



AUDIT: MONITORING AND CLOSURE REPORT

CAO Audit of IFC
CAO Compliance

C-I-R9-Y10-F126
June 20, 2013

Monitoring of IFC's Response

to CAO's Audit of IFC's Investments in
Agribusiness in the Ica Valley, Peru

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 CAO

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.

CAO (Office of the Compliance Advisor Ombudsman) is an independent post that reports directly to the President of the World Bank Group. 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).

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1. Summary

Between 1999 and 2006, IFC approved three investments in Corporacion Drokasa, a leading Peruvian agricultural and industrial conglomerate, and its wholly owned subsidiary Agrokasa. The initial investment, in 1999, directly financed Agrokasa's expansion of its agricultural operations in the Ica Valley, south of Lima. The second investment, in 2004, involved refinancing of Corporacion Drokasa. The third investment (the second in Agrokasa), in 2006, expanded asparagus growing operations through the acquisition and upgrading of a farm north of Lima. These investments were appraised under IFC's 1998 Environmental and Social Review Procedures and Safeguard Policies. In 2009, a fourth investment (the third in Agrokasa-Agrokasa III) was circulated for approval by the IFC Board under IFC's streamlined procedures. The project objective specifically was to further develop Agrokasa's operations in the Ica Valley—the first direct IFC investment in the Ica Valley operations since 1999.

The investment was to partly restructure Agrokasa's debt obligations, develop one of the Ica Valley farms, and support "hydraulic improvements" for its other Ica Valley farm intended to provide water where it was most needed and "reduce stress" on the aquifer. The project was described as including an intra-aquifer water pipeline and, if approved by the government, new wells and/or surface water intake(s). This investment was to be the first for this client applying the IFC 2006 Performance Standards. While seeking IFC Board approval, IFC Management became aware of unresolved issues identified during its due diligence, as well as the receipt by CAO of, as yet, unassessed complaints regarding the social and environmental impact of the project. IFC Management decided to withdraw the investment proposal from Board consideration.

Between June 1 and July 16, 2009, several complaints were filed with CAO regarding the impact of Agrokasa's operations on the Ica aquifer. Complainants maintained that Agrokasa's operation, among others, was contributing to overexploitation of the Ica aquifer through a high concentration of wells, drilling of new wells, and/or deepening of existing wells—without appropriate permits and required licenses. A further concern was Agrokasa's construction project to convey water from one farm—where water is more plentiful—to another farm where the wells are no longer so viable, without appropriate consultation with potentially impacted villagers and farmers.

The proposed investment was processed by IFC from September 2008 to June 2009. It was cleared for circulation to the IFC Board via streamlined procedure,¹ with a closing date of June 25, 2009. However, it was taken out of Board circulation by IFC before the closing date, and thus did not move forward to commitment. The focus of the CAO audit was therefore on IFC's process leading up to clearance of the potential investment for Board approval, with the objective of identifying observations, noncompliances, and underlying reasons for possible noncompliance that occurred while IFC processed the potential investment.

¹ Under a streamlined procedure, in the absence of a request by an IFC Board Executive Director for the project to be discussed by the Board, IFC management may proceed with the proposed investment after circulating it to the Board.



CAO finalized its Agrokasa (Ica Valley) audit on February 22, 2011. Key findings are set out in section 2 below. In cases such as this one, where an audit identifies compliance issues, CAO monitors IFC's response until such time as it is assured that IFC is addressing the issues appropriately.

This monitoring report is the second prepared by CAO since completion of the Ica Valley audit. An initial Monitoring Report was prepared and circulated in March 2013 (see Annex B). In May 2013, CAO received additional information from IFC in the form of a Response to CAO's March 2013 Monitoring Report (see Annex A).

IFC's June 2013 Response represents a significantly more detailed answer to CAO's audit findings than had previously been available. On this basis CAO decided it was appropriate to update its March 2013 Monitoring Report.

CAO's Operational Guidelines require CAO to keep an audit open until IFC has addressed any issues of non-compliance identified. Given that CAO's findings on compliance in relation to Agrokasa were limited to issues around the processing of an investment that was not finally approved, no specific response is expected at the project level. In relation to the audit's systemic implications, IFC has outlined changes in its policies and processes which are designed to better address situations such as those described in the audit. These changes, well implemented, should mean that E&S risks are better assessed, earlier in the project cycle. With improved risk assessment - increased due diligence, E&S assessment and consultation requirements would be expected to follow. While anticipating that challenges will remain in implementation, CAO determines that it has sufficient basis to close the audit at this stage.

