Interpretation Note on Environmental and Social Categorization

International Finance Corporation
World Bank Group

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Introduction

IN1. This Interpretation Note (IN) explains IFC's approach to environmental and social (E&S) categorization of proposed investments, and becomes effective on January 1, 2012.[IN1] This IN also contrasts the updated approach with the approach that prevailed before and was introduced as part of the 2006 Sustainability Policy for the purpose of highlighting how the practice has evolved over the years. Like most other multilateral financial institutions (MFIs), IFC utilizes a system of E&S categorization as part of its E&S due diligence (ESDD) process to convey a sense of the relative magnitude of potential risks and impacts associated with the investments it is considering for financial support. The most recent changes are in part responding to requests to harmonize the categorization methodology between MFIs (including IFC and the IBRD). While this IN attempts a comprehensive overview of the approach to E&S categorization, it is not intended nor can it cover all possible investment scenarios or categorization variables and therefore IFC's categorization will continue to be the result of professional judgment exercised in a manner consistent with the principles outlined in this interpretation note.

I. Background and Context

IN2. The 2006 Sustainability Framework,[IN2] which came into effect on April 30, 2006, introduced several changes to IFC's categorization methodology. The 2006 IFC Policy on Social and Environmental Sustainability included provisions for three categories for direct investments, namely A, B, and C, in accordance with the level of potential impacts of the proposed investment. For indirect investments (i.e., investments through financial intermediaries (FIs)), the Policy refers to category "FI" as well as category C when there is no adverse E&S risks and/or impacts.

IN3. The revised approach sought to de-link the categorization decision from procedural requirements related to IFC's ESDD and from the tools[IN3] that IFC required clients to apply to assess impacts. The changes introduced through the 2006 Sustainability Policy were intended to result in more informed categorization decision-making since the outcome of IFC's ESDD process would determine investment-level categorization, in contrast with the earlier approach (see Box 1). The revised approach would allow IFC to apply the most appropriate ESDD tool(s), regardless of the categorization.

IN4. The 2006 Sustainability Framework more clearly articulated the roles of IFC and its clients with regards to disclosure of information and sought to de-link IFC's institutional E&S categorization decision from project-level disclosure requirements (as required in Performance Standard 1). IFC's

Box 1: Categorization Before the 2006 Sustainability Framework

The E&S categorization system in use prior to the introduction of the 2006 Sustainability Policy (generally referred to as the "Safeguards Framework" or "Safeguard Policies") was based on the World Bank's methodology for public sector projects, where categorization was linked specific process requirements for the ESDD. For example, the Safeguard Policies required that all Category A projects conduct an Environmental Impact Assessment by independent experts not affiliated with the project, develop a Public Consultation and Development Plan, and have annual monitoring verified or conducted by a third party. For Category B projects the Safeguard Polices only required a project summary (Environmental Review Summary) written by IFC and did not require any community consultation.

Under the Safeguards Framework, categorization was generally determined before initiating the ESDD and was based on limited project-level information and/or on the typical sector/industry risks or E&S footprint. This early categorization often determined the assessment tools that were applied, even if they were not the most appropriate for the specific project circumstances. This methodology can work well for greenfield operations categorized at the planning stage; but is more difficult to implement its procedural requirements at later stages in the project cycle as is often the case with private sector financings.

[IN1] This IN should be read in conjunction with the 2012 IFC Policy on Environmental and Social Sustainability, as well as IFC's Access to Information Policy.

[IN2] The 2006 Sustainability Framework consists of the Policy on Environmental and Social Sustainability, the eight Performance Standards and the Policy on Disclosure of Information. In the 2012 update of the Sustainability Framework, the 2006 Policy on Disclosure of Information became the Access to Information Policy.

