Out of sight, out of mind?

The International Finance Corporation's investment through banks, private equity firms and other financial intermediaries.

The World Bank Group's International Finance Corporation (IFC) lending has grown enormously over the past decade, with commitments reaching a record $18 billion in the 2010 financial year. At the same time, there has been a significant shift in the way the IFC does business. Increasingly, instead of managing its loans and investments itself, it relies on financial intermediaries such as banks and private investment funds. In the 2010 financial year, finance sector lending made up over half of all new project commitments.

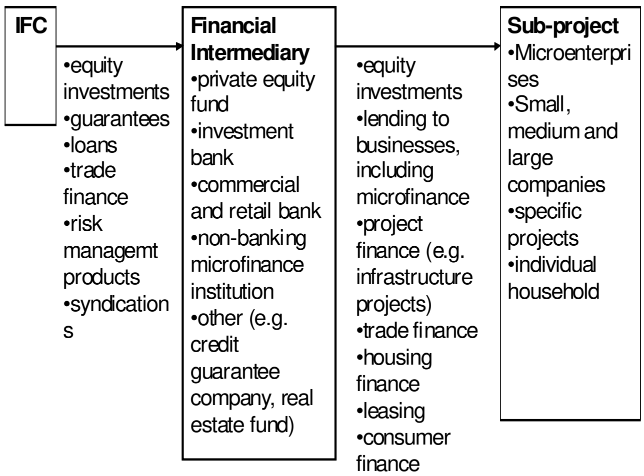
This paper analyses IFC lending through financial intermediaries, and finds a number of causes for concern, including a worrying lack of transparency, inadequate attention to social and environmental concerns, and a failure to link directly to proven developmental impacts. It sets out recommendations for a complete reformulation of the IFC's approach.

The International Finance Corporation (IFC) is part of the World Bank Group, and is controlled by its 182 member governments, who provide its capital and guarantee its lending. The IFC's purpose is to "create opportunity for people to escape poverty and improve their lives". IFC lending has grown enormously over the past decade, with commitments reaching a record $18 billion in the 2010 financial year. More recently, there has been a significant shift in the way the IFC does business. Increasingly, instead of managing its loans and investments itself, it relies on financial intermediaries such as banks and private investment funds. In the 2010 financial year, finance sector lending made up over half of all new project commitments.

As Diagram 1 below shows, the IFC supports financial intermediaries either by lending them money, buying shares in their business or through other methods such as providing guarantees for their lending. The financial intermediaries can then use this capital for a wide range of activities including financing specific projects, lending to large, medium or small businesses, and making equity investments in other companies.

The IFC justifies the use of financial intermediaries on two grounds. First, it argues that a well-functioning and developed financial sector is vital for economic development and thus, for poverty alleviation. Second, it claims that this is the main way it can support microenterprises and small or medium sized businesses; in effect by delegating the responsibility for managing that support to the financial intermediary.

Diagram 1: Financial Intermediary lending: how it works



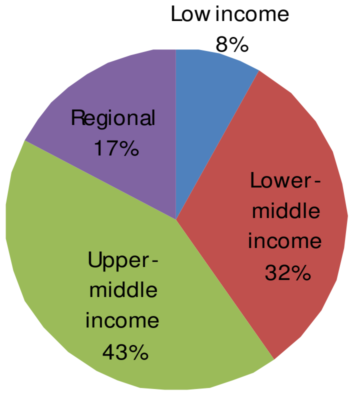
Supporting small businesses?