In preparing this updated report, CAO acknowledges that consultation and exchange of information between CAO and IFC in relation to the findings of the Ica Valley audit during the monitoring process were insufficient. To enhance the effectiveness of compliance monitoring in the future CAO will request (a) a post audit meeting with the team to clarify expectations around monitoring, and (b) a progress report from IFC prior to issuing of a monitoring or close out report.

2. CAO Audit Conclusions

The Agrokasa audit noted that the focus of IFC's technical and financial due diligence on the proposed Agrokasa III investment was on whether the client would be able to repay the loan. By pursuing this investment before an adequate environmental assessment (EA) was prepared and reviewed, CAO found that IFC would have proceeded without taking into account potential negative long-term and wide-ranging development impacts on other more vulnerable users: impacts that could cause economic displacement, impoverishment, and loss of access to potable water. CAO concluded that this course of action was inconsistent with and in violation of commitments made within IFC's Policy on Environmental and Social Sustainability and its role as a development institution.

At the more strategic level, CAO found that IFC did not ensure that water resource issues were adequately and more broadly considered before the potential investment decision. CAO found this to be a possible indication that IFC struggles to align its



strategic involvement in these issues with its investment practices. CAO concluded that IFC should assess how it applies its strategic understanding of sustainability issues at the investment level.

The basis for IFC's B categorization of the project was heavily predicated on the production of an adequate EA and its disclosure. CAO found that the initial categorization of the project as B by IFC's Environmental and Social department (CES) was supportable, but this was heavily dependent upon the production of an adequate EA addressing the key issues identified, particularly the sustainable use of water resources.

CAO found that the issue of overexploitation of the Ica aquifer and the extent of local concern was well known to IFC throughout its due diligence. Substantive concerns were raised internally and the Environmental and Social Review Summary (ESRS) documented potential noncompliances with multiple Performance Standards. Nonetheless, CAO found that IFC proposed to seek Board approval in this sensitive situation without an appropriate EA — and therefore without appropriate information disclosure and consultation with potentially affected parties. Without an underlying baseline assessment and understanding of the scale of aquifer depletion that would be provided by an EA, CAO found that information disclosure and consultations were rendered inadequate with respect to this central issue. This was crucial because, by the time the EA would have been completed and available for consultation with affected parties, the project would have been constructed. CAO found IFC's course of action to be inconsistent with Performance Standards 1, 4, 5, and 6 and the Disclosure Policy. CAO also found that the failure to require an EA early in the process prevented a proper discussion and analysis of alternative strategies for the client from taking place.

CAO found that the final Board Paper did not correctly reflect the outcome of IFC's due diligence in that it did not adequately represent the water issues discussed and the sensitivity. CAO therefore concluded that in this regard, the Board paper was incorrect.

CAO found that the scope and quality of environmental and social (E&S) due diligence undertaken by CES was appropriate to the level of risk identified, but that against a backdrop of community objection, commercial pressure to expedite the project, and an absence of effective support by CES Management, the E&S specialists' professional advice was overruled.

CAO found that no clear mechanism or process seemed to exist to reconcile professional differences, and/or bring them to a final conclusion. IFC management did not play its role in seeking ways to broker agreement and consensus within the project team to establish the position to be adopted. CAO concluded that the IFC strategy and procedures for developing and maintaining client relationships were unclear.

CAO found that CES staff were clear in their recommendations regarding the investment. In the face of resistance from the IFC's agribusiness department (CAG) and commercial pressure to move ahead with funding of an existing client, CAO found that CES Management were complicit in sidelining specialist(s) assigned to the investment who intensified their concern about the sustainability of the situation in the Ica Valley and had pointed out inconsistencies in the apparent permitting of water extractions. The



concerns of CES specialists relating to the environmental and social impacts of groundwater extraction in the Ica Valley were not reconciled by consecutive layers of IFC Management through engagement with the project team. The resulting capitulation on the requirement for an EA in advance of taking the project to the Board exposed IFC to increased risk and was inconsistent with IFC's procedural and disclosure requirements. CAG staff assured CAO that commercial pressure was not applied to ensure inclusion of the commitment within the 2008/09 program. However, CAO has reviewed documentation showing clear pressure, culminating in a request from CAG to move the requirements in the environmental and social action plan (ESAP) to a condition of disbursement rather than a condition of commitment.

