THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DATE: January 31, 2013

TO: Meg Taylor, Vice President, Compliance Advisory Ombudsman

FROM: Rashad Kaldany, Vice President, Global Industries

EXTENSION: 36787

SUBJECT: Report on Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries

We welcome the report by the CAO on an *Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries* (hereafter "the report"). As the first sector review by the CAO, this is a precedent-setting report, and provides an independent and fresh perspective on our work, and an opportunity for reflection on how to strengthen IFC's operational support to IFC's Financial Intermediary (FI) clients.

Overall, we believe we have the same objective as the CAO in ensuring the effective and efficient management of the E&S risks of our FI business. With reference to the specific findings in the report, other than a few points where we either agree or disagree, we essentially see the report present perspectives on how IFC could work differently or better to meet the above shared objective. Our detailed responses to the specific CAO findings and our proposed next steps are provided in the attached Annex.

FIs are a key channel to expand IFC's reach and development impact in our target markets. Over the past several decades, IFC has worked with hundreds of FIs in over 120 developing countries, delivering financial resources to millions of SMEs, microenterprises and individuals that it would never be able to reach directly. This engagement has strengthened the capabilities of FIs to fund activities in vital economic sectors such as agriculture, housing, manufacturing, infrastructure and social services. Our work with these clients has supported an estimated 100 million jobs[1].

Beyond working with client FIs as investment partners, IFC also plays a catalytic role in scaling up the provision of sustainable financial services in developing countries—by improving access to credit information and credit bureaus, promoting best practices in risk management and corporate governance, and promoting environmental and social (E&S) best practice. We believe this approach helps establish market benchmarks for good business practices and enables more systematic solutions to development challenges in our client countries, including on E&S risk management.

While we are encouraged by these results, the development agenda remains daunting. There are billions of people still living below the poverty line, and millions of enterprises without access to financial services, and this hinders economic growth and job creation. This reality makes it essential for us to continue to engage and expand our work with emerging market FIs, who share our commitment to sustainable development, so that we can together address these development

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[1] The report and summary are available on the IFC and Job Creation page at http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IDG_Home/JobCreation

challenges. Within this larger context, the management of E&S risks and the resultant development impact for the financial sector is important for IFC.

We therefore appreciate that the report recognizes the positive role that IFC plays in strengthening E&S sustainability in the financial sector. We are also happy to note that the CAO report finds a 90 percent compliance/success rate regarding the adoption of IFC's policy requirements by clients. We believe that the 2012 update of IFC's Sustainability Framework has helped further improve effective risk management and transparency and the steps we have taken to strengthen our E&S capacity and focus on FIs since 2006 are paying off.

The report also points to areas for improvement. While this is covered in greater detail in the Annex, it is important to recognize IFC's objectives with regard to E&S and other best practice. As reflected in IFC's 2012 Sustainability framework with reference to FIs, IFC does not evaluate all information at the sub-client level. We do not consider this necessary or efficient as our intent is to have our partner FIs manage this through an Environmental and Social Management System (ESMS). We do expect our FI partners to maintain all the requisite information about all their sub-clients, including E&S information and this is evaluated by IFC as part of our on-going supervision process. IFC's approach is to differentiate between clients that are exposed to significant E&S risk and those that are not; and (ii) sample sub-client investments during supervision visits to validate the effectiveness and implementation of client ESMS. Implementing an ESMS requires significant change management and is a journey of continual improvement that IFC and its partner FIs undertake. We have also noted the perception about our corporate messaging and we will work to build greater understanding of our work and impact with our stakeholders and partners.

Recognizing that there is always scope for improvement and there are areas we may not have fully explored, IFC proposes to enhance its engagement with external experts, civil society and other stakeholders on an ongoing basis to better understand concerns and suggestions and share IFC's approach to working with FIs. Based on these engagements, we propose to continually identify actionable areas for improvement, and make the necessary course corrections.

We would like to thank the CAO once more for this report and the opportunity it presents IFC to enhance the effectiveness of our mission. We look forward to working with the CAO and other stakeholders to remain on a path of continual improvement.

cc: Messrs. Jin-Yong Cai, Henrik Linders, James Scriven, Willam Bulmer, Ajay Narayanan

Encl.

