



MONITORING REPORT

**CAO Audit of IFC
CAO Compliance**

March 6, 2017

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

Office of the Compliance Advisor Ombudsman (CAO)
for the
International Finance Corporation (IFC)
Multilateral Investment Guarantee Agency (MIGA)
Members of the World Bank Group

About the CAO

The Office of the Compliance Advisor Ombudsman (CAO) 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).

The CAO's mission is to serve as a fair, trusted, and effective independent recourse mechanism and thus to improve the environmental and social performance of IFC and MIGA.

CAO consists of three unique and complementary functions, Dispute Resolution, Compliance and Advisory, which together provide a flexible framework for handling people's complaints and addressing systemic concerns about IFC and MIGA projects.

About CAO's Compliance Function

CAO's Compliance function provides oversight of IFC and MIGA investments with the objective of improving environmental and social (E&S) performance of the institutions. The Compliance function is activated when either of the parties opt for it following CAO's assessment of the complaint or when the Dispute Resolution process does not lead to an agreement between the parties. The Compliance function can also be initiated by the CAO Vice-President, the President of the World Bank Group or IFC/MIGA senior management. Following a compliance investigation, CAO may determine that it is necessary to monitor actions taken by IFC or MIGA until such actions assure CAO that its compliance findings are being addressed.¹

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

¹ CAO Operational Guidelines (2013) para. 4.4.6.

Introduction

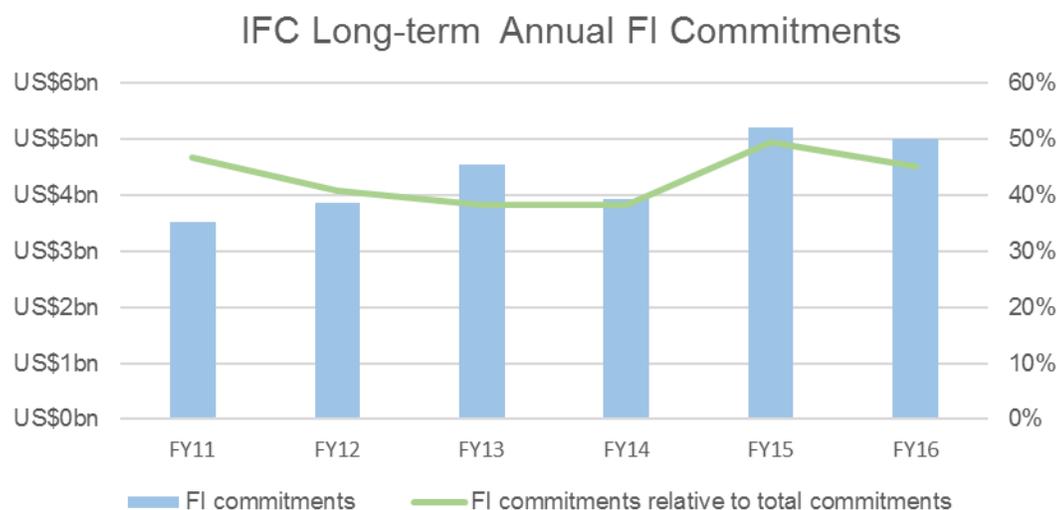
In June 2011, the CAO Vice-President initiated a compliance audit of IFC's application of E&S requirements to its financial sector investments. The findings of the review were published in February 2013 in the *CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries* (referred to as the FI Audit).²

Since the publication of the FI Audit, CAO has released two monitoring reports documenting actions taken by IFC to address the findings of the FI audit. This is CAO's third monitoring report following the FI audit.

Background

A large portion of IFC financing is delivered through third-parties known as financial intermediaries (FIs) including commercial banks, insurance companies, leasing companies, and private equity funds. IFC's FI clients provide finance to businesses (described by IFC as "sub-clients") through a range of financial products.

IFC provides investments and expertise to about 700 financial institutions and 220 private equity funds in more than 120 countries. In Fiscal Year (FY)16, IFC's new long-term commitments to FIs amounted to US\$5 billion (FY11 - US\$3.5 billion) with a committed FI portfolio at year end of US\$20.4 billion (FY11 – US\$17.2 billion).³



² CAO, *Audit of a Sample of IFC Investments in Third Party Financial Intermediaries (FI Audit)*. For further details, see <http://goo.gl/e368ha>. The FI Audit was finalized in October 2012, and published in February 2013, after finalization of IFC's Official Response. CAO updated its Operational Guidelines in March 2013. Through this update, the term 'compliance audit' was changed to 'compliance investigation'. This report uses both terms interchangeably.

³ IFC Annual Report for FY2011 and FY2016, see <http://www.ifc.org/annualreport>. Trade finance not included in stated commitments.

Through its investments in FIs, IFC seeks to “strengthen domestic capital and financial markets that support economic development at a scale of activity that is smaller than would be possible through direct IFC investments.”⁴ As a result, IFC argues that investments in financial intermediaries have the potential to expand IFC’s development impact and reach.⁵

In June 2011, the CAO Vice-President initiated an audit of a sample of IFC’s FI investments based on concerns that affected people may face difficulties in bringing the environmental and social (E&S) impacts of FI investments to CAO’s attention. Also relevant in the decision to conduct the audit was the growth of IFC investments through FIs, which constituted over 40 percent of IFC’s portfolio at the time. The FI Audit considered IFC FI investments during the period 2006 to 2011.

CAO published the FI Audit and IFC’s Official Response to the FI Audit in February 2013. CAO’s FI Audit noted that IFC’s approach to the management of E&S risk in its FI investments focused on the requirement that clients implement an environmental and social management system (ESMS).⁶ The FI Audit concluded that, while generally reviewing FI investments in compliance with relevant procedural requirements, IFC lacked a robust methodology for determining whether its FI clients were, in fact, implementing the ESMS as required. In this context, the FI Audit raised concerns that the end use of IFC funds by FI clients was opaque and, as such, IFC knew little about potential adverse E&S impacts of its financial sector lending. The FI Audit also noted that IFC’s approach to the assessment of capacity and commitment of FI clients to implement its E&S requirements was insufficiently structured and did not engage with the extent of change required to achieve its intended results. At the same time, CAO noted improvements in IFC’s approach to the management of E&S risk in its FI portfolio towards the end of the period under audit. See Annex A for a list of key findings from CAO’s FI Audit.

In September 2013, IFC released an Action Plan in response to the FI Audit. IFC committed to actions around three headings: a) Formalize a continual improvement framework for managing the E&S performance of the FI business; b) Establish a formal ongoing process of outreach, consultation, and dialogue with key stakeholders on IFC’s FI business; and c) Strengthen IFC’s advisory services to support regulatory, market, and client level capacity building to help raise the



⁴ IFC Sustainability Policy (2012), p 6-7.