CAO concluded that CES Management did not play an effective role in supporting the professional judgment of CES specialists, in protecting the broader interests of the IFC in applying its standards, and in protecting the interest of weaker parties in the emerging water conflict over scarce water resources in the Ica Valley. This, in combination with mismanaged client communications, produced an incoherent IFC approach, undermining and fragmenting IFC's position. The consequence was that the issues became external, IFC lost control over the process, and IFC damaged a client relationship.

CAO concluded that due to the lack of clarity and transparency around IFC's internal processing, the potential investment was circulated for Board streamlined approval with identified risks left unattended. The management processes within IFC did not work to resolve the fundamental conflict between the incentives within CES and CAG, and failed because the process of upward consultation within IFC Management was inadequate.

CAO concluded that IFC lacked an effective risk management process to ensure that different points of view of the project team were properly aired and either resolved or followed a process for proper disposition and conclusion before Board presentation.

3. IFC's Response as of June 2013

July 2011 Response

IFC states in its official response to the CAO audit dated July 6, 2011 that it agrees with CAO's recommendation that IFC should adopt a more strategic approach to sustainability issues when evaluating projects in environmentally and socially sensitive contexts and outlines changes that have been made to improve the integration of E&S concerns into its decision making. IFC also agreed with CAO's finding that its internal decision making and documentation, including the Board Paper should have reflected a more strategic assessment of the project context.

IFC, however, notes that its Sustainability Framework is not prescriptive in relation to whether a client needs to commission a formal EA, with "what information is required at what stage" requiring a judgment call. In the circumstances of the Agrokasa investment IFC asserts that its decision making was reasonable, particularly given that the company had been an established water user for many years, and that the requirement of an EA was adequately integrated into the client's ESAP.

Further, IFC takes issue with CAO's finding that the due diligence process was compromised due either to commercial pressures or by disregarding concerns that were raised by relevant professionals. At the same time, IFC recognizes that professional differences of opinion should have been addressed more promptly and effectively, possibly avoiding the deterioration of team and client relations that ensued.

June 2013 Response

In June 2013 IFC provided CAO with an updated and consolidated articulation of improvements in both policy and procedures addressing the findings of the CAO Agrokasa audit (see Annex A).

This document provides an update on new policies, procedures and practices that have been adopted to ensure that potentially significant environment and social risks are adequately understood before projects are presented to the Board. While the question of whether a full EA will be required prior to approval necessarily remains a matter of discretion, IFC identifies a number of measures that have been implemented to ensure that E&S risk is appropriately identified and assessed early in the project cycle. These include: (a) new guidelines which require IFC to consider sector and context risks when assigning a risk category to projects whose E&S footprint is not fully specified at the time of appraisal; (b) new risk screening tools which guide the assessment of country and sector risks; and (c) regularly commissioned country and sector risk reports. More specifically in relation to water use, IFC notes changes in the Performance Standards which focus on resource efficiency and require that a "project's water consumption does not have significant adverse impacts on others" (PS3).

With these changes in place IFC confirmed to CAO that, if a situation similar to the one encountered in the Agrokasa audit were to arise today, it would lead to a higher assessment of E&S risk, and thus increased due diligence and E&S assessment requirements prior to approval of a new IFC investment.

IFC's June 2013 response also responds to CAO's concerns regarding the extent to which (a) differing opinions around E&S issues are reconciled constructively, and (b) E&S staff are supported in voicing their professional judgment in contentious contexts. On these topics IFC recognizes that in certain projects and at certain times, the demands of E&S due diligence and a desire to process a transaction may generate tensions. As methods to manage such tensions, IFC points to the use of Peer Review Meetings (PRM) "as a forum for CES staff to discuss and agree upon significant E&S issues and mitigation measures associated with a proposed investment." In addition, the response highlights "existing steps in the investment review and processing process which require input and sign-off by the relevant CES specialist ... and act as a catalyst for escalation in cases where there is a lack of consensus within the investment team." Beyond issues of procedure, the IFC response acknowledges that a culture of mutual respect needs to be promoted and that this may have been problematic in the Agrokasa case. At the same time, the IFC response points out what is perceived as a "generally positive and constructive relationship amongst staff."