[IN3] E&S tools include, but are not limited to, E&S Impact Assessment, Resettlement Action Plan, Hazard Operability Assessment, Risk Assessment, and Community Engagement Plan.

institutional disclosure of E&S information under the 2006 Policy on Disclosure of Information is achieved through the Environmental and Social Review Summary (ESRS), which is made public prior to IFC Board of Directors' consideration of a proposed investment. IFC's ESRS was purposefully no longer to serve as the primary mechanism for local public disclosure of project-level information. IFC has, however, helped to facilitate the general public's access to clients' project information by providing links to websites and copies of key documents as attachments to the ESRS.

IN5. IFC's overall experience with the E&S categorization under the 2006 Sustainability Framework has been positive. Five years of implementation have highlighted opportunities to more effectively address challenges related to E&S categorization resulting from the changing nature of IFC's investment activities, which will contribute to achieve even better signaling of E&S risk through categorization. In addition, requests for greater institutional harmonization on categorization have led IFC to include inherent sector risk as an element for consideration (in addition to expected or potential impacts). Given the increasing importance of corporate financing and investments in financial intermediaries, IFC has given further attention to (i) categorization of business activities with undefined scope (e.g., very early phase investments, certain equity and corporate finance structures, credit facilities, and funds, among others) where a full picture of E&S risks becomes apparent only after IFC's investment; and (ii) differentiating risk levels in FI investments through categorization.

II. Categorization Approach Under the 2012 Sustainability Framework[IN4]

IN6. IFC's categorization review and update was guided by a number of principles, as outlined in Box 2. The updated approach intends to articulate more clearly why and how IFC uses E&S categorization to reflect the relative magnitude of E&S risks and impacts[IN5] based on information available at the time of IFC's ESDD. Moreover, the updated approach also specifies certain aspects of IFC's institutional requirements for disclosure in accordance with IFC's new Access to Information Policy. These categories are now defined as follows:[IN6]

Category A: Business activities with potential significant adverse environmental or social risks and/or impacts that are diverse, irreversible, or unprecedented.

Box 2. Key Principles of IFC's Updated Approach to E&S Categorization

- Maintain a project-level E&S categorization framework as it is a widely recognized and accepted practice among MFIs for signaling relative projects risks and/or impacts to stakeholders.
- Maintain the separation of process and documentation requirements from the categorization to the extent practicable.
- Use a risk-based categorization approach for projects with undefined scope/assets (e.g., some corporate loans, some equity deals, most FIs).
- Recognize the disclosure constraints and limitations associated with projects that have undefined or limited scope/assets at the time of approval.
- Recognize the need to be more aligned with peer institutions, but that complete alignment is unlikely given that IFC investment is 100% private-sector oriented and that its product and lending mix is unique.

[IN4] The full text can be found in paragraphs 40 to 44 of the 2012 Policy on Environmental and Social Sustainability.

[IN5] E&S impacts refer to any potential change to the physical, natural, or cultural environment; impacts on surrounding community; and/or health of community or workers resulting from the business activity to be supported. E&S risk refers to a combination of probability of certain hazard occurrence and severity of impacts resulting from such an occurrence. In making categorization decision CES will take into consideration the following characteristics of severity of impact(s) a) major and permanent, b) major but temporary, c) minor but permanent, d) minor but temporary, c) no impact; and the following characteristics of probability of impact(s) occurrence: a) common occurrence, b) known to occur, c) could occur, d) not expected to occur, e) extremely unlikely to occur. For more see Annex A.

[IN6] IFC applies specific monitoring and supervision requirements to category A and B including production and submission of annual monitoring reports, status reports on the Environmental and Social Action Plan, cooperation with periodic Site Supervision Visits (SSVs), and data required to update the Development Outcomes Tracking system (DOTS). Moreover, these categories of investment are also scored at the end of appraisal and during supervision using the environmental and social risk rating (ESRR), an internal tool designed to aid in quantifying the scrutiny to which the investment is subjected during supervision and to determine the frequency of SSVs. Category A and B projects are also scored at the end of appraisal and during supervision using the Performance Standards Achievement Rating (PSAR) to define the investee's performance before and after IFC intervention.
IFC applies neither monitoring, reporting nor supervision requirements to category C investments.

