

March 9, 2017

**IFC Response to “Third Monitoring Report of IFC’s Response to:  
CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries”**

IFC would like to thank CAO for the monitoring report and for the opportunity to provide feedback, both during the initial discussions between CAO and IFC and through this written response. IFC is committed to address relevant findings from the CAO monitoring report and constantly strives to improve its practices with regards to Environmental and Social (E&S) risk management by its Financial Institution (FI) clients.

In particular, we are working on the following actions to improve our performance and the assistance we give to clients: (i) assessment of country specific/contextual risk; (ii) development of more tailored and detailed E&S Action Plans (ESAPs) through intensive coaching of E&S Specialists working on FI investments and ongoing reviews of practices applied; (iii) intensive client engagement plans where IFC provides additional support to high risk and low capacity clients; (iv) continuous improvement of E&S assessment and supervision tools and training of IFC’s E&S Specialists and investment staff; (v) continued, intensive focus on working with clients on the development of External Communication Mechanisms; and (vi) enhancing consistency of appraisal and supervision work on this particular topic.

Specifically regarding the report, IFC welcomes CAO’s acknowledgment of the significant improvements that IFC has made over the last few years in this space, and shares the view that such performance can continue to be strengthened.

However, IFC disagrees with many of the observations in the report, which are not informed by IFC’s Board-approved Policy or procedural requirements regarding FI investments, but rather are CAO’s views, and are not supported by market practice. In addition, the conclusions presented in this monitoring report do not give an accurate view of IFC’s performance regarding its broader FI portfolio.

IFC also notes that many of the factual corrections provided to CAO staff during the feedback process for the draft monitoring report were ignored in this final report. We would particularly like to note the following:

- (i) Representativeness and accuracy: Given the small sample size, the selected projects are not representative, and statistics and conclusions based on this sample should have been appropriately caveated. While this fact is briefly acknowledged early in the report, statistics regarding the level of compliance in the five areas assessed are presented as “key takeaways” and create the perception that the findings pertain to the entire FI portfolio.

More importantly, CAO’s low assessment of IFC’s work quality is also not corroborated by independent findings of the Independent Evaluation Group (IEG). For example, based on internal IEG evaluations of IFC’s work, IFC’s work quality and E&S role and contribution had a success rate of 87% or higher at appraisal, and 89% or higher at supervision for FI projects over the last four years—the same period evaluated by the CAO.

- (ii) Correct benchmarks: Many of the observations in the report are not consistent with existing IFC policies and procedures. For example, our procedures do not require sub-project disclosure by banks.
- (iii) We provide further comments in the annex below regarding each conclusion in the report where IFC's requirements are mischaracterized or misrepresented.
- (iv) Actionable conclusions: The report lacks specific proposals to enable a constructive conversation about possible actions IFC could take to address key concerns.

IFC recognizes that striving for continuous improvement of our practices is the correct outcome of the compliance audit function CAO performs, but we dispute many of the conclusions drawn in this monitoring report. We would like to continue to engage with CAO to ensure that IFC's policies and procedures are more accurately reflected in future compliance reports.

## ANNEX: Feedback on Report Methodology and Presentation of Findings

The assessments undertaken and findings presented are partly based on inaccurate benchmarks. CAO states that: *“In reviewing each project, CAO assessed IFC’s Performance in relation to the five areas above. These reviews were conducted in accordance with the requirements of the 2012 Sustainability Framework and Environmental and Social Review Procedures (ESRPs).”* However, several aspects of the report either do not take into account existing procedures as codified in ESRP 2014, or are not related to/based on the 2012 Sustainability Framework approved by the Board. Rather, many conclusions are based on CAO’s own views and not Board-approved IFC policy or procedural requirements. For example, IFC’s non private equity (PE) Fund clients are not required to disclose sub-projects. The evolving voluntary practice of some of the Equator Principles institutions should not be used in the context of a compliance audit to assess IFC’s current appraisal and supervision work.

### a) IFC Pre-Investment E&S Review: E&S Appraisal

**Appraisal Quality Ratings.** The report concludes that, for the investments reviewed, IFC’s appraisal was in general not commensurate to the risk, due to lack of analysis of the portfolio risks, country specific E&S risks, current E&S practices including of the ESMS and capacity, or insufficient analysis of prior E&S performance. As IFC was not provided details on which specific aspects CAO found to be missing for each of the projects reviewed, or any suggestions on what could have been improved, we therefore have no basis to understand the rationale behind CAO’s conclusions.