While noting the changes in procedures outlined above, CAO's ongoing caseload suggests that the exercise of discretion in determining the extent and depth of E&S

assessment that is required at a given stage of project development will remain a point of contention in some investments. Further, CAO's experience suggests that the development of an organizational culture in which E&S concerns are appropriately voiced at key decision points, will require ongoing attention. Progress in relation to both of these areas will be revisited as relevant in CAO's ongoing compliance work.

4. CAO Monitoring Conclusion

CAO came to strong conclusions in its audit report about IFC's processing of the Agrokasa investment, and violations of policy provisions. In relation to the processing of the Agrokasa investment, IFC has chosen to disagree with CAO's audit findings, stating that it stands behind key judgments and decisions made. On the other hand IFC points out that it has, since 2009, made significant changes to its policies, standards and procedures related to the assessment of E&S risks.

CAO's Operational Guidelines require CAO to keep an audit open until IFC has addressed any issues of non-compliance identified. Given that CAO's findings on compliance in relation to Agrokasa were limited to issues around the processing of an investment that was not finally approved, no specific response is expected at the project level. In relation to the audit's systemic implications, IFC has outlined changes in its policies and processes which are designed to better address situations such as those described in the audit. These changes, well implemented, should mean that E&S risks are better assessed, earlier in the project cycle. With improved risk assessment - increased due diligence, E&S assessment and consultation requirements would be expected to follow. While anticipating that challenges will remain in implementation, CAO determines that it has sufficient basis to close the audit at this stage.

Annex A

June 10, 2013

IFC Management Response to CAO Monitoring Report on Agrokasa

IFC Management finds the CAO Monitoring Report of March 28, 2013 to be a restatement of the February, 2011 Agrokasa audit findings. As such, the Monitoring Report fails to take into account the many improvements identified below and is at odds with IFC's current operating environment. Further, as indicated in the July 2011 Management Response to the audit, IFC disagrees with some key audit findings, most particularly those relating to timing of release of the environmental assessment (EA) and managerial interventions during processing of the investment. IFC's Sustainability Policy and Procedures make clear that the timing of EA release (and related supporting documentation) is a discretionary judgment, based on project-specific circumstances and the level of information available at the time of IFC's due diligence. Additionally, the reference in the Monitoring Report to a breakdown in management decision-making remains unsubstantiated by the facts. In particular, a very clear decision was made that an EA, satisfactory to IFC, would be required before investment commitment. Most importantly, throughout the intervening years since Agrokasa was processed, IFC has continued to strengthen its approach to environmental and social assessment and decision-making. Management appreciates CAO's ongoing contribution to this continuous improvement process.

IFC has made a number of enhancements, both in policy and procedure, which address the CAO's audit findings related to IFC's proposed investment in Agrokasa. The Agrokasa investment was appraised during 2008/9 under the 2006 Performance Standards and Disclosure Policy. Since the processing of Agrokasa, IFC's approach to identifying and addressing the environmental and social dimensions of its investments in the agri-business sector has been considerably strengthened. In addition, there were a number of specific revisions to IFC's Sustainability Framework (came into effect 1/1/ 2012) which are directly relevant to the CAO's Agrokasa audit findings. There are also improvements in early risk screening identification at the country/sector level that are now in effect, and a more dedicated effort to explicitly coordinate with the World Bank on sector reform related to natural resources governance, including land and water. These enhancements, along with existing procedural checks and balances (see annex), collectively, reflect a major strengthening of IFCs approach to the key issues identified in the CAO audit.

1. CAO Clarification Requested: an update on any new policies, procedures or practices that have been adopted to ensure that potentially significant environment and social risks are adequately understood before projects are presented to the Board.