ANNEX 1: IFC responses on specific findings outlined in the CAO report

CAO Findings	IFC Comments
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.	We agree that it is important to have correspondence between our results and our messaging. We understand that the CAO's concerns revolve around the limited information that IFC can disclose about E&S results at the FI sub-client level and the ability to claim development outcomes and justify statements claiming positive E&S impacts. IFC's approach does not require IFC to review and evaluate all information at the sub-client level. We do not consider this necessary or efficient as our intent is to support the FIs to manage the risks through the ESMS. As is recognized in the CAO report, we do expect our FI partners to maintain the requisite information about all their sub-clients, including E&S information where the risks merit. This information is evaluated by IFC as part of our on-going supervision process. In order to maximize IFC's impact in the FI sector our approach is to: (i) differentiate between those clients that are exposed to significant E&S risk and those that are not; and (ii) sample sub-client investments during supervision visits to validate the effectiveness and implementation of client ESMS. Implementing an ESMS requires significant change management with the institution and a journey of continual improvement over time, and IFC and its FI partners undertake based on a shared commitment to sustainable development. IFC has been working to overcome the inherent challenges to collect and communicate the results associated with its activities and that of its FI clients. IFC's Development Outcome Tracking System (DOTS), developed as part of its ongoing efforts in this regard, is considered industry best practice amongst DFIs. IFC has recently taken a number of additional steps to enhance disclosure for its FI business, where feasible given client country regulations, in the new Access to Information Policy of 2012. IFC remains committed to working to improve the area of impact measurement and reporting. We have noted the perception about our corporate messaging and we will work to build greater understanding of our work with our stakeholders and partners. We will in any case engage with the CAO and other stakeholders to see if there are tangible steps we can take to address this difference in perspective.
4.2 IFC applies two different concepts of E&S risks	This is an area where we have a difference in perspective from the CAO. IFC believes that the concepts of 'do no harm' and 'credit risk' are interlinked, and that this association underlies the business case for sustainability. IFC reviews both aspects (E&S risk and credit risk) through the work undertaken by E&S staff and investment officers. Likewise, IFC also considers reputational risk that is directly and indirectly associated with the investment. We will engage with the CAO and other stakeholders to see if there are tangible steps we can take to address this difference in perspective.

4.3 IFC has three different types of E&S objectives: The CAO finds that 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 are being achieved. The current approach is focused on confirming that clients have implemented an ESMS.	We believe our E&S objective is clear–to ensure that our partner FIs have the necessary capacity and commitment, and take the necessary steps to manage their E&S risks, in a manner commensurate with the level of risk. The ESMS is the systematic means through which this objective can be accomplished. The new categorization process for FIs (introduced 1/1/12) aims to bring more clarity regarding the E&S risks of our FI investments, providing for the very diverse range of businesses and E&S risks that FIs represent. We will engage with the CAO and other stakeholders to try to build greater shared clarity on our objectives.
4.4 Despite interaction between IFC and other Development Finance Institutions, differing standards are a burden for clients: The CAO finds that the 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, effectively wasting development resources).	We agree with the CAO that we should seek to minimize the burden to clients arising from the various DFI E&S requirements. We believe that IFC has done a lot to enable harmonization of standards, while recognizing the different policies and principles that various DFIs subscribe to. We agree that there are efficiencies to be gained by standardizing multiple-lender requirements for clients and that this needs continued attention. This is an area of active engagement for IFC. Additionally, IFC's legal department is working on standardizing legal documentation. Since the IFC Performance Standards were adopted in 2006, IFC has engaged with other DFIs in supporting the harmonizing E&S assessment standards. This includes: • Support for the Multilateral Financial Institution (MFI) Working Group on Environment (the bi-annual meeting of environmental experts from MFIs represented usually at the Director level). • Support for E&S policy-update processes at DFIs through engagement and responding to requests for comments/feedback/advice (e.g.: official consultations with EIB, ADB, AfDB). • Bilateral engagement with individual DFIs (IADB, EBRD) or DFIs groupings (European DFIs). • Close consultation with European DFIs on harmonizing procedural approaches, as part of IFC's revised 2012 Sustainability Framework. This approach has led to the following outcomes: • EBRD modeled its Policy and Performance Requirements of 2008 on IFC's Performance Standards (requirements are almost completely compatible). • EBRD and IFC have been using a joint Exclusion List for co-financed FI projects since 2010. • European DFIs in 2009 and 2011 in the "Rome Consensus" decided to use IFC's Performance Standards as the E&S assessment standard. • The revised policies of EIB, ADB and IADB are much closer (e.g. scope of coverage) to IFC's Performance Standards. IFC has been engaged with other DFIs on harmonizing procedural approaches such as reporting as well. Since 2011, European DFIs have very closely aligned their approaches related to categorization, E&S screening, and reporting with those of IFC. IFC plans to continue this engagement to improve this harmonization further.

