

UPDATE ON IFC'S MANAGEMENT OF E&S RISKS IN ITS FI BUSINESS

OCTOBER 2015

- 1) This note provides an update on the evolving status of IFC's approach to managing environmental and social (E&S) risks in its Financial Intermediary (FI) business based on IFC's own experience, CAO reports, and ongoing feedback from external stakeholders. The update covers the status of the IFC action plan presented to CODE in September 2013 (**Action Plan**), as well as other enhancements and upgrades that are being made arising from our continual improvement process.

Status of the Action Plan Implementation

- 2) The **Action Plan**, prepared in response to the CAO audit of IFC's investments in FIs, seeks to improve IFC's dialogue with stakeholders, shorten the learning and course correction cycle for IFC in managing risks through its continual improvement process, and provide greater support to clients and their markets through its Advisory Services.
- 3) We are pleased to report that most activities covered by the **Action Plan** are on or ahead of schedule. A tabular representation of current status of the action items is provided the Annex I. An overview of our progress since the last update is outlined below.

On-going Stakeholder Engagement

- 4) IFC committed to engage, at least annually, in a dialogue with civil society organizations (CSOs), covering various aspects of IFC's FI business. IFC initiated this process in December 2012 after a meeting with CSOs in Brussels and since then has been regularly engaging with CSOs on its E&S risk management approach for FIs. The last meetings were held in September 2014 in Myanmar and during the Spring meetings in April 2015 in Washington DC. Future meetings are being scheduled around the Spring and Annual meetings and as required for addressing specific issues. We have seen a positive shift in CSO's interactions with greater focus on having a constructive dialogue on open issues, rather than a general questioning of the approach to the FI business.
- 5) Over the last few years we have been actively engaged in a dialogue with the CAO. IFC organized several meetings where we had open and informal technical conversations between IFC and the CAO around IFC's FI business and associated E&S risks. In addition IFC joined with the CAO to hold several "deep dive" sessions and workshops around E&S risk management for FIs, CAO operating guidelines, and lessons learned. The engagement has been beneficial for both IFC and the CAO and we intend to continue to strengthen dialogue with the CAO to better identify and incorporate lessons learned.
- 6) IFC accepts that there is a need to minimize the burden to FI clients arising from various DFI E&S requirements and has prioritized its engagement with other DFIs on harmonizing our standards and procedural approaches. As a result of these conversations, adjustments to harmonize the E&S approach for investments in private equity (PE) funds are being discussed among DFIs, in particular with the EDFIs, EBRD and EIB. On the approach to

banks, the discussion has been primarily focused on harmonizing the scope of application of the Performance Standards (PSs) in FI sub-projects. The EDFIs plan to start testing IFC's approach when the DFI investment is in the form of equity and other regulatory capital transactions. DFIs have also agreed to start rationalizing their advisory service offerings and offer their training sessions to FIs that are clients of other DFIs. IFC is also working on a rationalized and clearer approach to addressing excluded activities with FIs.

Continual Improvement Framework

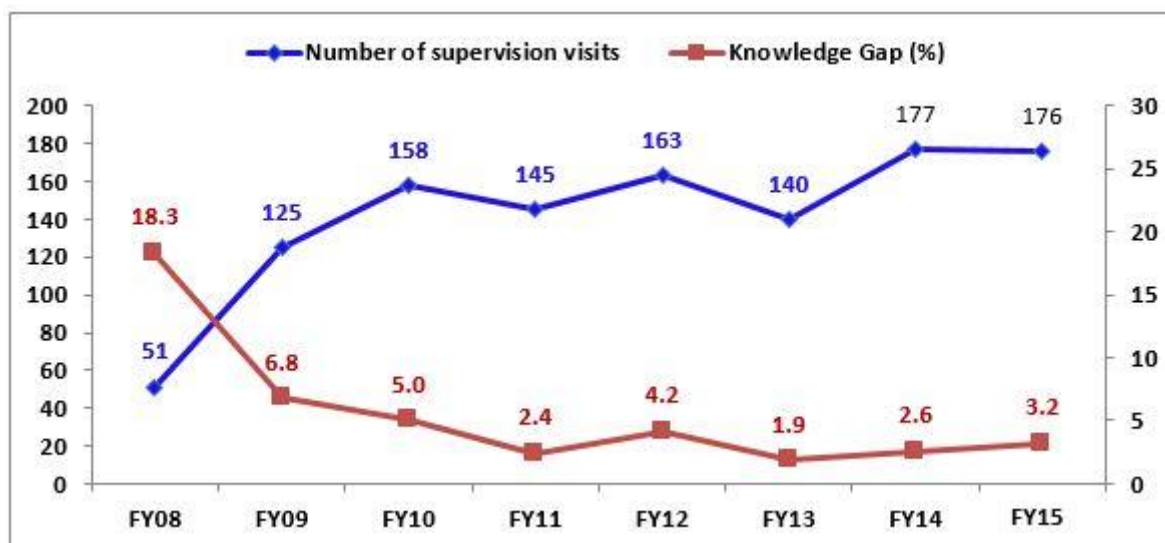
- 7) Our evolving FI business is taking us into more challenging areas with increasing E&S risks for us and our clients. IFC recognizes that E&S risk management needs greater attention in these areas and has committed to continually strengthen implementation of its policies and procedures. Over the last several years the following key enhancements were proposed and implemented in order to strengthen and deepen the quality and coverage of IFC's E&S risk management of FIs:

(7.1) Capacity and Commitment Assessments

Environmental and Social Review Procedure (ESRP) revision has been completed and went in effect in September 2014. The revised procedure now includes assessment of clients' capacity and commitment as key areas of appraisal and Investment Review Meeting (IRM) input by Environment, Social and Governance Department (CRKES). In addition the following key changes are included in the procedure: (i) at appraisal - a requirement to cross check clients' top exposures against IFC's Watch Lists and the list of companies under investigation by the CAO; revised risk based approach for PE funds' investments providing enhanced disclosure requirements; consistent set of E&S auditable criteria to be used by Specialists during the appraisal stage; guidance on disclosure to Senior Management and the Board of deviations from standard requirements, residual risk, exposures on Exclusion List/Restricted Activities and client commitment and capacity; and requirements for review of life and fire safety risks of FI clients, (ii) at supervision - expanded annual field supervision requirements to include FI-2 clients required to apply the Performance Standards; and revised protocol for validating the implementation of banking institutions' Environmental and Social Management Systems (ESMSs) through a review of a sample of sub-clients and/or review of their E&S due diligence (ESDD) as reflected in a defined sample of loan files.

(7.2) Increased Supervision

IFC has committed to cover all FI-2 clients required to apply Performance Standards and our implementation is on track. In FY15 IFC conducted 176 supervisions of financial intermediaries and private equity funds clients, and 191 in total for all of IFC's portfolio (compared to 140 in FY13). Out of those 87 were FI-2 clients with PS requirements (39% of all FI-2 clients with PS requirements).

Graph 1: Evolution of E&S Supervision Visits and Knowledge Gap**(7.3) Enhanced Disclosure**

In addition to the disclosure of information outlined in IFC's Access to Information Policy (AIP) IFC proposed and has taken the following steps to address enhanced disclosure of IFC FI projects:

- a) IFC revised the set of standard E&S provisions for PE funds to enhance legal provisions pertaining to PE fund investments in higher risk business activities. These provisions have been implemented for projects processed since September 2013 and the annual disclosure of all PE fund sub-projects to which new covenants apply started in November 2014. The listings are published as an update to Summary of Investment Information (SII) under the E&S tab. To date sixteen funds (Abraaj North Africa Fund, ADP II, Capman Russia II, CDH Fund V, CoreCo Fund, GC Credit, IBEF II, India 2020 II, Infuse Capital, Lereko Metier, Mediterranea II, Navegar I, New Hope Agriculture and Food Fund, Palestine Fund, Real LRIF, Yi Ming,) have disclosed their sub-projects. The aspect of public disclosure for other regulated FIs poses some additional challenges and this is covered later in the note.
- b) IFC revised the Annual Environmental Performance Report (AEPR) format for FI clients to include reporting by FIs on development of a grievance and communication mechanism, complaints received and responses provided. We expect to start receiving updated reports from clients including implementation and effectiveness of the mechanism starting in the next supervision cycle.