IFC is required to present new investment proposals to Board along with an appropriate analysis of environmental and social risks. An Environmental and Social Action Plan (ESAP) delineating mitigation actions to be taken by the client to address environmental and social issues, including, when relevant, completion, and disclosure of the Environment and Social Impact Assessment (ESIA) must be available to the Board. In the Agrokasa case, IFC accepts the CAO finding that the Board Paper should have had a more detailed account of the importance of and issues to be covered by the environmental assessment (EA) and this is a lesson that has been learned for future transactions.

A number of changes in IFC's Performance Standards and Access to Information Policy (AIP), outlined below, improve early risk assessment that informs IFC's environmental and social engagement with the client as well as decision-making as well as overall transparency.

Relevant Access to Information Policy Improvements:

- a) **Post-Board Disclosure.** IFC's new AIP allows for the disclosure of assessment documents post-Board. This improvement was made in light of the fact that IFC invests in projects at varying stages of development or where the use of proceeds may not be known at the time of Board approval (such as in the case of corporate finance). **Now, when risks become**

- known after Board approval, IFC may also disclose the relevant assessment documents, as well as any new or revised ESAPs.
- b) ESAP Updates. In addition, IFC will disclose the status of implementation of the ESAP' action items agreed upon by the client.
 - c) BCS Disclosure. IFC now discloses to the Board, where applicable, more detailed information about IFC's own determination of Broad Community Support (BCS).

Relevant Performance Standard Improvements:

- d) Focus on Resource Efficiency. The revised Performance Standards (PS) put a new and broader focus on resource efficiency (including water use). In cases where a prospective client is a significant consumer of water, PS3 now requires that "the client shall adopt measures that avoid or reduce water usage so that the project's water consumption does not have significant adverse impacts on others."
- e) Revised Categorization. The revised Sustainability Policy has changed the approach to categorization to include inherent sector risks, such as significant use of water resources, in addition to direct impacts within the project footprint.
- f) Improved Requirements for Stakeholder Engagement. PS1 has clarified requirements for stakeholder analysis and attention to different stakeholder groups' views and concerns. This includes more attention to differentiated needs based on aspects such as age, gender, poverty, or vulnerability.

Relevant Early Risk Detection Improvements:

- g) Enhanced Early Risk-Screening Tools. Newly developed early risk screening assessment tools, including an accompanying matrix to assess country/sector risks against numerous criteria, such as legal and regulatory framework, natural resource governance, labor, infrastructure, IFC policy, etc. have now been deployed.

This substantially expands and formalizes early E&S risk assessment procedures at the country, commodity, sector and project levels. These tools are collectively intended to promote early, pro-active and systematic consideration of key country, sector and commodity-level constraints to achieving the developmental, environmental and social performance outcomes of a prospective IFC investment. The structure of the country/sector risk assessment report generated has been designed in order to ensure alignment with IFC Performance Standards requirements. To date, more than 12 countries/sectors risk assessment have been conducted.

- h) In September 2012, IFC Management approved a series of recommendations pertaining to prospective new land-intensive agricultural investments. These were developed based on a comparative analysis between the Responsible Agricultural Investment (RAI) principles and IFC's Performance Standards. As a result, IFC now requires a baseline assessment of project impact on food security in food insecure locations, public disclosure of key terms and conditions of concession/lease agreements in cases of government to private transfers of land; and provides for added emphasis on protection of customary rights and consultation with those currently living on and/or using the land in question. This review is additional to the usual Performance Standard requirements' and due diligence process.
- i) Third-party Research and Expertise. IFC now regularly commissions "Maplecroft", a UK based risk assessment consultancy firm, to undertake country/sector risk reports to identify key E&S risks and map key stakeholders associated with the agricultural sector in which IFC is considering an investment.
- j) Global Risk Mapping. A new Global Map of E&S risks in agricultural commodity production (GMAP) has been developed and is under pilot use with 15 Equator Principles Financial Institutions. Using a methodology aligned to IFC's PSs, especially supply chain related requirements, the GMAP facilitates decision making by assigning color-code risk scores to each country/commodity combination. The risk score helps users conduct systematic, high-level E&S due diligence associated with agro-commodity trade finance. In cases of "red" combinations, further due diligence is required to document and assess a portfolio client's risk assessment and management approach.