Category B: Business activities with potential limited adverse environmental or social risks and/or impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures.

Category C: Business activities with minimal or no adverse environmental or social risks and/or impacts.

Category FI: Business activities involving investments in financial intermediaries or through delivery mechanisms involving financial intermediation. This category is further divided into:

- FI–1: when an FI's existing or proposed portfolio includes, or is expected to include, substantial financial exposure to business activities with potential significant adverse environmental or social risks or impacts that are diverse, irreversible, or unprecedented.
- FI–2: when an FI's existing or proposed portfolio is comprised of, or is expected to be comprised of, business activities that have potential limited adverse environmental or social risks or impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures; or includes a very limited number of business activities with potential significant adverse environmental or social risks or impacts that are diverse, irreversible, or unprecedented.
- FI–3: when an FI's existing or proposed portfolio includes financial exposure to business activities that predominantly have minimal or no adverse environmental or social impacts.

IN7. IFC recognizes that the investments it considers have different levels of information available at the time of IFC's ESDD. In some cases, the use of proceeds from IFC's investment is known and well understood, as is typical in traditional project finance. In many other cases, however, IFC's investment is not directed at specific physical assets (such as working capital finance and most equity investments) or it will lead to future investments (such as most FI operations or investment facilities or funds), and the use of proceeds is therefore indeterminate at the time of IFC's decision to invest.

IN8. Given the inevitable uncertainty associated with future investments, IFC has included an important provision in the updated approach to E&S categorization in the 2012 Sustainability Policy. When there is a material change in client's businesses activities or when the client plans to enter into a new business area that is materially different from what was represented when approved by IFC's Board of Directors, IFC will assess whether this change alters the client's environmental and/or social risks profile. In cases where the changes are material, IFC will require clients to adjust its management system in a manner consistent with (i) potential E&S risks and/or impacts associated with material changes of the new businesses activity; and (ii) other applicable requirements stipulated in the Performance Standards. This, however, will not affect the E&S category assigned to the original investment as IFC's institutional disclosure has already taken place.

III. Categorization of Direct Investments with Defined Scope/E&S Footprint

IN9. Where the use of proceeds of IFC financing and the associated E&S footprint of the business activity are known/largely known at the time of the decision to invest (such as in traditional project finance), IFC will determine the business activity's E&S category based on its E&S risks and impacts. The proposed categorization approach for this category of investments will include the assessment of inherent risks related to the sector of operation,[IN7] as well as the context of the business activity's likely geographic setting. Assessing inherent risks represents an additional consideration to the current practice of E&S

[IN7] Inherent E&S risk is the E&S risk related to generic aspects of an industrial sector or commercial activity excluding management or mitigation measures.

categorization, which has been based largely on potential or actual impacts. In practice, this will translate into having a larger number of projects categorized as Category A. This approach will better align IFC with the prevailing practice across other MFIs, including the World Bank.

IV. Categorization of Direct Investments with Undefined Scope/E&S Footprint

IN10. In traditional project finance, IFC's ESDD focuses on the client's assessment and mitigation of specific project E&S risks and impacts in reference to the Performance Standards. The situation is materially different in the case of some corporate loans, equity, working capital finance, or predevelopment phase investments (often in the form of equity), where the use of proceeds is undefined/largely undefined and not dedicated to a specific investment activity, where the use of proceeds is for exploratory / investigative work to determine if a development may be feasible or where little is known about the physical attributes, site, and impacts of the investment at the time of IFC's ESDD and investment decision.

IN11. Where the use of proceeds of IFC financing and/or the E&S footprint of the business activity cannot be well enough understood/defined at the time of IFC's ESDD, IFC will determine the E&S category based on risks inherent to the particular sector, as well as on the likelihood of a development taking place and on what can be reasonably known about the environmental and social characteristics of the business activity's likely geographical setting. Consequently, it is expected that investments which involve sectors that are of inherent high risk and are expected to be located in sensitive environmental areas or areas with significant social disruption will be categorized as A. Investments in sectors of inherent high risk but likely located in lower E&S risk settings will be categorized as A or B depending on availability of specific information. For instance, when IFC's investment is not related to any specific activities which would increase the company's footprint (e.g., financial restructuring or liquidity support) or financed activities which are within existing footprint (e.g., brownfield) or financed activities which are for exploratory / investigative work, the IFC's investment would typically be categorized as B.