As a result of the IFC's reporting methodology, it is difficult to ascertain to what extent the IFC supports microenterprises and small or medium sized businesses. In published documents, the IFC says it uses the size of the loan or investment made, and not the actual size of the recipient company to analyse its support to different sizes of companies. It does this despite having clear definitions for microenterprises and small and medium businesses, based on number of staff and amount of assets and/or sales. Though the size of loans and the size of the company are potentially related, there is no predefined relationship between the two. Therefore, while the IFC claims an emphasis on lending to microenterprises, and small and medium businesses it is unclear how it knows this, or how the public can verify whether or not sub-project lending does actually

LICs bottom of the list

As Figure 1, below, shows, only 8 per cent of the IFC's 2009 commitments, by value, to financial intermediaries were directed specifically at low-income countries (LICs). This confirms longstanding critiques that the IFC tends to neglect smaller, poorer countries, and focuses its investments in areas where the need for publicly backed finance is lower. Low-income country policymakers are concerned that IFC support goes "mostly to a very few [of the] largest projects and transnational investors", where (a) the need for concessional finance is lower and (b) potential development benefits are smaller than in poorer countries and small and medium enterprises.

Figure 1: IFC FI project commitments by country level of development, FY2009



Lack of transparency

The IFC does not publish information about what share of overall commitments is made to which type of intermediary, and has not responded to requests for this data. As noted above, its statistics on lending to microenterprises, small or medium companies are not transparent. Nor does it publish disaggregated data that would allow examination of other critical issues such as the level of support for large infrastructure projects. The very short '*Summaries of Proposed Investments*' it does publish contain very little detail, and no contractual information. They are not updated throughout the lifetime of the loan or investment, though the IFC has said it plans to rectify this . More shockingly, no summaries are published for trade finance investments, despite these representing over a third of the total 2009 commitments, as shown in Figure 2, below.

The IFC does not systematically aggregate or analyse the lending of the financial intermediaries that it supports. It has no visible strategy and assessment regarding the overall and country-specific allocation of its resources to sectors or types of companies by the financial intermediaries that it supports.

Lax on tax havens?

Sometimes the IFC invests in a financial intermediary that is registered in an "offshore financial centre" - more commonly known as a tax haven or secrecy jurisdiction. For example, the China Environment Fund, in which the IFC invested $15 million in the 2009 financial year, is registered in the Cayman Islands, although it undertakes its investments in China.

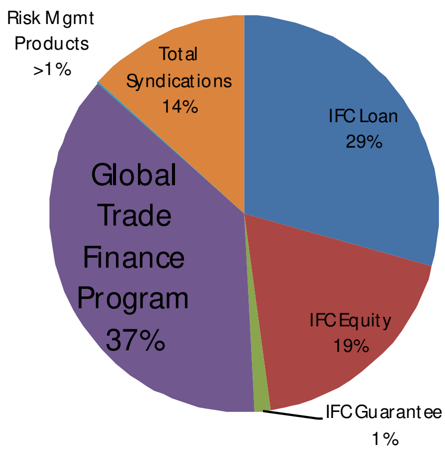
The IFC does not publish nor provide upon request documentation of the amount of investments in financial intermediaries that are registered in secrecy jurisdictions or with majority owners domiciled there.

Legislation in secrecy jurisdictions usually lacks strong disclosure requirements for firms, which makes it extremely difficult for the public or even shareholders to oversee the use of funds or for people to learn of IFC-backed projects which impact their lives, livelihoods or environment. As the Tax Justice Network has argued, the use of secrecy jurisdictions creates opportunities for money laundering, theft of state assets and tax evasion and avoidance.

In April 2010, the World Bank Group, which includes the IFC, issued a paper describing how it handles tax evasion and lending to offshore financial centres. Unfortunately, the paper is vaguely worded and lacking in the sort of detail which would inspire confidence in the extent and nature of due diligence practices for operations in secrecy jurisdictions.

In the paper, the World Bank claims that the use of secrecy jurisdictions can be legitimate to avoid double taxation. As the Tax Justice Network and other leading NGOs have pointed out in a recent letter to the IFC, this claim is problematic. The justification of avoiding double taxation can easily be misused to legitimise the use of secrecy jurisdictions for other purposes. Instead, these NGOs argue that World Bank Group beneficiaries should have to meet certain criteria when using intermediate jurisdictions, including that the arrangement should reflect real economic activity, there should be automatic disclosure of the beneficial ownership, and that companies undertake country by country reporting of the profits made, sales, and tax paid in each country in which they operate.