⁵ IFC Official Response to CAO FI Audit (January 31, 2013).

⁶ An ESMS is a set of policies, procedures, tools, and internal capacity to identify and manage a financial institution’s exposure to E&S risks of clients. Further details available from IFC’s First for Sustainability website, see <https://goo.gl/qaQ4I7>

standard of E&S risk management in the financial sector in emerging markets.^{7, 8}

CAO published its first monitoring report in relation to the FI Audit in October 2014⁹ and its second monitoring report in October 2015.¹⁰ In these reports, CAO noted that actions taken by IFC following the preparation of the Action Plan address a number of CAO's findings (see Annex B). In particular, CAO's monitoring has welcomed the development of an ESMS Diagnostic Service (described in Annex B), and IFC's efforts to support capacity building among its clients in the sector. While CAO has acknowledged increased guidance provided to IFC staff on appraising and supervising FI projects, CAO has also noted that IFC's updated procedures narrow the application of the Performance Standards (PS) as approved by the IFC Board.¹¹ CAO's monitoring has also raised concerns that IFC had not developed a methodology to evaluate the effectiveness of an FI client's approach to identifying and managing E&S risk.¹²

In order to provide an enhanced measure of the effectiveness of IFC's response to the FI Audit, CAO decided to review a sample of active FI investments committed under the 2012 Sustainability Framework for this third monitoring report.¹³

⁷ IFC's FI Action Plan. For further details see <http://goo.gl/zf0WMJ>

⁸ In response to a subsequent CAO investigation of IFC's investment in Banco Ficohsa, IFC noted that systemic findings from that investigation are being addressed through the Action Plan developed in response to the FI Audit. Further details on CAO's Investigation of IFC's Investments in Banco Ficohsa are available at <http://goo.gl/2vkPn8>

⁹ CAO (2014), First Monitoring Report of FI Audit. For further details see <http://goo.gl/b3F3qY>

¹⁰ CAO (2015), Second Monitoring Report of FI Audit. For further details, see <https://goo.gl/9wE0O9>

¹¹ IFC revised its Environmental and Social Review Procedures (ESRPs) in July 2014. The ESRPs provide guidance to IFC staff on appraising and supervising an IFC investment. The revised ESRPs guide staff to ensure that the Performance Standards are applied "For project finance and corporate loans with tenor of not less than 36 months and funding-defined assets as part of a project amounting to at least \$10 million of total capital cost, compliance with all PSs is required. Additional guidance is provided for other financial transaction. See ESRP 7 (July 2014), para 3.2.2. ESRPs available at <https://goo.gl/cEJlOk>.

¹² For further details, see CAO's first and second monitoring reports available at <http://goo.gl/b3F3qY> and <https://goo.gl/9wE0O9>.

¹³ IFC's Sustainability Framework includes i) Sustainability Policy – IFC commitment and requirements for pre-investment review and supervision; ii) Performance Standards – client implemented E&S requirements; iii) Access to Information Policy – IFC commitment and requirements for information disclosure.

Methodology

For this monitoring report, CAO reviewed a sample of 38 active FI investments committed under the 2012 Sustainability Framework.¹⁴ The sample was selected through a combination of i) random selection, ii) IFC recommendations, and iii) selective additions for the purpose of achieving regional balance and coverage of IFC ESMS Diagnostic Service clients.

The sample was not designed to be statistically representative of IFC's FI portfolio, but rather to provide insights into the development of IFC's approach to E&S issues since the completion of the FI audit. Annex C provides further information on the sample.

CAO's project level reviews focused on the following five areas:

- i) IFC Pre-Investment E&S Review: E&S Appraisal. Addressing IFC's assessment of the E&S risk posed by the FI client's business, as well as IFC's assessment of the client's capacity to manage that risk.
- ii) IFC Pre-Investment E&S Review: Development of Mitigation Measures. Considering IFC's approach to the development of mitigation measures to manage potential E&S risk of IFC's investment.
- iii) IFC Supervision of the Investment. Addressing IFC's supervision of active FI investments, in particular the extent to which IFC has assured itself that required measures to manage E&S risk are being implemented.
- iv) External Communications and Grievance Mechanisms. Addressing the application of IFC's requirement that an FI client establish an external communication and grievance mechanism to receive complaints from people affected by the FI's investment activities.
- v) IFC Sub-Project Disclosure. Addressing the extent to which sub-project disclosure requirements are met in relation to IFC's private equity clients.

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).

The sections below deal with each of the five areas in turn. Each section identifies the applicable IFC E&S requirements, notes the number of projects reviewed where IFC's performance was found to be materially compliant or better, provides a narrative justifying this assessment, and identifies significant changes in IFC's approach compared to what was observed in the FI Audit. In relation to each section, CAO also identifies examples of both good and unsatisfactory practice as observed in the sample. While examples of unsatisfactory practice are, by definition, non-compliant, examples of good practice are instances of compliance or performance which exceed compliance.

As the FIs selected as part of the sample are not the subject of a specific complaint to CAO, their names are not disclosed.

¹⁴ Investment active as of Q4 FY16. Investments committed prior to January 1, 2012 were not considered in selecting the sample, as a key point in IFC's response to CAO's FI Audit was that IFC's approach to E&S risk management in the FI portfolio had improved since the implementation of the 2012 Sustainability Framework.

Summary of Results

Number of projects reviews in the sample where IFC was found materially compliant ¹⁵	
IFC Pre-Investment E&S Review: E&S Appraisal	<div style="display: flex; align-items: center; justify-content: center;"> 23 38 </div>
IFC Pre-Investment E&S Review: Development of Mitigation Measures	<div style="display: flex; align-items: center; justify-content: center;"> 12 38 </div>
IFC Supervision of the Investment	<div style="display: flex; align-items: center; justify-content: center;"> 13 35 </div>
Accountability: External Communications and Grievance Mechanisms	<div style="display: flex; align-items: center; justify-content: center;"> 2 35 </div>
IFC Sub-Project Disclosure	<div style="display: flex; align-items: center; justify-content: center;"> 2 5 </div>

¹⁵ For example, for IFC Pre-Investment E&S Review: E&S Appraisal, 23 of the 38 investments reviewed were found to be in material compliance. Where insufficient data was available due to the current stage of an investment or where specific IFC's requirements were not applicable to the investment (e.g. Accountability and IFC Sub-Project Disclosure), CAO did not assess IFC's performance in those investments.

Monitoring Results

IFC Pre-Investment E&S Review: E&S Appraisal

Summary of requirements:

Analysis of whether IFC E&S review prior to investment in the FI was commensurate to risk. Topics reviewed include analysis of portfolio risk, adequacy of ESMS review, and review of client commitment and capacity to implement IFC E&S requirements.