IN12. In case of corporate investments IFC's ESDD will focus on two aspects of the client's operations. First, IFC will review the capacity, maturity, and reliability of the client's E&S corporate management system to effectively manage E&S performance, including its ability to enable current and future project compliance with IFC's PS. The review will also consider the E&S performance of a representative set of the client's existing operations and assets (where they exist) where these serve as a proxy for the general type of E&S risks and impacts associated with the proposed investment that need to be managed.

IN13. Notwithstanding those situations where the project context mitigates inherent sector risk, it is expected that the approach outlined above will result in some investments being categorized as Category A on the basis of very limited information. In such cases, moreover, since it is too early to fully understand the investment's physical footprint, it may also be too early for clients to conduct full-fledged impact assessment and/or undertake a process of Informed Consultation and Participation (ICP), or for IFC to undertake an analysis of whether Broad Community Support (BCS) exists. In such situations attempts to undertake ICP could lead to raised expectations amongst communities that a project is about to go ahead when in reality, it may not do so. These clients will still need to demonstrate PS compliance (including appropriate E&S assessment, stakeholder engagement and disclosure), and evidence of ICP, where required). Furthermore, clients will be required to develop full E&S Assessment and undertake ICP and disclosure as part of project feasibility studies as the physical footprint is defined. The disclosure of this information will be managed in accordance with IFC's Access to Information Policy.

V. Categorization of Financial Intermediary investments

IN14. In its determination of FI–1, FI–2, or FI–3 E&S categorization, IFC will consider the tenor, size, and type, as well as the sector-level exposure of its proposed investment in an FI.

IN15. For each investment, IFC's ESDD will include the review of the existing and prospective portfolio of the FI client to assess reputational risks to IFC, including those arising from E&S issues. E&S categorization for FI-related investments will consider the nature of the FI's portfolio that can be attributed to IFC financing.[IN8,IN9]

IN16. Category FI-1: Where the FI's portfolio and planned financing activities include a significant number of higher risk transactions (namely project finance and large long-term corporate loans) with exposure to high risk sectors, IFC will categorize such a proposed investment as FI-1. The following types of investments will typically be categorized as FI-1:

- General purpose debt, sub-debt, Tier 2 and Tier 3 capital or equity investments in banks with significant exposure to project finance and long-term corporate loans;
- Targeted-debt or risk sharing facilities where the pool of assets covered is high risk in nature, such as infrastructure; and
- Investment funds, including private equity funds, where the fund invests in high risk sub-projects, such as an infrastructure or natural resource fund.

IN17. Category FI-2: Where the FI's portfolio and planned financing activities are comprised primarily of lower risk transactions (all transactions other than project finance or large long-term corporate loans) to borrowers exposed to low- or medium-risk sectors and/or a limited number of higher risk type of transactions (project finance and long-term corporate loans) in high- and medium-risk sectors (e.g., infrastructure, extractive industries, large agribusiness, and energy), FI-2 category will be assigned. The following types of investments will typically be categorized as FI-2:

- Universal banks where there is limited portfolio exposure to higher risk transactions in high- and medium-risk sectors;
- Targeted debt or risk sharing facilities where the pool of assets covered is low to medium risk in nature;
- IFC support for financial workout of distressed asset facilities;
- Construction finance with limited adverse environmental or social risks and/or impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures;
- Leasing finance where the assets leased are for corporate use (e.g., light and heavy equipment);
- Insurance coverage such as maritime, construction, large-scale agribusiness, environmental insurance, , and performance guarantees; and
- Private equity and investment funds where the fund invests in low- and medium-risk sub-projects.

