of adverse social and environmental outcomes as a result of IFC's FI investments.
- There is evidence of risk of significant adverse social and environmental outcomes as a result of IFC's FI investments.
- It is not possible to conclude whether there are indications that policy provisions (or other audit criteria) may not have been adhered to or properly applied.
- It is not possible to conclude whether policy provisions, whether or not complied with, have failed to provide an adequate level of protection.
- It is not possible to conclude whether policy provisions, standards, or other audit criteria were not thought to be applicable but perhaps should have been applied.
- There is no evidence that the application of some aspect of a policy, standard, guideline, or procedure resulted in adverse social and environmental outcomes.
- A compliance audit could yield information or findings that might better inform the application of policies (or other audit criteria) to future projects.

#### 5. The CAO Decision

The CAO concludes that this compliance appraisal highlights the need for the CAO to undertake audits of IFC's different financial sector projects to assess whether:

- The actual social or environmental outcomes are consistent with or contrary to the desired effect of the policy provisions.
- The failure to address social or environmental issues as part of the review process resulted in outcomes that are contrary to the desired effect of the policy provisions.

The CAO concludes that this case merits an audit of IFC. In accordance with the CAO's Operational Guidelines, the CAO will develop Terms of Reference based on this determination and thereafter conduct audits of the 63 projects identified to form the sample.

This audit, like other CAO audits of IFC, will focus on IFC, and how IFC assured itself of the environmental and social performance of its investments. The CAO *does not* audit IFC's clients. Consequently, in this audit, the CAO will not present any judgment on the environmental and social performance of IFC's clients.