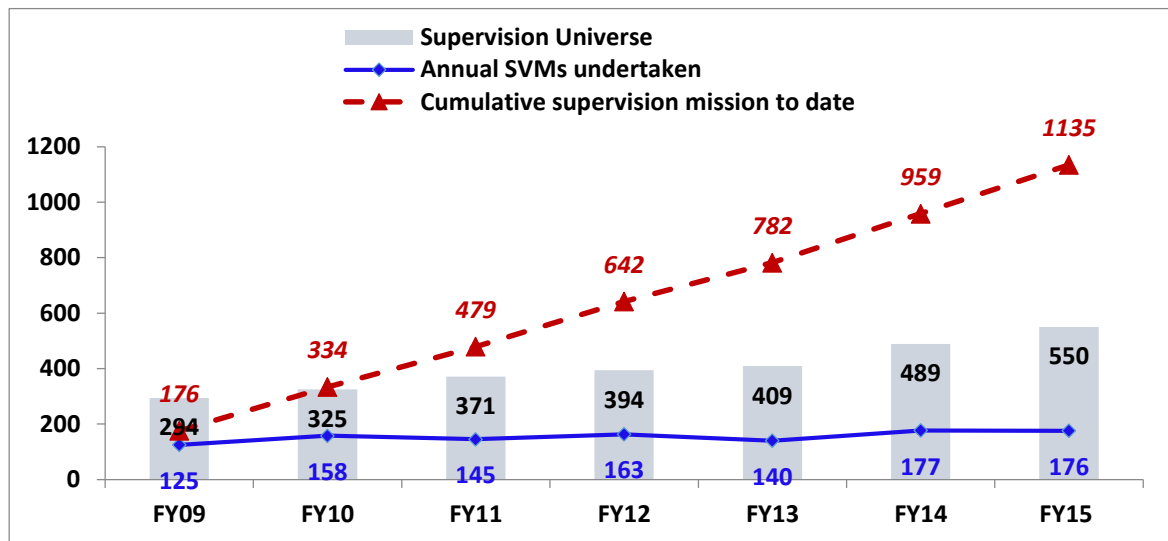
(7.4) Sub-project Reviews

The sub-project review approach has been formalized and is included in IFC's ESRP under section 9. The supervision of banking clients now includes a review of a sample of E&S due diligence prepared by the FI. Sample selection criteria has been developed and include amongst others: types of products provided by the FI, top exposures, key sectors of lending, high and medium E&S risk sectors and sectors with known E&S or other reputation risks. Typically a minimum of ten ESDD files are reviewed during a supervision visit. IFC is also

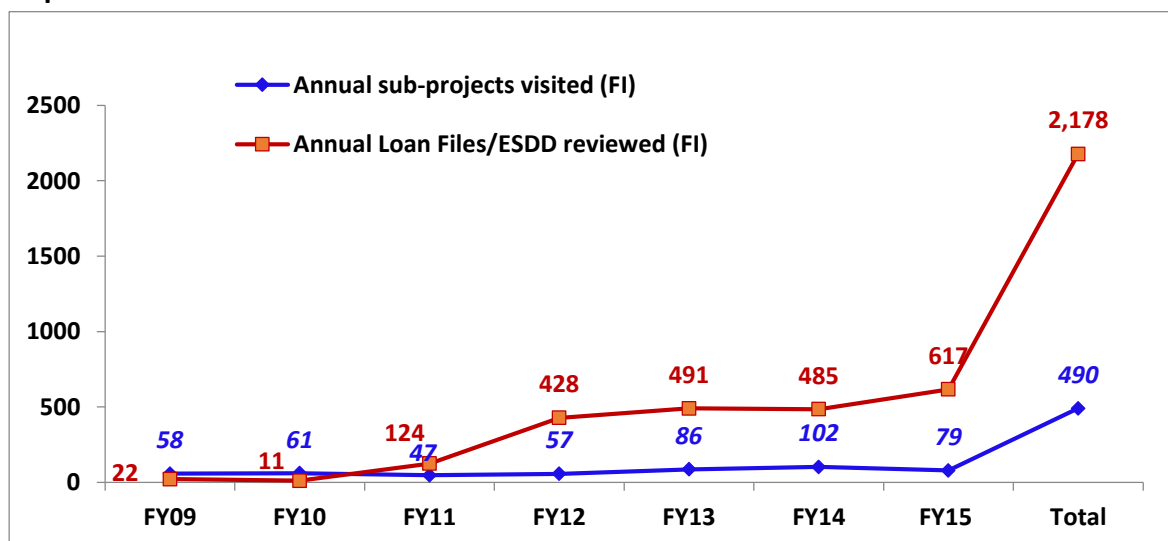
currently piloting review of larger samples for clients that have already implemented their ESMS for 1-2 years to ensure it is being adequately rolled out and to enhance the representativeness of the sample.

IFC currently actively supervises approximately 550 clients on E&S risk management and has conducted 1,135 field supervision visits over the last seven FYs (Graph 2). Since the adoption of the CAO FI Action Plan IFC has increased the review of ESDD loan files of banking clients to over 600 annually (Graph 3). To date IFC has cumulatively reviewed over 2,100 loan/investment files and visited approximately 500 sub-clients as part of its ESMS implementation validation process.