[IN8] In cases where IFC's investment is targeted to a specified end use (e.g., microfinance credit line), IFC's requirements regarding E&S risk management (as described in paragraph 33 of the Sustainability Policy) will cover the specified end use only. However, if the FI supports similar activities from its own account, then IFC's requirements will apply to the entire asset class in order to avoid different risk management approaches across the same asset class. IFC will also encourage its clients to manage E&S risks throughout their entire portfolio.

[IN9] In cases where IFC provides equity or financial support of a general purpose, without a specified end use, IFC requirements regarding E&S risk management (as described in paragraph 33 of the Sustainability Policy) will apply to the entire portfolio of the FI that is originated from the time IFC became a shareholder or investor.

IN18. Category FI-3: FI-3 category will be assigned to FIs where IFC supports investments that typically carry limited or no E&S risks. The resulting portfolio of lower risk transactions will typically consist predominantly of short-term finance, microfinance, retail, consumer finance, student loans, mortgage finance, retail consumer leasing finance, as well as transactions such as insurance (apart from surety bonds and performance guarantees for large development or infrastructure projects), certain types of trade finance products (typically not including warehouse and supply chain finance), interest, and currency swaps.

VI. E&S Categorization and Disclosure

IN19. In accordance with IFC's Access to Information Policy, E&S categorization determines IFC's institutional disclosure requirements for E&S information as well as the timing of disclosure of investment-related information before IFC Board consideration of the investment.[IN10] This section only covers those IFC's institutional disclosure requirements that are linked to E&S categorization. A full presentation of disclosure and access to information requirements are available in IFC's Access to Information Policy.

VII. Disclosure for Direct Investments with Defined Scope/E&S Footprint

IN20. For those business activities where the use of proceeds from IFC financing and the associated E&S footprint are known/largely known at the time of the decision to invest (such as in traditional project finance), IFC will follow its current practice related to its institutional disclosure of E&S and investment-related information. IFC will disclose a Summary of Investment Information (SII) no later than 60 days, in the case of Category A investments, or 30 days, in the case of all other investments, prior to consideration of the investment by IFC's Board of Directors. In addition, for each proposed Category A or B investment, IFC will disclose an ESRS. The ESRS will be disclosed no later than 60 days in the case of Category A investments, or 30 days, in the case of Category B investments, prior to consideration by IFC's Board of Directors. Along with the ESRS, IFC will disclose the Environmental and Social Action Plan (ESAP) (where such a plan is required by IFC) and any other relevant E&S documents pertinent to the investment.

IN21. The Access to Information Policy introduces post-Board disclosure requirements for IFC, some of which are contingent on E&S categorization. For category A and B investments where an ESAP was required by IFC and disclosed before IFC Board consideration, the status of implementation of ESAP actions will be disclosed by IFC as updates become available to IFC via client reporting.

IX. Disclosure for Direct Investments with Undefined Scope/Assets

IN22. For business activities where the use of proceeds is largely unknown at the time of IFC's ESDD, IFC will continue to follow the timeframes established in its 2006 disclosure practice, which is no later than 60 days in the case of category A investments and 30 days in the case of all other categories. The client will disclose relevant E&S information to the Affected Communities, following the requirements of Performance Standard 1, once this information is available. This may be after IFC has received Board approval for its investment.

IN23. The 2012 Access to Information Policy introduces important post-Board disclosure requirements for business activities with undefined scope/assets. Some of these requirements are contingent on the E&S categorization. In the case of category A and B investments, once the use of proceeds is known, IFC

[IN10] The Access to Information Policy addresses IFC's institutional disclosure requirements and general provisions on access to information. IFC client requirements for community engagement, consultation, sharing of information and local disclosure are outlined in Performance Standard 1.

will update its disclosure documents to reflect the findings of any ESDD-related work that has taken place post-Board approval. This includes IFC disclosure of any ESAP required for review by IFC that has been produced post-Board approval as well as regular updates on the status of implementation of the ESAP.