- k) Water Footprint Tool. A water footprint methodology (tool) has been developed to benchmark water usage, particularly in water-stressed regions, to gain an early understanding of the scope for conservation measures and related solutions which can protect water users and communities.
- l) Country Situation Analyses (CSAs). CSA reports, an outcome of IFC's revised Palm Oil Strategy, have been and are being developed for several countries. Although initially prompted by prospective palm oil investments, they are proving to be of equal value in gaining an early understanding of risks relevant to other land intensive agro-commodities.

2. CAO clarification requested: an update on any new policies, procedures or practices that have been adopted to ensure that: (a) differing opinions around E&S issues are reconciled constructively, and (b) that E&S staff are supported in voicing their professional judgment in contentious contexts. Noting that similar tensions continue to play out in our current case load, CAO requests information on how IFC is monitoring the effectiveness of measures taken to address these management issues.

We agree with CAO that it is important to have procedures and practices within IFC to ensure that differences of professional opinion can be quickly resolved. Typically, this is handled at the Manager-level, but occasionally may need to be escalated to Director or above. It is important to note the use of Peer Review Meetings (PRM) which is described in the E&S Review Procedures, as a forum for CES staff to discuss and agree upon significant E&S issues and mitigation measures associated with a proposed investment. In addition, existing steps in the investment review and processing process which require input and sign-off by the relevant CES specialist continue to afford consideration of E&S issues and act as a catalyst for escalation in cases where there is a lack of consensus within the investment team.

Further, although procedure is very important in this regard, it is also vital that a culture of mutual respect is promoted. It is understood that this dimension may have been problematic in the Agrokasa case. However, the level of disputes between staff on E&S issues overall is very low and we believe that this reflects a generally positive and constructive relationship amongst staff. Examples of how practices are evolving to reinforce the probability of achieving common understandings amongst investment teams and minimizing conflict include:

Relevant Institutional Practices and Improvements:

- a) Training. Following the approval of the Sustainability Framework, CES has trained around 1,000 IFC operational staff. This training includes role playing on how to work together as an effective team and the importance of elevating issues promptly in cases of differences of opinion with investment staff to resolve differences as early as possible and avoid 'personalizing' a problem. Awareness has been raised and new training programs have also been rolled out for agriculture and financial markets investment staff, regarding early risk screening assessment tools, GMAP and the strengthened Performance Standards. This reinforces a "One IFC" initiative.
- b) More frequent Pre-appraisals of Projects. Joint investment and CES staff teams now routinely undertake more pre-appraisals for prospective higher risk agriculture and forestry investments to inform early stage decision-making. See also Annex One.
- c) More Formal Decision-Making Process. E&S specialists must provide their written input to the PDS-Concept, COC memorandum, IRM book, Board Report, in addition to the ESRS/ESAP, which is agreed upon with the client. The PDS-IR must be cleared by the relevant E&S specialist. CRM and IRM meetings must include CES staff and interventions for relevant projects. These are documented in the minutes.
- d) Accountability. Investment Directors are now more highly sensitized and are accountable for E&S policy implementation at time of internal investment approval. The CES Director has a seat on the COC and is empowered to raise differences of opinion to the Vice Presidential/COC level. There is also quarterly reporting by CES to the Corporate Risk Committee which provides yet another avenue for issues to be brought to senior management attention.
- e) Expertise. CES has re-designed the role of specialist "sector leads", emphasizing quality and knowledge sharing. These sector leads (ex. agriculture/forestry), possess particular industry

expertise and are thus in a strong position to facilitate/leverage interventions with peers and investment staff.

Annex One

Figure 1: Early Risk Assessment Risk Factors for Tiering

Tier I (Manager) <i>All of the Below Should be True to be Tier I</i>	Tier II (Director) <i>All of the Below Should be True to be Tier II</i>	Tier III (ROC) <i>If Any of the Below are True, the Project Should be Reviewed by ROC**</i>	Tier III (COC) <i>If Any of the Below are True, the Project Should be Reviewed by COC**</i>
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REPUTATIONAL AND OTHER RISKS

Environment and Social Risks

Projects with minimal or no adverse risks or impacts involving the areas addressed by the Performance Standards.

Projects where there are potential but limited adverse social and environmental impacts that are few in number, largely reversible, and readily mitigated.