Graph 2: Annual and Cumulative E&S Supervision Missions



Graph 3: Annual Sub-Project and E&S Diligence File Reviews to validate ESMS Implementation

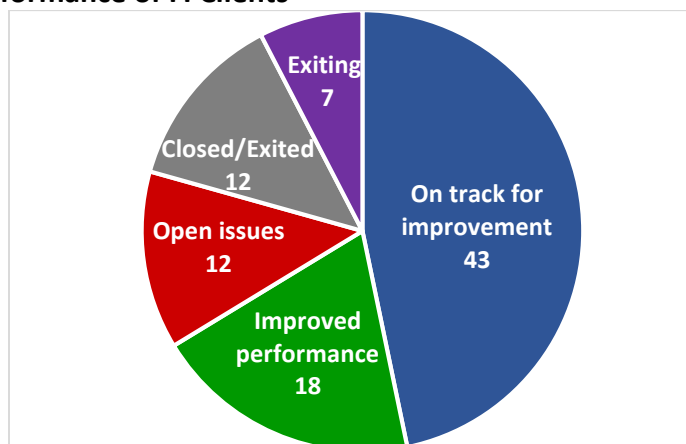


(7.5) Building internal capacity and culture

IFC has developed and is implementing an internal capacity and communications strategy to strengthen understanding and ownership of E&S issues with client facing relationship managers and senior investment staff in the Financial Institutions Group (FIG). Key activities that have been implemented in FY15 as part of this strategy are highlighted below:

- a) The FIG management team has been sending regular messages to staff on the fundamental importance of E&S risk management and importance of FIG staff to understand and take ownership of Performance Standards and E&S risks. These messages form part of the departmental communications strategy and are delivered through email communication, staff meetings and departmental retreats.
 - b) Supporting the messaging from FIG management, FIG and CRKES jointly developed a training program titled “Proactive Engagement with Clients on E&S Issues - a FIG Priority” for investment staff. Over the last year FIG and CRKES delivered two workshops for staff in the Mumbai/Hong Kong, SAR, China offices in November 2014 and Johannesburg/Nairobi offices in February 2015. An additional workshop on lessons learned - organized jointly with CRKES and CAO - was delivered during the FY15 Knowledge Forum week in Washington DC. These workshops now form part of the core departmental training and additional workshops are being planned for the regional offices in Istanbul and Mexico.
 - c) IFC is also in the process of identifying necessary changes to internal business processes and systems (MIS, ESRDII, iDesk) that will enable better data management and strengthen internal coordination mechanisms.
- 8) In addition to the actions proposed in the Action Plan IFC conducted a review of all FI clients (92 clients, not including funds) with ongoing E&S non-performance issues (Environmental and Social Risk Rating (ESRR) of 3 or 4). For each client, IFC developed an action plan jointly with the client containing the necessary course of actions to move the client towards compliance. This has become part of IFC's portfolio supervision and tracking, and a majority of the cases have been brought back on track. IFC has exited a few deals and we continue to have a few cases where finding a solution has not been so easy. The status is reflected in the Graph 4 below.