Number of projects reviewed in the sample found in material compliance



Justification for rating:

The quality of IFC's pre-investment E&S review was variable. In some instances, detailed analysis was evident with E&S risk being identified early in the appraisal process and an analysis of client capacity to manage identified risks. However, in 15 of the 38 investments reviewed, CAO found that IFC's review was not commensurate to risk. Gaps observed in IFC's review included: i) not considering E&S risk related to the client's existing loan portfolio; ii) not reflecting country E&S risk in the review; iii) lack of analysis of the client's current E&S systems and practices; and iv) insufficient analysis of an FI client's prior E&S performance when assessing commitment and capacity to implement IFC's requirements. IFC's E&S review was, more often, commensurate to risk in relation to private equity funds, and micro, small, and medium enterprise focused investments, as compared to general purpose banking investments. In six cases, CAO observed additional investments being provided to FI clients with unresolved E&S compliance issues.

Significant changes since the FI Audit:

Some improvements in the E&S review process were noted: for example, there is evidence that IFC E&S staff are more active earlier in the appraisal process, thus facilitating improved engagement with clients on their approach to E&S risk management and development of opportunities for improvement. Further, there are indications that sub-project level risk is emerging as a consideration at review. Combined with increased staffing, improved guidance, and tools, this has resulted in a general improved understanding of client approaches to E&S risk management. Other positive developments in practice were noted in individual investments in the sample, but not systematically implemented, even in relation to high-risk investments. These included: i) IFC staff conducting E&S appraisal visits to FI sub-projects prior to IFC's investment; ii) one instance where IFC staff convening a peer review meeting to consider potentially significant E&S risks of an FI investment; and, iii) IFC using its ESMS Diagnostic Service as part of its appraisal process for one investment.

Example of good practice:

IFC considered an investment in a private equity fund with an existing exposure to a high risk sub-project which IFC considered to be potentially non-compliant with the Performance Standards. As part of IFC's review, staff visited the sub-project and another potential sub-project of the fund to understand the fund's approach to E&S risk management. IFC staff sought expert internal advice on managing the risk at the sub-project level. Based on its review, IFC structured the investment to: i) limit IFC's exposure to the high risk project; ii) support the client on implementation of IFC's requirements; and, iii) provide IFC with an opt-out from future investments by the fund which IFC would consider to potentially contravene the PS.

IFC Pre-Investment E&S Review: E&S Appraisal (cont.)

Example of unsatisfactory practice:

IFC made an equity investment in a large commercial bank which had a portfolio of investments which included high E&S risk profiles. IFC recorded that, due to national regulatory constraints, documentation of examples of the client's E&S due diligence for recent high risk transactions were not available. Further, IFC E&S staff were requested to expedite the E&S review to accommodate the investment timeline. Relevant information in relation to the E&S risk of the investment was omitted from the Board Paper.

IFC Pre-Investment E&S Review: Development of Mitigation Measures	
<p><i>Summary of requirements:</i></p> <p>IFC is required to define any E&S actions that the client should undertake to address gaps to meet applicable E&S requirements, and include these in an E&S Action Plan. In the case of FIs that are engaged in projects with potentially significant E&S risks, gaps must be closed to ensure compliance with the applicable requirements before IFC commitment or disbursement.</p>	<p>Number of projects reviewed in the sample found in material compliance</p>  <p>12 38</p>
<p><i>Justification for rating:</i></p> <p>Even where significant gaps are identified at pre-investment review, mitigation measures applied by IFC are generally pro forma in nature and do not correspond to an analysis of the client’s systems, capacity, resourcing or operating environment. As a result, the realism of the agreed mitigation measures and timeframes is doubtful. This is of particular concern in relation to FIs that are engaged in projects with potentially significant E&S risks. In such cases, and where significant gaps in client E&S performance exist, a realistic action plan would need to provide a level of detail not generally seen in the investments reviewed. Longer implementation timeframes and commitments to more active support from IFC, including involvement in sub-project E&S review processes, may be required to meet compliance requirements in such circumstances.</p> <p>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.</p>	
<p><i>Significant changes since the FI Audit:</i></p> <p>The number and detail of mitigation measures utilized by IFC has increased, however, these remain standardized in nature and are rarely tailored to the specific situation of the client.</p>	
<p><i>Example of good practice:</i></p> <p>Prior to approving an additional investment with an existing client in a post-conflict country, IFC applied its ESMS Diagnostic Service. The outcome was the development of an action plan tailored to the specific situation of the client. IFC went beyond the usual pro forma approach in terms of the detail provided and the articulation of specific deliverables that corresponded to identified gaps in the client’s E&S performance. Innovatively, IFC’s investment agreement included both positive and negative financial incentives linked to the client’s implementation of the action plan.</p>	
<p><i>Example of unsatisfactory practice:</i></p> <p>In making an equity investment with a commercial bank, IFC agreed to terms which potentially limited the application of the PS. Specifically, IFC agreed its client, which had a significant number of investments with high E&S risk profiles, would apply the PS using only ‘commercially reasonable efforts’ and where non application of the PS did not result in breach of contract. While IFC senior management requested rigorous and early supervision of the investment, as agreed with the client, IFC agreed that the first site supervision visit would be conducted 18 months post-disbursement.</p>	

IFC Supervision of the Investment	
<p><i>Summary of requirements:</i></p> <p>IFC is required to assure itself that client E&S Conditions of Disbursement (CODs) have been met and assure itself that the FI client is implementing the ESMS as agreed. Supervision should include reviews of both the FI's E&S Due Diligence (ESDD) and its monitoring of investments with significant environmental and social risks. The frequency and focus of supervision should be commensurate to risk.</p>	<p>Number of projects reviewed in the sample found in material compliance</p> <p>13 35</p>
<p><i>Justification for rating:</i></p> <p>The quality of supervision in the sample of investments was variable. In some instances, IFC reviewed client documentation, conducted site supervision visits to the FI, and reviewed a sample of FI sub-projects to assess compliance in a manner that was commensurate to risk. In the majority of cases, however, supervision did not provide assurance that the FI client was implementing an ESMS that met IFC's requirements. In a number of instances, IFC did not assure itself that FI clients were meeting E&S commitments in a timely manner. IFC's reviews of client prepared Environmental and Social Due Diligence (ESDD) assessments of sub-clients are an important part of supervision. IFC had documented an ESDD review in 20 of the 38 investments in the sample. In these investments, the quality and depth of the reviews varied considerably. While good practice examples were observed, no standard methodology for ESDD review was observed. In several cases, IFC concluded that the FI client's E&S performance was satisfactory, although the IFC's supervision documentation did not provide a basis for a positive compliance finding.</p> <p>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.</p>	
<p><i>Significant changes since the FI Audit:</i></p> <p>Updates to the ESRP provide significant additional guidance to IFC staff on supervision of FI investments, in particular on the selection criteria for ESDD reviews. As noted above, however, implementation of these requirements was inconsistent.</p> <p>Based on IFC data, there has been an increase in the intensity of E&S supervision compared to the period reviewed in the FI Audit. Knowledge gap projects (e.g. projects on which IFC did not have up-to-date supervision information) fell from 6.8% of the portfolio in FY09 to 3.2% in FY15. Most significantly, the number of ESDD reviews conducted by IFC increased from 22 in FY09 to 617 in FY15. At the same time, however, the number of IFC site visits to FI clients relative to the size of IFC's FI portfolio has fallen from 42% FY09 to 32% FY15.¹⁶</p> <p>In 2015, IFC revised the Annual Environmental Performance Report (AEPR) which now requires FI clients to provide additional details in relation to ESMS implementation, compared to what was required in the previous reporting format.¹⁷</p>	