All E&S appraisal findings are reviewed and approved by the relevant Sector Leaders who ensure that the assessments are commensurate with the risk and in line with the requirements set forth in the ESRP and Sustainability Framework. The ESRP includes details on key appraisal aspects, and IFC has developed detailed auditable criteria against which each client is being assessed.

In addition, several criteria such as commitment and country-specific risks were only included (as IFC previously outlined in its FI Action Plan updates) in 2014 and would hence not be available for projects appraised prior to those changes. IFC has already been working to strengthen these aspects. For example, review of country/contextual risks was first introduced for FI projects in 2014 and only now in 2017 for direct investments. More guidance has already been developed to support E&S Specialists on this appraisal aspect, and, together with coaching for individual Specialists, this is expected to improve the quality of assessments and consistency across the team.

The report states that some positive developments were noted in the performance of individual investments, but were not systematically implemented. These include, for example, IFC staff conducting E&S appraisal visits to FI sub-projects prior to IFC’s investment, use of peer review meetings to consider all potentially significant E&S risks, and using E&S Management System (ESMS) Diagnostic Services as part of the appraisal process. *IFC would like to note that not all of these tools are appropriate for every investment.* For example, during appraisal, sub-project site visits are and can only be conducted for PE Fund investments where IFC is participating in a 2<sup>nd</sup> or later closing of the Fund. For these Funds, IFC already systematically reviews all existing investments either through desk review or site visits. Also, sub-project visits for non PE fund clients can only be made after IFC’s investment. Peer review meetings are meant to support decision making in projects with complex or new E&S issues, and are not needed for all high risk projects (as these go through more formal internal reviews). The use of ESMS Diagnostic Services was developed

and pilot tested over the last three years with the aim to apply selectively to clients who need more hands on service. IFC's appraisals already cover all aspects reviewed during the diagnostic.

**PS Threshold Exceptions.** In several areas of the report CAO identifies “unsatisfactory practices” with regard to IFC’s application of the Performance Standards: e.g., “...CAO has also noted that IFC’s updated procedures narrow the application of the Performance Standards (PS) as approved by the IFC Board” and “Of particular concern, CAO notes a number of instances where IFC agreed to restrictions in the application of the PS that are not provided for in the Sustainability Policy. In one case, IFC agreed that an FI client need only make “commercially reasonable efforts” to apply the PS to its borrowers. In others, IFC agreed that the FI need only apply the PS to borrowers where individually negotiated loan threshold size, purpose, and tenor requirements were met.”

These statements are misleading in that IFC has neither narrowed the application of the PSs nor set thresholds for specific projects/clients without prior Management and/or Board approval. The PS threshold approach, included in the ESRP, was discussed with the Board in 2014. It further specifies the notion of “higher risk business activities” included in the Sustainability Policy and originally defined in the 2012 Interpretation Note for FIs. The ESRP in fact expands that definition to include all long-term corporate and project finance activities, which are the types of finance for which the PSs were designed. In addition, the thresholds to determine corporate and project finance go well beyond the existing market practices of comparable institutions, such as the Equator Principles institutions and other Development Finance Institutions (DFIs). Although we are continually seeking to improve the quality and consistency of these practices, IFC is of the opinion that the accurate identification and documentation of proposed exceptions in Management and Board papers has significantly improved.

**MSME Definition.** In Annex D of the Monitoring Report, CAO compares the micro, small, and medium enterprises (MSME) definitions used in three MSME investments in the sample to IFC’s official MSME definition. In two of the cases, “FI Investment One” and “FI Investment Two” the definition used by IFC’s legal agreements is broader than the official definition. This is a purposely selected sample within the sample selected by CAO, which does not illustrate the overall adherence of the sampled IFC FI investments to the MSME definition, and certainly cannot be generalized to IFC’s overall FI SME business. In this context it is important to note that following IEG’s report titled “The Big Business of Small Enterprises: Evaluation of the World Bank Group Experience with Targeted Support to SME,” IFC management committed to several actions related to the tracking and reporting of IFC’s FI-SME business, including strengthening the SME definition in board papers and legal documents as well as the methodology for flagging SME investments. In its most recent rating of IFC, IEG has rated the progress on the recommendation encompassing these actions as “substantial.” IFC will continue to focus on ensuring that SME investments are flagged accurately, and use IFC’s standard definition of SMEs.