4.5 IFC has further opportunities to encourage the adoption of a shared vision and industry standards: The CAO finds that 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. Separately, these steps could free up IFC resources to play a more strategic role, such as focusing on results and outcomes (see below), working with new clients, working in countries where capacity is weak, and identifying and sharing good practice across regions/countries.	We agree that IFC should continue to encourage the adoption of a shared vision and industry standards on E&S matters of interest to the financial sector, and we will explore how to take some of the suggestions outlined in the report forward. Since 2006, IFC has been working with market players to spread the use of best practice standards. To date, 77 commercial financial institutions have adopted the Equator Principles. In addition, the 15 European DFIs and 34 OECD Export Credit Agencies have decided to use IFC's Performance Standards as their underlying E&S assessment standard. IFC is a signatory to the UN Principles for Responsible Investment and works with its clients active in capital markets and the Insurance industry on enhancing their E&S practices. IFC is also engaged in work with financial-sector regulators (e.g.: China, Brazil, Peru, Indonesia, Nigeria, Vietnam, and the Philippines) to elevate E&S practices in those markets. Experience has demonstrated that multi-stakeholder engagement of this kind is an effective way to leverage IFC's standards, enhance E&S outcomes, and better support clients. Many clients are now disclosing various aspects of their E&S performance and outcomes through their Annual or CSR reports. IFC is also disclosing more information regarding the E&S performance of its FI clients, consistent with the 2012 Access to Information Policy. IFC recognizes that there are further opportunities to enhance transparency by encouraging clients to report on their sustainability performance. We intend to deepen our engagement and training efforts with stakeholders in all areas of our work.

4.6 IFC's focus on the ESMS does not necessarily achieve a broader management and cultural change process: The CAO finds that 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, reduces the potential impact of the E&S requirements because the emphasis is on the input (the ESMS) rather than on the output (do no harm). The ESMS can become merely an end in itself (a box-ticking exercise), rather than a means of enhancing E&S performance outcomes on the ground.	We agree with the CAO objective here that E&S risk management needs to be internalized by the FI as a means to achieving performance outcomes on the ground. We believe the adoption of an effective management system is the foundation for E&S risk management in a financial institution. The effectiveness of such systems varies from client to client and often depends on numerous factors—including client capacity, availability of qualified consultants to support the FI in its risk-management efforts, and market and regulatory incentives for E&S risk management in general. IFC is committed to helping our clients gain a better understanding of the benefits related to E&S risk management. But not all IFC investments will lead to a broader cultural change process at the institutional level. Some institutions are not exposed to sufficient E&S risks to warrant such a cultural change. As a result, the influence of the ESMS on broader culture change will be commensurate with the FI's exposure to significant E&S risk. IFC's approach to ESMS validation through sub-client site visits was not assessed in the CAO audit, but constitutes an important part of IFC's supervision methodology. IFC believes that this supervision process provides a holistic view of the effectiveness of implementation of a client's ESMS. Under the new 2012 revised Sustainability Framework, where the risk so requires, such as with private equity funds, IFC directly reviews high-risk sub-projects and provides enhanced reporting and disclosure. Through our advisory services, we continue to focus on helping banks to build capacity and supporting banking regulators to adopt E&S best practices. We would be interested in ideas from the CAO what more IFC can do in this regard.