Projects which may have significant adverse E&S impacts that are diverse, irreversible, or unprecedented, and likely could not be mitigated for a relatively long period of time because of *inherent risks common in the sector*, and which do not present unique high risk situations that would be precedent setting in terms of IFC's approach to E&S risk management.

Projects which may have significant adverse E&S impacts that are diverse, irreversible, or unprecedented, and likely could not be mitigated for a relatively long period of time; AND with 'extra-ordinary' risks or that present unique high risk situations that would be precedent setting in terms of IFC's approach to E&S risk management.

Annex B



MONITORING REPORT

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1. Background

The 2010 CAO compliance audit focused on IFC's potential investment in an agribusiness project in the Ica Valley in Peru. The proposed investment was processed by IFC from September 2008 to June 2009. It was cleared for circulation to the IFC Board via streamlined procedure,¹ with a closing date of June 25, 2009. However, it was taken out of Board circulation by IFC before the closing date, and was not approved by the IFC Board. The focus of the CAO audit was therefore on IFC's process leading up to clearance of the potential investment for Board approval, with the objective of identifying observations, noncompliances, and underlying reasons for possible noncompliance that occurred while IFC processed the potential investment.

2. CAO Audit Conclusions

The focus of IFC's technical and financial due diligence on the proposed Agrokasa III investment and its credit review requirements was on whether the client would be able to repay the loan. Within this aspect of the due diligence, IFC's technical and financial specialists considered the water issue only in the context of credit risk. By pursuing this investment before an adequate environmental assessment (EA) was prepared and reviewed, IFC would have proceeded without taking into account potential negative long-term and wide-ranging development impacts on other more vulnerable users: impacts that could cause economic displacement, impoverishment, and loss of access to potable water. The CAO concluded that this course of action would have been inconsistent with and in violation of commitments made within IFC's Policy on Environmental and Social Sustainability and its role as a development institution.

At the more strategic level, IFC did not ensure that water resource issues were adequately and more broadly considered before the potential investment decision. The CAO found this to be a possible indication that IFC struggles to align its strategic involvement in these issues with its investment practices. The CAO concluded that IFC should assess how it applies its strategic understanding of sustainability issues at the investment level.

The basis for IFC's B categorization of the project was heavily predicated on the production of an adequate Environmental Assessment (EA) and its disclosure. The CAO found that the initial categorization of the project as B by IFC's Environmental and Social department (CES) was supportable, but this was heavily dependent upon the production of an adequate EA addressing the key issues identified, particularly the sustainable use of water resources.

The CAO found that the issue of overexploitation of the Ica aquifer and the extent of local concern was well known to IFC throughout its due diligence. Substantive concerns were raised internally and the Environmental and Social Review Summary (ESRS)

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documented potential noncompliances with multiple Performance Standards. Nonetheless, IFC proposed to seek Board approval in this sensitive situation without an appropriate EA — and therefore without appropriate information disclosure and consultation with potentially affected parties. Without an underlying baseline assessment and understanding of the scale of aquifer depletion that would be provided by an EA, information disclosure and consultations were without context and essentially meaningless with respect to the impact on aquifer depletion. The CAO found IFC's course of action to be inconsistent with Performance Standards 1, 4, 5, and 6. The CAO also found that the failure to require an EA early in the process prevented a proper discussion and analysis of alternative strategies for the client from taking place.

The overall effect of not requiring an EA rendered the consultation process an effectively meaningless exercise in the context of the part of the project referred to as “hydraulic improvements” because by the time the EA would be completed and available for consultation with affected parties, the project would have been constructed. The CAO found IFC's approach to require the Environmental Assessment for the project and its disclosure as a condition of commitment for the project to be inconsistent with the IFC's Policy on Disclosure of Information. The CAO therefore concluded that in this regard, IFC violated its own Disclosure Policy.

The CAO found that the final Board paper did not correctly reflect the outcome of IFC's due diligence in that it did not adequately represent the water issues discussed and the sensitivity. The CAO therefore concluded that in this regard, the Board paper was incorrect.

The CAO found that the scope and quality of environmental and social (E&S) due diligence undertaken by CES was appropriate to the level of risk identified, but that against a backdrop of community objection, commercial pressure to expedite the project, and an absence of effective support by CES management, the specialists' professional advice was overruled.