## **b) IFC Pre-Investment Review: Mitigation Measures**

CAO’s analysis of mitigation measures implies that ESAPs included in Summaries of Investment Information (SIIs) and legal agreements must define every step to be taken by clients to successfully implement appropriate E&S risk management practices. The ESRP and Access to Information Policy (AIP) only require inclusion of key milestones/mitigation measures to be agreed upon with clients. Where appropriate, IFC requires its clients to develop and provide for IFC’s review detailed ESMS development and roll-out plans as well as training plans. These entail very detailed, step-by-step action items. This approach is in line with IFCs’ policies and procedures as IFC does identify all actions that need to be taken,

while only including key milestones into ESAPs disclosed to the public. IFC agrees, however, that by adding steps identified in detailed ESMS roll-out/training plans or in appraisal assessments in general, the depth of ESAPs can be enhanced, particularly for FI-1 and FI-2 clients that apply the Performance Standards. IFC does not believe more detailed ESAPs for lower risk clients are necessary.

IFC would also like to note that as part of its enhanced supervision and capacity building efforts for clients, detailed Engagement Plans for approximately 40 of its higher risk portfolio clients have already been developed and are being discussed with clients. IFC will provide intensive support to these clients and the analysis of implementation support needed is reflected in these engagement plans.

The report also found that costed analysis of the impact of developing a PS-compliant ESMS and implementation support needed is typically lacking. There is no requirement for IFC to cost ESMS development, and clients are themselves better positioned to estimate these.

As indicated above, in various sections of the report CAO criticizes IFC's application of the PS threshold. It appears that several projects have been inaccurately rated non-compliant on both the "appraisal assessment" as well as "mitigation measures" criteria due to perceived incorrect application of PS threshold criteria.

The report also states that "...CAO also notes instances where IFC agreed to the inclusion of thresholds for MSME financing that were more expansive than IFC's standard thresholds for MSME financing (see Annex D). These investments did not require the application of the Performance Standards. An assessment to support non-application of the Performance Standards to larger than usual investments in these instances was absent." This is highly misleading as the criteria for applying the Performance Standards is clear and was not triggered by these projects. IFC's Specialists consistently determine the applicability of the Performance Standards based on IFC's procedures and a review of the activities to be supported, and not based on whether the project targets MSMEs.

### **c) IFC Supervision of the Investment**

CAO's findings regarding key gaps in IFC's supervision work include: "IFC did not assure itself that FI clients were meeting E&S commitments in a timely manner," "the quality and depth of the [ESDD] reviews varied considerably," "no standard methodology for ESDD reviews was observed," and "in cases where IFC identified gaps in client E&S performance, IFC generally did not agree with the client on a time bound or resourced action plan to address the issues."

Without details on specific gaps or recommendations for each project rated as non-compliant IFC cannot comment on these ratings, conclusions drawn, and/or appropriateness of overall findings. CAO's findings are also in stark contrast to IEG findings, which over the last 4 years rated the success rate of IFC's E&S work quality and E&S role and contribution in FI projects at supervision consistently at or above 89% versus 37% of the CAO review (13/35). IFC's Environment, Social and Governance Department (CES) will undertake its own internal review to assess the implementation of supervision requirements and the quality of its supervision work, including quality assurance, and ascertain the validity of gaps identified by CAO and develop recommendations for improvements.

Evaluation reviews and supervision reports clearly identify gaps in client performance that need to be addressed, actions to be taken and timelines for their completion. Portfolio work with clients has been

intensified over the last few years and, through regular interaction between the Financial Institutions Group and the CES departments, gaps in performance of poorly performing clients are discussed and next steps agreed upon. Clients with significant gaps in their E&S performance (E&S Risk Rating (ESRR) 4) are not considered for repeat investments, and IFC will re-engage with ESRR 3 clients only if there is sufficient evidence that the client is making sustained progress in addressing the gaps.

In addition to the requirements set forth in the ESRP regarding supervision of clients, particularly review of clients' E&S Due Diligence (ESDD) and overall implementation of their ESMS, IFC has already pilot tested new and enhanced approaches, and these will be rolled-out over the next 2–3 years globally, where appropriate. IFC would like to note, however, that the scope of ESMS implementation assessments needs to vary by type of FI, risk level, and stage of ESMS implementation, and therefore detailed ESMS implementation reviews are not always the most appropriate tool.

With regards to the example of unsatisfactory practice provided in this section, IFC's Sustainability Policy is very precise about the "defined use of proceeds" approach and requires (paragraphs 36 and 44) ring-fencing the proceeds to avoid supporting certain sub-projects. This is the only way IFC can operate in many countries until clients improve their ESMSs and is consistent with the Board's desire that IFC engage in frontier countries and with low capacity clients. In addition, IFC is actively engaging with the financial sector in the country, along with local NGOs and other DFIs, to find solutions to the financing of activities in sensitive regions.