Figure 2: Project commitments, type of product, FY 2009

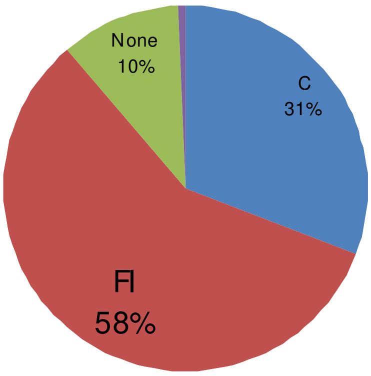


The implementation of IFC policies and 'performance standards' is based on a certain amount of transparency and public process. It is difficult to identify a manner by which projects funded through financial intermediaries domiciled in secrecy jurisdictions would meet basic transparency, consultation, and participation standards.

Social and environmental concerns

Financial intermediaries can pose social and environmental risks through the sub-projects and businesses which they finance. The IFC categorises financial intermediary financing as either 'category C' - with a low risk of adverse social or environmental impacts - or 'category FI', where the risk of bad impacts may be medium or high. As Figure 3 below shows, the majority of IFC support for financial intermediaries is for projects with a medium or high risk of adverse social and environmental impacts.

Figure 3: Categorisation of projects FY2009, share of overall project commitments



However, the way the IFC assesses potential social and environmental impacts is woefully inadequate, and significantly worse than comparable institutions. Major problems include:

- **Lack of expertise to conduct assessments:** in 2009 there were only five social and environmental specialists, plus six consultants working on FI lending at the IFC, far too few to conduct effective assessments for the 500 or so financial intermediaries in the IFC's current portfolio.
- **Little analysis of what financial intermediaries actually do:** unlike the Asian Development Bank or Overseas Private Investment Corporation (OPIC) , the IFC review does not normally require analysis of subprojects or companies funded with IFC support after board approval. In contrast to other public financial institutions, including those using IFC Performance Standards, the IFC delegates most assessment, categorisation, monitoring and oversight responsibilities to the financial intermediary and relies on self-reported data.
- **Secrecy and lack of transparency:** the IFC does not make public IFC contracts or partnership agreements with financial intermediaries. This raises concerns that the IFC may not routinely require disclosure clauses, binding language on environmental, social or governance issues or exit or veto clauses in its contracts.
- **Poor outreach and consultation:** outreach to communities affected by the project or sub-projects appears to be extremely limited or non-existent. Claims that affected communities would be able to communicate with IFC staff via the Compliance Advisor Ombudsman (CAO) are based on weak evidence. The CAO has no list of financial intermediary sub-projects and affected communities are not made aware of this grievance mechanism in any systematic manner, either by the IFC, financial intermediaries or subproject companies.
- **Insufficient oversight and monitoring:** there are no disclosed schedules for onsite visits and verification measures.

By contrast, OPIC, which utilises the IFC Performance Standards, requires that all agreements with financial intermediaries contain covenants which include but are not limited to:

> "(1) compliance with all applicable Performance Standards, Industry Sector Guidelines, host country laws and regulations, and any supplemental standards identified by OPIC;
>
> "(2) mitigation commitments, including those contained within any required [Environmental Sector Assessment Programmes] and Remediation Plan;
>
> "(3) notification and reporting requirements, including the format for annual reports based on OPIC-approved monitoring methodology; and
>
> "(4) on-going stakeholder engagement and reporting requirements."

Developmental impact?

The IFC has three basic justifications for its financial intermediary support. First, it claims that there are benefits to the country from general financial sector development. Second, it aims to increase access to credit and financial services for those who find this hard to come by, mainly microenterprises and small and medium businesses. Third, it argues that financial intermediaries can be good ways of channeling money to some larger infrastructure undertakings and other projects. However, the IFC does not require that the financial intermediary through which it channels its money has specific development mandate or objective.