The CAO also found that no clear mechanism or process seemed to exist to reconcile professional differences, and/or bring them to a final conclusion. IFC management did not play its role in seeking ways to broker agreement and consensus within the project team to establish the position to be adopted. The CAO also concluded that the IFC strategy and procedures for developing and maintaining client relationships were unclear.

CES review staff were clear in their recommendations regarding the investment. In the face of resistance from the IFC's agribusiness department (CAG) and commercial pressure to move ahead with funding of an existing client, CES management were complicit in sidelining specialist(s) assigned to the investment who intensified their concern about the sustainability of the situation in Ica and had pointed out inconsistencies in the apparent permitting of water extractions. The concerns of CES specialists relating to the environmental and social impacts of groundwater extraction in the Ica Valley were not reconciled by consecutive layers of IFC management through engagement with the project team. The resulting capitulation on the requirement for an EA in advance of taking the project to the Board exposed IFC to increased risk and was

inconsistent with IFC's procedural and disclosure requirements. CAG staff assured the CAO that commercial pressure was not applied to seek to ensure inclusion of the commitment within the 2008/09 program. However, the CAO has reviewed documentation showing clear pressure, culminating in a request from CAG to move the requirements in the environmental and social action plan (ESAP) to a condition of disbursement rather than a condition of commitment.

The CAO concluded that CES management did not play an effective role in supporting the professional judgment of CES specialists, in protecting the broader interests of the IFC in applying its standards, and in protecting the interest of weaker parties in the emerging water conflict over scarce water resources in the Ica Valley. This, in combination with mismanaged client communications, produced an incoherent IFC approach, undermining and fragmenting IFC's position. The consequence was that the issues became external, IFC lost control over the process, and IFC damaged a client relationship.

The CAO concluded that due to the lack of clarity and transparency around IFC's internal processing, the potential investment was circulated for Board streamlined approval with identified risks left unattended. The management processes within IFC did not work to resolve the fundamental conflict between the incentives within CES and CAG, and failed because the process of upward consultation within IFC management was inadequate.

The CAO concluded that IFC lacked an effective risk management process to ensure that different points of view of the project team were properly aired and either resolved or followed a process for proper disposition and conclusion before Board presentation.

The CAO also concluded that it is not evident that IFC at any time proactively identified or acted on the risk that a conflict that was mainly internal could have consequences for its client relationship.

3. IFC's Response as March 2013

IFC states in its official response dated July 6, 2011 that it stands behind the judgment made by its managers, and explicitly states IFC is satisfied by how the organization handled the process. IFC also explicitly states that it strongly differs from CAO in that in its opinion, no undue commercial pressure was exercised, and that there was no disregard of concerns raised by "relevant professionals."

IFC further argues that taking an investment decision and publicly announcing it without an adequate environmental impact assessment is in line with both the procedural requirements, as well as the intent behind IFC's policies and processes. IFC also argues that this approach has no material effect on IFC's assessment of meaningful consultations around project impacts with potentially impacted people.

IFC explicitly expresses that it differs in opinion from the CAO in relation to the findings central to how IFC processed the Agrokasa investment. The CAO can only interpret this



as IFC being generally satisfied with the way the organization processed the AgroKasa investment.

4. CAO Monitoring Conclusion

The CAO came to strong conclusions in its audit report about IFC's processing of the AgroKasa investment, and violations of policy provisions. IFC has chosen to disagree with the CAO regarding these conclusions by stating that it stands behind all judgments and decisions made. The CAO has observed no movement or change in position from IFC during the almost two years that have passed since the CAO finalized its audit.

CAO has provided information and clarifications concerning its findings to IFC's senior management, IFC's internal review processes, and to relevant departments within IFC. CAO's monitoring and evaluation system has provided feedback that any systemic change in IFC's approach is unlikely if IFC does not acknowledge and address the shortcomings identified in a managerial context.

The CAO at this point has exhausted its leverage and can only conclude that in this audit it has failed in inducing systemic change, and uptake of its findings and conclusions, and subsequent potential improvement of the environmental and social performance of IFC.

The CAO Operational Guidelines prohibits CAO from closing any audit until satisfied that IFC will move back into compliance. This audit will therefore remain open.