4.7 IFC's E&S requirements have not been adapted for FM clients: The CAO finds that the current E&S requirements are not optimally designed to assist FM clients in improving the E&S performance of their subclients.	We disagree with this finding. IFC's approach to FIs has been designed specifically for FIs and documented in the Environmental and Social Review Procedures and the Sustainability Policy since 2006. Additional adjustments and enhancements to our approach are made on an ongoing basis as part of our business-process-review efforts. FIs are expected to manage E&S risks associated with the investment activities supported by IFC financing. IFC requires all FI clients to develop and operate an ESMS commensurate with the level of E&S risk in their portfolio and prospective business activities. The ESMS must incorporate relevant principles of Performance Standard 1 on Assessment and Management of Environmental and Social Risks and Impacts. All FI clients must also manage the working conditions of their workforce in accordance with relevant aspects of Performance Standard 2 on Labor and Working Conditions. In the case of the financial sector, this typically relates to employment practices and conditions. Under IFC's Sustainability Policy, higher-risk FI sub-projects must apply the Performance Standards when they receive project finance or long-term corporate finance from an FI. This approach is intended to ensure full consistency between IFC's direct funded projects and the rare cases where larger projects or corporations are supported by an FI using IFC funds. We therefore believe that our approach is designed to recognize the nature of FI investments. More clarity on IFC's E&S risk management approach for FIs is provided in the FI Interpretation Note available on: http://www1.ifc.org/wps/wcm/connect/38d1a68049ddf966af3cbfda80c2ddf3/InterpretationNote_FIs_2012.pdf?MOD=AJPERES
4.8 IFC's approach to E&S requirements has precluded a structured approach to assessing two key elements of a successful E&S program: client capacity and Commitment: The CAO finds that IFC does not have a structured approach to assess and address two key elements of a successful E&S program: client commitment at the highest levels of the organization; and client capacity to implement an effective E&S management system using internal and/or external resources.	IFC agrees with the CAO that client commitment and capacity are the two essential elements for an effective E&S management system. IFC does have a structured approach to assess client commitment and capacity, and it is a central part of our appraisal process and decision to proceed with an investment. Building on a foundation of shared commitment to sustainable development that is established at the time of appraisal, IFC seeks to work in partnership with our FIs clients, making available various resources, providing advisory services, and engaging jointly in market interventions to bring about systemic change. Our aim is not only to increase the capacity of our clients but also to influence financial markets by increasing awareness of the benefits of E&S risk management. IFC's corporate governance team is exploring synergies with FI clients to support integrating E&S into their corporate governance structures. We would be interested in ideas from the CAO on what more can be done to strengthen the establishment of client commitment and capacity at appraisal.

4.9 Standardized implementation requirements do not accommodate different levels of E&S development: The CAO finds that the 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. This can lead to unrealistic expectations about client implementation of the E&S requirements, and reduces IFC's ability to maximize the effective allocation of its resources.	We agree with the CAO objective that implementation requirements need to be appropriate to the level of risk, the clients capacity and market conditions, but do believe that our current policy finds a good balance between applying a standard and being pragmatic. There is sufficient flexibility built into IFC's processes and procedures to accommodate country and client circumstances without undermining client accountability and timely implementation of agreed actions. IFC analyzes the level of E&S risk management at the institutional and national level as part of its appraisal process. As a result, the E&S action plan developed at the time of investment and agreed to with the FI client accommodates variations in client capacity by adjusting implementation periods and incorporating oversight clauses (e.g. sub-project oversight, more frequent action plan reporting, etc IFC has also launched an advisory services product for E&S risk management under its Access to Finance business line that focuses on enabling systemic change in key markets by helping banking regulators to adopt E&S best practices and creating market capacity to support FIs. We would be interested in ideas from the CAO on how we can improve our approach in this area.
4.10 The quality of E&S assessment has improved: The CAO finds that 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. The commitment of IFC's E&S and GFM staff to working with their clients on E&S issues has improved substantially. However, this has yet to address the underlying limitations of the ESMS-based approach to E&S management.	We agree with this finding. IFC appreciates the finding that the quality of our E&S due diligence and client support has improved over the last five years. We remain committed to strengthening and refining our approach to ensure that we manage the E&S risks of our business in a manner that is appropriate to the nature and context of our clients' businesses and the markets in which they operate.

4.11 The allocation of E&S resources is not cost-based: The CAO finds that the lack of a cost-based approach to allocate E&S resources makes it impossible to assess the efficiency and effectiveness of IFC's E&S activities.	We share the CAO intent that we need to be efficient in deploying our E&S resources. Our approach to supervision is risk-based, which also captures cost-effectiveness considerations. A key example is the annual supervision plan prepared for portfolio projects. Decisions regarding which projects need supervision visits are based on a combination of four criteria: 1) the E&S risk category assigned to the investment; 2) the client's management practices and implementation of the Action/ESMS Plans; 3) timing of the last supervision visit, and 4) findings from the most recent Annual Environmental Performance Report. In general, all higher-risk clients are visited annually or more frequently, while lower-risk clients are visited every two years. We believe a purely cost-based approach could lead to perverse outcomes such as projects with low risks being visited often simply because there is a specialist located in proximity to the project. Nevertheless, we review our processes and procedures regularly to ensure they are efficient and cost-effective. This is an area where we propose to engage with the CAO to better understand their findings and explore if there are steps that can be taken to improve our resource allocations.