X. Disclosure of Financial Intermediary Investments

IN24. For all FI investments, regardless of E&S category, IFC will disclose an SII 30 days before consideration of the investment by IFC's Board of Directors. For investments with E&S category FI-1 and FI-2, the SII will include (i) the rationale for IFC's E&S categorization; (ii) a description of the main E&S risks associated with the investment and key elements of the Environment and Social Management System (ESMS); and (iii) key measures identified to strengthen the ESMS.

IN25. The 2012 Access to Information Policy introduces post-Board disclosure requirements for IFC in regard to FI investments, some of which are contingent on E&S categorization. For category FI-1 and FI-2 investments where an ESAP was required by IFC and disclosed before Board consideration, the status of implementation of ESAP actions will be disclosed by IFC as it becomes available. IFC will also disclose any ESAP that it required but that was produced after approval of the investment by IFC's Board of Directors.

SUMMARY OF THE REVISED APPROACH

Investment Type	Category	Basis for categorization	Pre-board disclosure IFC	Pre-board disclosure Client – project level	Post-disbursement disclosure by IFC	Post-disbursement disclosure by Client
Direct, Defined assets	**A**	Both actual and potential impacts identified during IFC ESDD. Inherent sectoral and setting risk will also be considered in the categorization determination.	IFC discloses SII and ESRS/ESAP no later than 60 days before Board presentation along with client-prepared E&S information. IFC discloses a summary of BCS determination before the Board (if applicable)	Clients disclose locally (and/or in an appropriate place) E&S documentation as soon as possible but no later than 60 days before Board.	IFC discloses periodic status on implementation of ESAP, prepared by client. IFC reports on project-level DOTS indicators.	Periodic reports on Action Plan Implementation to affected stakeholders.
	B		IFC discloses SII and ESRS/ ESAP no later than 30 days before Board presentation along with client-prepared E&S information. IFC discloses a summary of BCS determination before the Board (if applicable)	Clients disclose locally (and/or in an appropriate place) E&S documentation asap but no later than 30 days before Board.	IFC discloses annual status of implementation of ESAP, prepared by client. IFC reports on project-level DOTS II.	Periodic reports on Action Plan Implementation to affected stakeholders.
	C		IFC discloses SII no later than 30 days before Board presentation.	None	None	None
Direct, Undefined assets	**A, B**	Inherent sectoral and setting risk.	IFC discloses SII and ESRS no later than 60 days for Category A or 30 days for Category B prior to Board consideration.	None	IFC's discloses client documentation including Action Plan on its website. Thereafter, IFC discloses annual status of implementation of the Action Plan, as relevant. IFC discloses DOTS indicators when required. IFC updates ESRS/ESAP with project information	Client publicly discloses all relevant E&S documentation. Periodic reports on Action Plan Implementation to affected stakeholders.
	C		IFC discloses SII no later than 30 days prior to Board consideration.	None	None	None

Investment Type	Category	Basis for categorization	Pre-board disclosure IFC	Pre-board disclosure Client – project level	Post-disbursement disclosure by IFC	Post-disbursement disclosure by Client
FIs	**1**	Risks based on tenor, size, type and sectoral exposure	IFC discloses SII no later than 30 days before Board presentation along with information on the E&S Management System and ESAP, if required.	None	IFC discloses periodic status of implementation of the ESAP, as relevant For high-risk private equity funds, IFC discloses a list of the high-risk subproject investments made by the fund IFC discloses DOTS indicators for FIs.	
	2			None	Same as above	None
	3			None	None	None

Annex 1: Sustainability Policy, Performance Standard and Guidance Note Language Related to Supply Chains

	Probability				
Severity	A	B	C	D	E
1					
2					
3					
4					
5					

Severity of Threat	Probability of Occurrence
1. Major and Permanent Impact	A. Common Occurrence
2. Major but Temporary Impact	B. Known to Occur
3. Minor but Permanent Impact	C. Could Occur
4. Minor but Temporary Impact	D. Not Expected to Occur
5. No Impact	E. Extremely Unlikely