#### **d) External Communication and Grievance Mechanism**

IFC agrees that appraisal and supervision of the External Communication Mechanism (ECM) requirement needs to be further strengthened. FI clients struggle with implementation of this requirement as it goes beyond existing market practices. However, there are several areas where the report (i) inadequately reflects the requirements set out in IFC's policies and procedures; (ii) does not take into account the evolution of practices and IFC's current appraisal and supervision approach in this area; or (iii) does not accurately reflect earlier updates made by IFC. IFC disagrees with statements such as "*IFC's appraisal and supervision of these requirements has either been absent or unsatisfactory.*"

IFC requires clients that apply the PSs to develop and implement an ECM to receive and register external communications and complaints from the public at large. The FI is required to screen and assess issues raised, track and document responses (if any), and report to IFC on its effectiveness. The report refers to "*grievance mechanisms,*" which is not a PS requirement for FIs. The scope of the ECM is clearly outlined in the Interpretation Note of FIs presented to the Board and does not encompass what would be required under a Grievance Mechanism. IFC will adjust the Interpretation Note to further clarify that Grievance Mechanisms are not required for FIs, consistent with Performance Standard 1 (PS1).

As outlined in IFC's annual updates to the Board's Committee on Development Effectiveness (CODE) and CAO, IFC faced initial delays in appraising client's practices in this regard and working with them during supervision to put into place good practices. While, during the initial phase, IFC had not developed a systematic approach to ensure key appraisal and supervision findings were captured in the E&S Review Database (ESRD) II, since 2014 IFC has significantly strengthened the appraisal and supervision of the ECM requirement. Auditable criteria developed to guide Specialists in the assessment were incorporated into ESRDII in 2014, assessment findings have been documented in ESRDII since then, a brief guidance for clients has been developed, and the Annual Environmental Performance Report (AEPR) format was

changed in 2015 to enable reporting by clients. IFC also intensified its supervision efforts over the last 18 months to ensure clients develop and adequately implement ECMs in line with PS1. Through systematic tracking IFC follows up closely during supervision with clients on progress made and has prioritized follow-up on this requirement for all FI-1 and FI-2 clients that apply the PSs as part of its E&S risk management practices. We thank the CAO for mentioning that IFC has strengthened its appraisal and supervision of this requirement.

As the report is based on desk reviews of a large majority of the projects in the sample and the key findings regarding ECMs have only been documented in ESRDII since the beginning of 2015, the report's findings regarding compliance to appraise and supervise client's ECM are based on incomplete information. IFC provided status updates on its work with clients through its updates to CODE, and clearly flagged that practices were changed only in 2014/2015. Inaccuracies in the report findings could have been avoided by conducting interviews with the relevant E&S Specialists or by selecting projects appraised *after* the auditable criteria were introduced and ESRDII changes came into effect. A constructive and targeted monitoring activity would have been to compare IFC's appraisal and supervision work for clients that were appraised and supervised before and after these changes in IFC's practices have been made.

In its assessment, CAO mentions clients that are required to have an ECM in place. This includes 11 projects where IFC only supports MSME finance and for which clients do not apply the Performance Standards to the portfolios supported with IFC financing, which, due to their very limited E&S impact, do not justify having an ECM in place. The CAO methodology distorts the number of clients the CAO has found to be non-compliant with the ECM based on IFC's established practice.

Based on IFC's own assessment of the 24 clients required to establish an ECM included in the CAO sample, 23 have an accessible channel that stakeholders can use to contact them regarding inquiries and complaints. Five clients have already developed procedures to address and log them and are reporting to IFC on inquiries received and how they have been handled.

In addition, of the 134 clients currently in IFC's overall portfolio that are required to have an ECM in place, 93 (69%) have an accessible channel in place and 39 (29%) have developed procedures. This stands in stark contrast to the impression created through the report where the statistic given is 2 out of 35 clients. Examples of good practices are emerging amongst IFC clients with regard to the establishment and implementation of an ECM.

IFC, as outlined in previous updates on its FI Action Plan, will continue to review ECM practices during appraisal and systematically document these findings, and has already started to follow-up with clients regularly during supervision and track status of implementation of this requirement as well as its effectiveness.

#### **e) IFC Sub-Project Disclosure**

**PE Fund Sub-Project Disclosure.** As IFC has indicated to the CAO, we have adequately disclosed all information required for 4 of the 5 Funds assessed; the compliance level is therefore 80%. This information was provided to the CAO on more than one occasion. In addition, the audit does not reflect appropriately on the good practice IFC has established with regards to PE Fund sub-project disclosure which goes far beyond the requirements set out in IFC's AIP.