¹⁶ For further details see IFC's *Update on IFC's Management of E&S Risks in its FI Business* October 2015. Available at <https://goo.gl/7wr4gg> (October 10, 2016).

¹⁷ An AEPR is an E&S performance report which FI clients are required to complete and submit to IFC annually. Further details available at <https://goo.gl/4chCTI>

IFC Supervision of the Investment (cont.)

Example of good practice:

As part of supervision, IFC trialed an “ESMS Implementation Review” with a number of FI clients in Sub-Saharan Africa. This review includes an analysis of 50 ESDDs prepared by the FI in accordance with IFC’s E&S requirements, site visits to sub-projects, and an assessment of the FI’s ESMS. The reviews are prepared by IFC E&S staff and third party consultants contracted by IFC. This type of review goes into significantly more detail than IFC’s regular site supervision reports and provides an enhanced analysis of the FI’s ESMS implementation. Given that the first reviews under this program were prepared in 2016, CAO was not in a position to assess the adequacy of IFC’s action to close identified gaps in client performance.

Example of unsatisfactory practice:

IFC made an SME targeted investment with a commercial bank that was acknowledged as lending to high risk sectors. To mitigate the risk of lending to projects with adverse environmental impacts, IFC included a covenant in the loan agreement that prevented the use of IFC funding to support investments in an environmentally sensitive region of the country. The investment agreement did not require the client to implement the PS, although loans to larger businesses than those anticipated by IFC’s official definition of an SME were allowed (see Annex D).

To date, IFC has found the client’s E&S performance satisfactory on the basis of reviews of the client’s annual reports. Given the expanded definition of SME lending for this project, however, IFC is potentially exposed to higher (E&S) risk sub-projects than would usually be the case for an SME loan. IFC’s supervision has not engaged with this issue nor has it considered whether the bank has complied with the restriction against lending to support business activities in the environmentally sensitive region.

Accountability: External Communications and Grievance Mechanisms	
<p><i>Summary of requirements:</i></p> <p>IFC’s Sustainability Policy requires FI1 and FI2 clients to operate an ESMS incorporating relevant principles of PS1. IFC’s guidance notes affirm that an external communication mechanism applies to all projects and that a grievance mechanism applies to some projects.</p> <p>IFC is required to assure itself that FI clients establish an external communications and grievance mechanism as part of their ESMS. Such mechanism should provide accessible channels for the FI to receive complaints that allege an E&S impact in relation to the FIs investment activities and/or borrowers/investees in its portfolio.¹⁸</p>	<p>Number of projects reviewed in the sample found in material compliance</p> 
<p><i>Justification for rating:</i></p> <p>IFC commenced implementation of systems to appraise and supervise this requirement in 2014. From the projects sampled, IFC has not systematically reviewed clients’ approach to receipt of complaints at appraisal nor has it required mitigation measures to address the requirement that FI clients establish an external communications and grievance mechanism. IFC’s appraisal and supervision of these requirements has either been absent or unsatisfactory.</p> <p>CAO did not review any projects where IFC had assured itself of adequate implementation of this requirement. In a minority of cases reviewed, recent IFC supervision has considered this requirement and noted gaps in client’s implementation.</p>	
<p><i>Significant changes since the FI Audit:</i></p> <p>IFC has only sought to implement this requirement in relation to FIs with an investment made under the 2012 Sustainability Framework. IFC has noted to CAO that IFC faced initial delays in implementing this requirement and, since 2014, IFC noted that it has strengthened its appraisal and supervision of this requirement.</p> <p>IFC has developed guidance for its FI clients on this requirement. CAO has observed, however, key gaps in this guidance for FI clients who support higher E&S risk activities, specifically: i) guidance on ensuring the mechanism is easily accessible and understandable to potential complainants; and, ii) inclusion of procedures for the handling of confidential complaints.</p> <p>IFC’s revised AEPR format includes a requirement for an FI client to report its procedures and implementation of its ‘External Grievance and Communication Mechanism’.</p>	
<p><i>Example of good practice:</i></p> <p>CAO did not review any examples where IFC had adequately assured itself that an FI had implemented an external communication and grievance mechanism.</p>	
<p><i>Example of unsatisfactory practice:</i></p> <p>In the majority of cases reviewed as part of the sample, IFC has not adequately assured itself at appraisal and/or at supervision of its FI client’s approach to handling external complaints in regard to the requirements.</p>	

¹⁸ IFC 2012 Sustainability Framework, para. 35; PS Guidance Notes: PS1 GN108 & GN110; and, Interpretation Note on Financial Intermediaries, para. IN20 and IN50, available at <https://goo.gl/enZ42U>.