The IFC claims to measure a project's actual developmental impact through its Developmental Outcome Tracking System (DOTS). The templates used, however, contain only a few indicators that measure a direct impact on the poor (such as access to financial services), or impact on the environment or local communities. DOTS also lacks information about the impact on different income or social groups. They do not disclose information disaggregated by project. Further, the IFC does not evaluate the developmental impact of the sub-projects supported by the financial intermediary. The results of the DOTS evaluation are not publicly disclosed at individual project level. Though the IFC plans to publish the DOTS indicators for direct investments, it does not intend to do this for financial intermediary support.

There is no systematic link to national development strategies for financial intermediary support, and the IFC does not have a clear policy framework in this area. Given this lack of data about its specific impacts and links to coherent national strategies, the IFC overly relies on a belief that any financial sector development automatically benefits the poor.

Conclusions & recommendations

The IFC's approach to financial intermediary support is based on the mistaken premise that the development of any part of the financial sector is likely to be beneficial for developing countries. In reality, as the recent global financial crisis has demonstrated, it matters enormously what kinds of banks, private investment funds, and other investment funds are supported by publicly backed institutions like the IFC. The sub-projects and investments made by those financial intermediaries which, de facto, act on behalf of the IFC, are very important; many can potentially have significant adverse impacts for poor communities and the environment.

Therefore, the most logical approach would be for the IFC to work only through financial intermediaries that themselves share the objectives that the IFC professes, to support sustainable development and reduce poverty. Supporting the development of locally owned institutions with poverty reduction and sustainable development as part of their core objectives could strengthen the financial sector without generating negative environmental or social impacts.

To ensure that the 'right kind' of financial intermediaries are supported, and that the IFC and the public, including those affected by a project or subproject, are able to properly monitor this support, a clearly defined strategic framework should be set out. This would:

- **Focus on outcomes** by developing a clear strategy and framework that links to national plans. An approach that seeks to support dynamic and responsible financial intermediaries should start by avoiding those with potentially negative impacts or irresponsible practices. This means that:

  Those with portfolios including any lending with high risks of negative social and environmental impacts should not receive IFC support.

  No IFC funding should go to financial intermediaries domiciled or with majority owners domiciled in secrecy jurisdictions.

  FI investments should meet standards currently applied to IFC microenterprise projects, banning activities that "impinge on the lands [...] owned by Indigenous Peoples without full documented consent of such peoples".

- **Support small businesses** by selecting financial intermediaries that support microenterpriuses and small and medium enterprises, based on a sensible and verifiable definition of these categories.
- **Insist on high transparency standards** including the public disclosure of environmental, social and governance language, including transparency and consultation requirements, in contracts, subcontracts, investment and partnership agreements with FIs and sub-projects or subcontractors. This should apply to all the IFC's activities, including investments made under trade finance facilities.
- **Ensure proper monitoring and oversight** by, among other things, including binding language in all agreements and contracts specifying the manner by which the IFC may exercise veto power over investments or partners and may divest from an investment, without prejudice or fee, in the case of client (project or subproject) violation of IFC policy, law, or treaty obligations.

At a minimum, in the short term, the IFC should adopt the best policies of other public financial institutions, such as the ADB and OPIC, including:

- Disclosure for high risk projects 120 days in advance of board consideration;
- Strongly enhanced sub-project disclosure requirements;
- A strong move away from reliance on self reported client data, assessment and monitoring toward increased due diligence directly by IFC;
- Enhanced community consultation, participation, monitoring measures;
- Inclusion of all Performance Standards and policies in legally binding contract, subcontract and partnership agreements.

Until the IFC radically changes and transparently discloses its approach to financial sector interventions, it not only misses opportunities to provide the most effective support for sustainable development; but also risks significantly undermining it.

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