IFC's 2012 AIP requires IFC to "*periodically disclose a listing of the names, locations, and sectors of high risk sub-projects that have been supported by IFC investments through private equity funds, subject to regulatory constraints and market sensitivities*" (AIP, Para 25). The report states that "*In three cases, however, disclosure had not been updated in more than one year, although the PE fund had made additional investments during that period.*" At an operational level, "periodic" disclosure means that IFC discloses once a year information about all subprojects in portfolio (as of January) made during the previous calendar year (e.g., an investment made by a Fund on Sep 15, 2016, will be disclosed in 2017 along with all other investments made during 2016). IFC obtains the portfolio information, including sector, name and location from the Fund Managers who review and clear the information to be disclosed. There is hence a time lag between the date of investment by the Fund and the disclosure on IFC's website. Information for 4 of the 5 funds reviewed by CAO were updated last as of January 2016 in accordance with this practice. In addition, several findings that informed the report's non-compliant ratings are inaccurate as follows. This was communicated to the CAO, but the report did not include the correct data:

- "*For one of the two investments disclosed the only location information provided was 'world' and 'the sector was given as 'manufacturing' (although the fund reports to IFC that the company is involved in meat processing).*" In the most recent (2016) disclosure none of sub-projects disclosed has as location listed "world" or "manufacturing." IFC tracks both the Country of Operations and Country of Incorporation. In the case of the beef processing investee, Cayman Islands is the Country of Incorporation of the legal entity holding the shares, while China is the country of operation. Through a simple google search, the location of the operations can easily be identified as China. And the operations are appropriately identified as "beef processing." IFC would like to note that the information is based on the Fund Managers sector classification, which is used for reporting to all DFIs and aligned with the disclosure at the Fund Managers' own website.
- "*In January 2015 IFC disclosed two investments made by the Fund in 2013 and 2014. IFC has not yet, however, disclosed four new investments the Fund made in 2015.*" This is incorrect. The fund only made 3 additional investments in 2015 and these were disclosed appropriately.
- "*In some instances, the extent of information made available on the IFC website was limited to the extent that it made identification of the business activities being financed difficult.*" For all sub-projects information on name, location and sectors was provided in line with IFC's policies and procedures. Business activities can be easily identified through this information. In addition, most funds have very detailed information on their investee companies available at their own website.

More importantly, IFC's current practice goes beyond its own requirement by disclosing sub-project relevant information for all investments made, not only Category A sub-projects. IFC to date has disclosed 18 investments made by these five Funds, none of which was a Category A sub-project required to be disclosed by the 2012 AIP. In addition, as of January 1, 2016, there were 42 funds in IFC's portfolio with 215 investee companies. IFC disclosed information relating to 41 funds and 200 investee companies, which represents over 90% coverage. The report therefore needs to correct the statistics cited for overall level of compliance, "significant changes since the FI Audit" or "examples of good practices."

**Non-PE Fund Sub-Project Disclosure.** The focus of the CAO monitoring report is clearly stated as a "compliance" review of IFC's work against its own policies and procedures. Therefore, statements such as

*“With regard to the majority of IFC’s FI portfolio (i.e. non-private equity funds), however, there is no requirement for IFC or the FI client to disclose any sub-project information”* do not belong in a compliance audit.

In addition, good practice examples should focus on aspects IFC has committed to implement through its AIP, Sustainability Policy, ESRP, etc. It is not clear why CAO includes in their audit the Equator Principles disclosure as an example of good practice as the report is meant to focus on implementation of IFC’s requirements, not external practices.

IFC would like to note that it has continued its collaboration with the Equator Principles institutions/secretariat throughout the last year to strengthen awareness around voluntary disclosure and transparency in the market. In addition, IFC has undertaken a survey among its high risk clients to understand practices and constraints in implementing sub-project related disclosure by banks and is in the process of establishing a working group with various financial sector stakeholders to develop a disclosure framework that could be utilized by the banking sector going forward. Based on the disclosure framework discussion, and emerging practices in the market, IFC is also developing a good practice note for clients to help them understand the rationale and provide practical guidance on sound disclosure. As part of the Annual Community of Learning (attended by Equator Principles members, DFIs and Export Credit Agencies (ECAs) all seeking to apply the IFC Performance Standards), IFC also hosted a Panel and discussion on Disclosure and Transparency in the financial sector.