IFC Sub-Project Disclosure	
<p><i>Summary of requirements:</i></p> <p>As per IFC’s Access to Information Policy, IFC commits 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 (PE) funds, subject to regulatory constraints and market sensitivities.</p>	<p>Number of projects reviewed in the sample found in material compliance</p> 
<p><i>Justification for rating:</i></p> <p>CAO reviewed five IFC investments in PE funds. In four of these, IFC disclosed the name, sector, and location (country) of at least one sub-project supported by the PE funds. In three cases, however, disclosures had not been updated in more than one year, although the PE fund had made additional investments during that period. 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.</p>	
<p><i>Significant changes since the FI Audit:</i></p> <p>Regular disclosure of private equity sub-projects by IFC is new since the advent of the 2012 Access to Information Policy (AIP).</p> <p>In response to the FI Audit, IFC committed to disclosure of all investee companies of IFC-supported PE funds subject to regulatory constraints and market sensitivities. IFC has reported to CAO that, as of January 1, 2016, there were 42 funds in IFC’s portfolio, with 215 investee companies. Of these, IFC has noted that IFC has disclosed information relating to 41 funds and 200 investee companies.</p> <p>With regard to the majority of IFC’s FI portfolio (i.e. non-private equity funds), IFC has committed to collaborate with the Equator Principles Financial Institutions (EPFIs) to promote voluntary FI sub-project disclosure to help shift market practices on transparency.¹⁹</p>	
<p><i>Example of good practice:</i></p> <p>An IFC banking client, that subscribes to the Equator Principles,²⁰ has disclosed a summary of its E&S pre-investment review for a project it financed. The disclosure outlines a description of the project, the FI’s assessment of E&S risks, project consultation, and approach to project monitoring. Specific risks of the project are identified and an action plan, which responds to these risks, is disclosed.²¹ This represents an example beyond compliance with IFC requirements.</p> <p>More generally, the trend among EPFIs is towards disclosure. Of the EPFIs, eight are IFC clients and they have disclosed the name, location, and sector of 41 sub-projects they have financed. EPFIs regularly disclose aggregate information about completed transactions by sector, region, and E&S risk category (A, B or C). This practice was also observed in a non-EPFI FI client as part of its Global Reporting Initiative (GRI) commitment.</p>	

¹⁹ For further details, see IFC October 2015 and 2016 statements, available at <https://goo.gl/VGHF7O> and <https://goo.gl/n0zTH9>.

²⁰ The Equator Principles (EP) are a set of voluntary E&S requirements modeled on the IFC Performance Standards. To date, 84 financial institutions have subscribed to implement EP in relevant investments. See <https://goo.gl/AdQlqU> (accessed October 24, 2016).

²¹ Further details available <https://goo.gl/EOwrXN> (accessed October 10, 2016).

IFC Sub-Project Disclosure (cont.)

Example of unsatisfactory practice:

In 2013, IFC made an investment in a PE fund which IFC categorized as involving high E&S risk. 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. Disclosure reviews are undertaken on an annual basis.

For one of the two investments disclosed, the only location information provided was “world” (although the fund reports to IFC that the company has business operations in three specific countries); the sector was given as “manufacturing” (although the fund reports to IFC that the company is involved in meat processing); and the disclosure only names the parent company although any E&S impacts would likely be linked to the operations of subsidiaries.

Discussion

This monitoring report confirms CAO's earlier observation that IFC's approach to the management of E&S risk in its FI business lines has improved since the period subject to the FI Audit. CAO welcomes the continued attention IFC has devoted to improving E&S risk management among its FI clients. Increased resources, growth in E&S specialists dedicated to FIs, revisions in guidelines, and piloting of new ESMS appraisal and supervision tools have resulted in an improved understanding of FI clients' approach to E&S risk management. These improvements, however, have not been implemented systemically in relation to clients that finance business activities with high E&S risk profiles. Further, when 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. This led to situations where identified client E&S performance issues were not remedied over extended periods.

Assessment and identification of E&S risk

CAO's monitoring has noted general improvements in IFC's pre-investment review since the release of the FI Audit. CAO has observed that IFC's E&S staff are generally included earlier in the appraisal process and sub-project level risk is emerging as a consideration at review. CAO has also observed instances of good practice where IFC used the ESMS Diagnostic Service as part of its pre-investment E&S review. In such cases, IFC demonstrated that the Diagnostic Service can provide a deeper assessment of the client's approach to E&S risk management and result in the development of a more detailed E&S Action Plan which is linked to financial incentives for implementation.

Notwithstanding this improvement, CAO notes that the quality of IFC's pre-investment review was highly variable. In relation to FIs making investments involving higher E&S risk, CAO observed that IFC's review was, in the majority of cases, not commensurate to risk. In such cases, CAO observed a range of shortcomings in IFC's performance. These included investments where IFC: i) assessed the FI client's portfolio risk only in terms of broad sector exposure rather than considering the client's exposure to specific business activities; ii) undertook a review of client's ESMS that was formulaic or otherwise lacking in depth; and/or, iii) did not conduct a robust analysis of the client's capacity to implement IFC's requirements. Generally, IFC's review of its client's capacity to implement IFC's E&S requirements was rudimentary.

Management of E&S risk in MSME targeted FI investments

A priority for IFC's FI investments is to support micro, small, and medium enterprises (MSMEs).²² As of June 2014, IFC reported that 67 percent (US\$12.7 billion) of its long term committed FI portfolio was committed to MSME financing globally.²³ MSME investments generally involve less environmental and social risk and often do not require the application of the IFC Performance Standards.²⁴

²² For further details, see <https://goo.gl/dxaCR8> (accessed October 11, 2016).

²³ IFC (2014) IFC Financing to Micro, Small, and Medium Enterprises Globally. Available at <https://goo.gl/mWW4Ae> (accessed October 11, 2016).

²⁴ IFC (2012) Interpretation Note on Small and Medium Enterprises and E&S Risk Management, see <https://goo.gl/ue8byc>

The IFC Sustainability Policy provides for IFC to restrict its E&S assessment to a portion of an FI client's portfolio if IFC's funding is both traceable and intended for a specified end use.²⁵ In such cases, IFC requires the FI client to implement IFC's E&S requirements in relation to the targeted portion of the portfolio.

Twenty-eight investments in CAO's sample were flagged by IFC as MSME targeted investments.²⁶ In 10 of these 28 investments, IFC's legal agreement with its FI client specified that IFC funds should be used only for MSME financing. However, only 3 of these 10 investments included a mechanism that would allow traceability of IFC funds.²⁷

As mentioned above, 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.

Development of mitigation measures

In response to gaps identified during pre-investment review, E&S mitigation measures remained standardized in nature and were rarely tailored to the specific situation of the client. Analysis of necessary resources and cost of developing a PS compliant ESMS was absent. Analysis of the implementation support clients would need to meet IFC E&S requirements was also lacking.

In the majority of investments reviewed, IFC required FI clients that intended to finance higher risk activities to develop an ESMS to apply the Performance Standards prior to IFC's first disbursement. The average time from IFC Board approval to IFC's first disbursement for the 15 investments requiring the application of the Performance Standards prior to first disbursement was 100 business days.²⁸ Of these investments, eight required the application of the Performance Standards for the first time. In the contexts where IFC is providing finance to FIs with limited or no prior experience in implementing the Performance Standards, questions as to the realism of such timelines emerge.

Further, CAO observed projects where the applicability of the Performance Standards was determined by approaches developed by IFC. This occurred through two approaches. CAO observed four instances where IFC and the client included provisions in the investment agreement that restricted application of the Performance Standards to loans where defined sub-project loan size, purpose, and tenor

²⁵ IFC Sustainability Policy 2012, para. 44. ESRP 7 para. 3.2.3 and 3.2.4.

²⁶ Of the 38 investments in CAO's sample, IFC flagged 28 investments as MSME investments. IFC has three criteria for flagging an MSME investment: i) Targeted SME projects; ii) SME-focused FI (e.g. projects that provide investment or advisory services to an FI which has more than 50 percent of commercial loans, by number, to MSMEs at the time of the investment); and, iii) projects that have an active MSME advisory engagement at the time of the investment.

²⁷ The three investments are IFC Risk Sharing Agreements. IFC agreed to share the risk of sub-borrower defaulted on a defined portfolio of MSME investments. The FI client was required to report to IFC on a quarterly basis all loan in the portfolio. In one investment, additional measures were agreed to improve traceability of activities which IFC supported. General information on these investment products available at <https://goo.gl/8t4eOm> (accessed February 6, 2017).

²⁸ Based on an average of the 15 investments in CAO's sample which required application of PS prior to IFC's disbursement. This average does not include i) five FI investments which had excessive delays (over 365 days) between IFC Board Approval and IFC disbursement not as a result of an E&S issue, and ii) five investments which had post-disbursement application of the PS.

requirements were met.²⁹ More commonly, CAO observed instances where an FI client had included threshold requirements in their ESMS on the application of the Performance Standards that were not present in the investment agreement. Both approaches developed by IFC are not described in the Performance Standards as approved by the IFC Board.

General supervision

IFC's supervision of its FI investments was highly variable. Positively, CAO observed the utilization of ESMS Diagnostic Service and the ESMS Implementation Review with clients during supervision in six cases. Both tools provided IFC with deeper understanding of its client's ESMS, while the latter tool included a framework to assess the implementation of IFC's requirements through multiple ESDD reviews and sub-project visits. More generally, through the review of client ESDD assessments and joint IFC-client site visits to sub-projects, the intensity of IFC's supervision was noted as having increased compared with what was observed in the FI Audit. At the same time, CAO notes that an IFC requirement for IFC to annually visit FIs which are required to apply the PSs was only met in 44 percent of the relevant investments sampled.³⁰ In four investments which require the application of the PS,³¹ IFC has not completed a site visit yet. More commonly, IFC completed a site visit however, at a frequency less than annual.

In the majority of cases reviewed, IFC's supervision did not provide assurance of implementation of IFC's E&S requirements by the FI client. While reviewing client prepared ESDD assessments is an important part of IFC's supervision, no standard methodology for such a review was observed. Further, in relation to higher risk investments, where application of the PS to sub-projects was required, CAO found that IFC's approach to supervision did not provide assurance of client compliance either in relation to E&S due diligence or monitoring.

In cases where IFC identified gaps in client E&S performance, IFC did not generally develop a corrective time bound or resourced E&S Action Plan to address shortcomings in the FI's E&S performance. Rather, the tendency was to report gaps in performance to the client and follow up on these during the next supervision cycle – a year later. This led to situations in which identified gaps in client E&S performance were not remedied or not fully remedied over longer periods of time.

Further action is also required to support client capacity to implement the Performance Standards. IFC seeks to build client capacity through online courses, and trainings on E&S risk management, review of client prepared ESDDs and joint IFC-FI sub-project supervision visits. However, these measures are not implemented in a coordinated or systematic way. CAO acknowledges IFC's efforts to grow market capacity to support FIs in E&S risk management. However, CAO notes that further effort is required in this area to support FIs in their understanding and ability to manage high E&S risk sub-projects.

More fundamentally, IFC's approach to supervision was not observed to support systematic analysis of sub-project level E&S risk or the extent to which such risk was being effectively managed by the FI. Gaps included a lack of: (a) client reporting on portfolio level E&S risk (e.g. number and size of category

²⁹ For example, in one instance a client was required to apply the Performance Standards where the sub-project capital cost was in excess of US\$25 million and the tenor of the loan was 36 months. In another instance, a client was required to apply the Performance Standards where the sub-project loan was in excess of US\$1 million and 12 month tenor.

³⁰ IFC ESRP 9.2.8 Table 1.

³¹ All four investments were categorized as FI2.

A, B, and C projects in the client’s portfolio); (b) client reporting on the number of projects required to implement IFC Performance Standards; (c) a methodology for verifying the effectiveness of client ESMS implementation; and (d) other metrics for quantifying E&S risk such as sector and country exposure. In the investments reviewed, such data was not collected, aggregated, or reported.

In these circumstances, it is not possible to assess the level of E&S risk to which IFC is exposed through its FI portfolio or to what extent this risk is being mitigated through client ESMS systems. As a result, it is also not possible to reach conclusions on the extent to which improvements in IFC’s E&S supervision are sufficient to address the underlying E&S risk attached to its FI investments. Thus key concerns regarding IFC’s approach to the supervision of E&S risk in its FI portfolio as raised in the FI Audit remain.

Disclosure and accountability

IFC noted measures to improve disclosure and accountability to potentially affected communities as part of its response to the FI Audit. These included enhanced disclosure of projects being supported through PE funds and the requirement that all FI clients develop mechanisms to handle public complaints about the E&S impacts of their investment activities.

CAO notes progress on disclosure in relation to IFC PE funds where IFC has disclosed the sub-projects they finance. This is an important step forward. 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.

At the same time, CAO notes that 53 commercial financial institutions which subscribe to the Equator Principles have implemented a framework for consent based disclosure of the name, location, and sector of over 900 sub-projects since 2014. Of these EPFIs, eight are IFC clients and these FIs have disclosed the name, location, and sector of 41 sub-projects they have financed.³²

The EPFIs among IFC’s clients regularly disclose aggregate information about completed transactions by sector, region, and E&S risk category (A, B, or C). This practice was also observed in a non EPFI FI client as part of its participation in the Global Reporting Initiative (GRI). CAO notes and welcomes IFC’s commitment to collaborate with the EPFIs to “promote voluntary FI sub-project disclosure to help shift market practices on transparency”.³³ CAO encourages IFC to provide additional detail on concrete actions or targets in relation to this commitment.

Based on CAO’s review, implementation of measures to enhance accountability for FI lending remains a challenge. IFC supervision of FI clients’ external communication and grievance mechanisms was limited, with only initial steps towards establishment of such mechanisms having been taken in some cases. Supervision of the extent to which FI clients are requiring implementation of grievance mechanisms at the sub-client level was absent. In this context, CAO has concerns that its findings regarding the development of external communications and grievance mechanisms that are readily accessible to affected communities and about which affected people are informed, have not yet been appropriately addressed.

³² Equator Principles members reporting available at <https://goo.gl/3ltkAv> (accessed October 11, 2016).

³³ IFC (2016), *Improving IFC’s Approach to E&S Risk Management*. Available at <https://goo.gl/9cgD7Y> (accessed October 25, 2016).

Conclusions

This monitoring report confirms that the quality and intensity of IFC's review and supervision of FI investments has improved since the release of CAO's FI Audit. However, it also flags ongoing concerns that IFC does not, in general, have a basis to assess FI clients' compliance with its E&S requirements. This is of particular concern in relation to FI clients that are supporting projects with high E&S risks, and where IFC does not have assurance that the development of a client's ESMS is leading to implementation of IFC's Performance Standards at the sub-project level.

At the same time, CAO notes a number of good practice examples which could be built upon and expanded. These included the E&S Diagnostic Service and the ESMS Implementation Review. Well implemented, these tools provide IFC with a better understanding of its FI clients' ESMS and ESMS implementation capacity. They also provide a framework for developing tailored mitigation measures to support compliance.

While CAO's review has documented gaps in IFC's approach to ensuring that people affected by the business activities of its FI clients have ready access to external communications and grievance mechanisms, CAO welcomes IFC's recent commitment to promoting sub-project disclosure among its FI clients. Clarifying the content of this commitment and establishing benchmarks for improved disclosure will be important next steps in this respect.

CAO's mandate requires monitoring until actions taken by IFC assure CAO that IFC is addressing its compliance findings. In relation to the FI Audit, CAO acknowledges steps IFC has taken to improve its approach to E&S risk management, while at the same time concluding that the measures taken and proposed do not provide assurance of compliance. Accordingly, CAO will keep this monitoring process open. Due to the nature of the issues, and the systemic changes that are required to address the findings CAO expects to carry out its next FI monitoring exercise in 2019.

Annex A: Key Findings for CAO's FI Audit, Released in February 2013

CAO Finding No.	Findings of CAO's Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries
4.1	IFC's E&S processes and results do not fully correspond to IFC's overall corporate message. The IFC approach, which is based on achieving change through the application of a management system, does not generate information about actual E&S results at the sub-client level.
4.2	There is a lack of clarity about when IFC's two different concepts of E&S risk [do no harm and credit risk] apply thus creating the possibility that IFC's systems do not effectively minimize environmental or social harm that may result from the action of clients or sub-clients.
4.3	There is a lack of clarity about IFC's actual E&S objectives. In addition, there is not a systematic approach to assessing whether the two broader objectives [do no harm and have a positive impact] are being achieved. The current approach is focused on confirming that clients have implemented a ESMS.
4.4	Differing E&S requirements of the various development finance institutions places a burden on IFC's clients and fails to take advantage of potential opportunities to increase the efficiency and leverage of the DFIs, individually and collectively.
4.5	There are potential opportunities for IFC to encourage the adoption of a widely shared vision of industry standards for acceptable E&S practices, behavior, and results. Requiring clients to report and disclose E&S performance and to engage third-party assurers to provide an independent check would further contribute to the propagation of global norms, while improving disclosure.
4.6	IFC's focus on establishing a ESMS as a legally required product—instead of as part of a more fundamental change management process—creates the risk of a reporting and compliance orientation on the part of the client. This focus, in turn, means that the ESMS can become an end in itself, rather than a means of enhancing E&S performance outcomes on the ground.
4.7	IFC's E&S requirements have not been adequately adapted for FM clients and are thus not optimally designed to assist FM clients in improving the E&S performance of their sub-clients.
4.8	IFC does not have a structured approach to assess and address two key elements of a successful E&S program: client commitment and client capacity to implement an effective E&S management system.
4.9	IFC's current approach to the application of E&S issues to financial markets transactions does not adequately reflect the significant differences in client capacity and the business, institutional, and cultural setting in which they operate.
4.10	The deployment of high quality E&S staff to work on FM investments in recent years has had a material impact on the quality of support provided to clients. However, this has yet to address the underlying limitations of the ESMS-based approach to E&S management.
4.11	IFC's allocation of E&S resources is not cost based. IFC does not have an adequate system in place to determine whether E&S resources are being used efficiently, or whether certain functions should be outsourced.

Annex: B Summary of Key Actions Reported by IFC in Response to CAO Audit

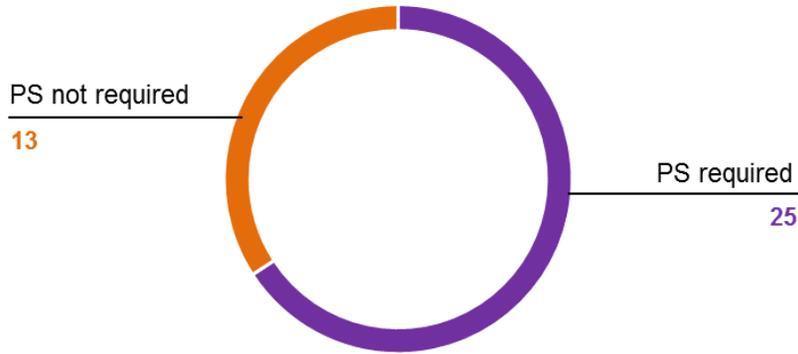
- IFC updated its **Environmental and Social Review Procedures (ESRPs)** for FI investments. Specifically, the revised procedures provided more detailed guidance to staff on appraising and supervising FI investments. Further, IFC outlined changes to the circumstances in which IFC requires its FIs to apply the Performance Standards to sub-clients.
- IFC noted progress in the **development of a system to track E&S gaps**, with management informed of gaps on a quarterly basis.
- IFC reported it developed **new tools to guide investments** in instances where IFC is investing in a country/sector with specific challenges. These include third-party country contextual risk briefing reports, media intelligence reports and research briefs.
- IFC piloted an **ESMS Diagnostic Service** with 20 FI clients to identify E&S risk areas and enable benchmarking of the client's performance. The tool reviews an FI's approach to E&S risk management in terms of its policies, procedures and processes, and capacity for implementation IFC's requirements. The objective of the diagnostic is to identify risks and areas for improvement, and provide recommendations for improvement. IFC staff compile the diagnostic based on a review of the client's ESMS documentation, on-site interviews with FI management and staff, and in some instances, site visits to sub-projects. The performance gaps identified during the diagnostic are addressed by a set of recommendations that prioritizes areas for improvement with deliverables specified.
- IFC reported that it had conducted a **comprehensive review of all FI clients** (excluding Private Equity clients) with ongoing E&S non-performing issues. For each case, IFC reported that it developed a corrective action plan jointly with the client. In a number of cases, IFC noted that it had exited FI investments which had E&S non-performing issues.
- To support **market capacity development**, IFC reported that it has supported a Train the Trainer program in multi countries and held a training program for Private Equity funds operating in Asia and Pacific region.
- IFC asserted that it sought to create a **strong internal understanding and ownership of E&S issues** among its staff through increased messaging by senior management, development of a tip sheet and E&S training programs for Investment staff.
- IFC reported a **significant increase in capacity** for its E&S Department (CRKES) in the period FY15-17 which has facilitated the increase in E&S staff dedicated to FIs.

Further details on actions taken by IFC is available in its Update on IFC's Management of E&S Risks in its FI Business (October 2015).³⁴

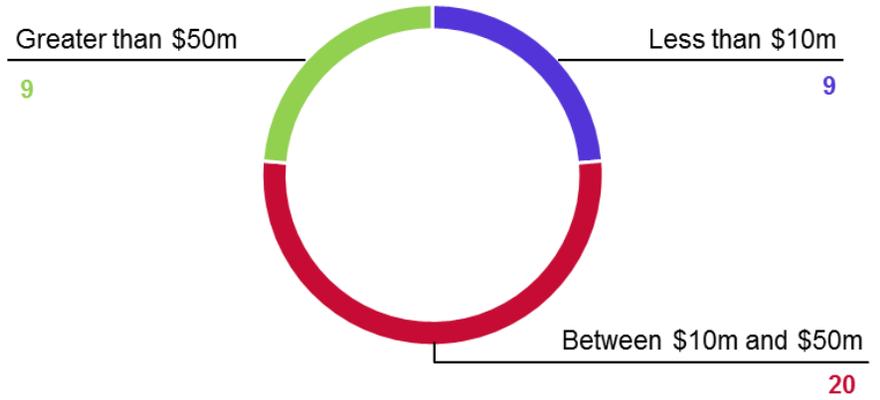
³⁴ Available at <https://goo.gl/pd8ePZ> (accessed September 2016).

Annex C: CAO Sample Distribution and Sample Selection Process

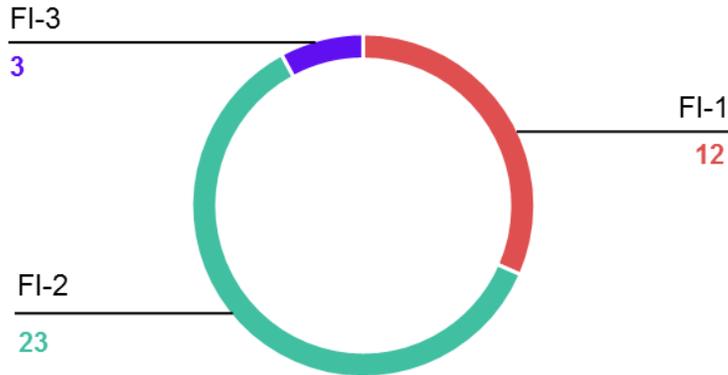
Investment Requiring Performance Standards



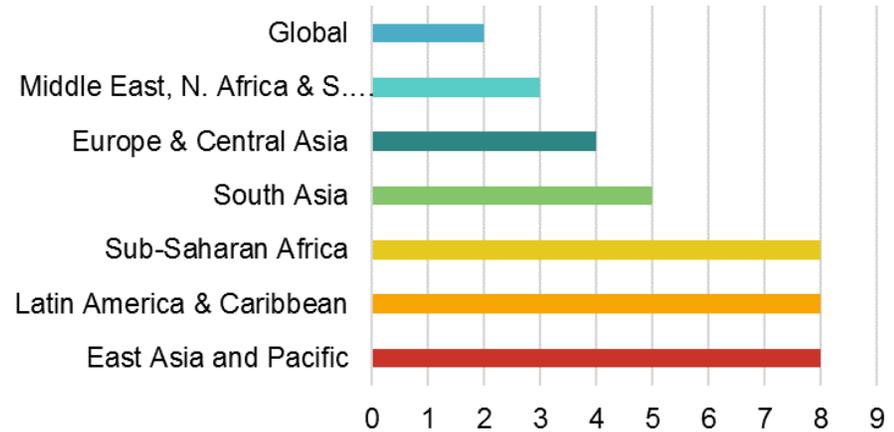
Disbursement of IFC's Committed Investments, Number



E&S Risk Categorization



Number of Investments in Sample by Region



Sample Selection process

The sample of 38 IFC FI investment post January 1, 2012, was selected through a combination of i) random selection, ii) IFC recommendations, and iii) selective additions for the purpose of achieving regional balance and coverage of IFC ESMS Diagnostic Service clients.

Random selection

Random number generator utilized to select 20 FI investments disclosed by IFC with a Board Approval date between January 1, 2012 and September 30, 2015. Investments where IFC had not completed a disbursement were excluded.

IFC recommendations

CAO requested a sample list of FI investments from IFC on the basis of client type, investment product, risk and client performance. IFC recommended 14 FI investments to CAO. Of these, CAO selected 5 investments on the basis of client type and regional diversity.

Selective additions

An additional 13 investments were selected by CAO to ensure balanced regional coverage and representation of projects where IFC's ESMS Diagnostic Service had been applied.

Annex D: IFC's Definition of MSME

IFC defines an MSME as a business which meets two of the following criteria; i) less than 300 employees, ii) less than US\$15 million in total assets, iii) less than US\$15 million in total revenue.³⁵ A definition of an MSME may be included in IFC's legal agreement with its clients. As a proxy, IFC may consider loans by an FI client to a business below US\$1 million (US\$2 million for more advanced economies³⁶) as MSME loans.³⁷

In the sample, CAO observed various MSME definitions included in IFC's legal arrangements with its clients. Examples of these definitions are detailed below.

	Max Employees	Total Assets	Total Revenue	Other Criteria
IFC's MSME Definition	300	US\$15 million	US\$15 million	N/A
FI Investment One	No criteria	No criteria	US\$60 million	N/A
FI Investment Two	500	US\$15 million	US\$15 million	N/A
FI Investment Three	No criteria	No criteria	No criteria	US\$1 million sub-loan exposure

³⁵ Additionally, IFC provides specific criteria for defining a business as micro and small. For further details, see <https://goo.gl/aJM1s8> (accessed October 11, 2016).

³⁶ "Advanced Countries" are: Argentina, Brazil, Chile, China, Colombia, India, Korea, Mexico, Morocco, Peru, Russia, South Africa, Thailand, Tunisia, Turkey, and all EU accession countries— Poland, Hungary, Czech Republic, Slovakia, the Baltics, and Slovenia

³⁷ IFC (2012), Interpretation Note on Small and Medium Enterprise and Environmental and Social Risk Management <https://goo.gl/aJM1s8> (accessed October 11, 2016).