Graph 4: E&S Performance of FI Clients



IFC's Advisory Services

- 9) IFC has been facilitating a knowledge network for banking regulators and associations since 2012. The Sustainable Banking Network (SBN) now has 24 members in five markets, where IFC has large exposures – East Asia and Pacific (China, Indonesia, Laos, Mongolia, Philippines, Thailand, Vietnam), South Asia (Bangladesh, Nepal, Pakistan), Latin America & Caribbean (Brazil, Colombia, Honduras, Paraguay, Peru), Middle East and N. Africa (Morocco, Turkey) and Sub-Saharan Africa (Kenya, Nigeria). The Central Bank of Pakistan, Kenya Banking Association, and Honduras banking regulator/and association, joined the Network in FY15. IFC is in dialogue with regulators in several other key markets, where we have large exposures. To further expand the SBN and engage the potential SBN members, IFC has also launched a global survey on E&S Risk Management in 17 countries.
- 10) To support market capacity development, IFC has been working through third party providers to support financial sector improvement of E&S practices. Train of the Trainer (TOT) program was first successfully launched in Nigeria and later expanded to China, Mongolia, Bangladesh and Vietnam. Two consulting firms were selected to deliver TOT: ERM for Mongolia, Bangladesh and China and FI Konsult for Vietnam. Several TOTs and FI trainings have already been delivered in Vietnam (14 banks trained) and China (20 banks trained) with more planned to be delivered this FY. In May 2015 IFC also conducted a pilot training for PE funds operating in the Asia and Pacific region, that was attended by over 70 participants representing over 30 fund managers from the region. As a result of this event the fund managers with support from IFC established a community of practice (CP) to share on regular basis their E&S risks management experiences and challenges. The first meeting of this CP has been scheduled for the Q3 of FY16. Building on this experience IFC decided on rolling out the training program to other regions throughout FY16.
- 11) In FY14 the Advisory Services program completed the development and pilot-testing of an ESMS diagnostic tool that allows E&S Specialists and operational teams to undertake a more systematic and in-depth assessment of FI clients' systems and their capacity to manage E&S risks. Findings of the diagnostics are then used to prioritize clients' needs for advisory support in post-diagnostic improvements. While the target number for the pilot was 8 clients, client interest and demand was encouraging and the diagnostics were conducted for 12 banks in 8 markets (Bangladesh, China, Georgia, Haiti, Honduras, Mexico, Turkey, and Vietnam). Ten (10) of these 12 banks were IFC clients. In China and Vietnam, the banking regulators joined IFC teams in diagnostics to observe and learn. After the successful pilot IFC continued implementing ESMS diagnostic services over FY15, conducting diagnostics for additional 6 banks in 6 markets (Armenia, Bhutan, Morocco, Oman, Philippines and Turkey). More diagnostics are planned in FY16 for CAF and LAC clients. Under the ESMS implementation support service, IFC signed agreements with 2 clients in China and 1 client in Myanmar and expects to enter into agreements with an additional client soon. ESMS diagnostics services and implementation support will be merged into CRKES's overall Enhanced Client Support service going forward and will include ESMS diagnostics, development and implementation as well as client capacity development and other support as needed.

Areas of continued IFC focus

- 12) IFC has significantly enhanced the disclosure of its investments in private equity funds sub-projects. These are cases where IFC money is used for specific, identifiable projects.
- 13) The civil society community has asked us to consider similar disclosures with respect to high-risk sub-projects of our regulated financial entity clients such as Banks, even as in these cases IFC's financing is not directed to a specific project.
- 14) There is general recognition that banking and privacy laws in most countries constrain the disclosures that a Bank can make regarding its portfolio or a specific sub-project.
- 15) Mandating such disclosure would entail asking FI clients to have each of their own sub-clients/borrowers waive the confidentiality protections that form an integral part of prevailing banking privacy laws and long standing commercial practices. IFC needs to consider the views of the financial sector players, and in particular the local banking regulators in this regard. Based on early discussions with banking regulators, DFIs and other market players, IFC sees that there is potential to make progress on this area, through voluntary disclosure mechanisms such as those being initiated by the EPFIs. IFC is exploring various options and pilots and will continue to engage with its Board as well as other key stakeholders to move this forward.
- 16) There has also been a push to consider third party assessments in the review of IFC's FI business. IFC is in the process of piloting two approaches that involve third party assessments. The first pilot is to consider the use of third party consultants in sampling sub-projects of FIs to validate the FIs ESMS implementation. The second is considering expanding the scope of IFC's current third party verification of the annual report data to include the E&S performance of IFC.

Follow up

- 17) IFC will continue providing updates on our implementation of the Action Plan and continue to engage with the Board and stakeholders. We remain firmly on a path of continual improvement of our operational performance.

Annex 1: Status of Action Plan Implementation

Key steps proposed in the Action Plan¹	Specific actions to be taken	Status
Capacity and commitment assessments	<ul style="list-style-type: none"> Develop guidance for FI Specialists to assess capacity and commitment of clients and have it approved by CRKES management 	Completed
	<ul style="list-style-type: none"> Revise ESRP to include capacity and commitment as key areas of appraisal and IRM input by CRKES 	Completed
	<ul style="list-style-type: none"> Develop a coaching session for FI Specialists 	Completed <i>(an on-going task)</i>
Increased supervision	<ul style="list-style-type: none"> Increase coverage of FI level site visits to cover all FI-2 clients with PS requirements 	Completed <i>(an on-going task)</i>
E&S provisions for PE Funds	<ul style="list-style-type: none"> CRKES and LEG to revise the set of standard E&S provisions for PE funds to enhance legal provisions control over investments in higher risk business activities 	Completed
	<ul style="list-style-type: none"> Start annual disclosure of all sub-projects for projects to which new covenants apply 	In progress <i>(started from April 2015. Sixteen funds disclosed their sub-projects in FY15)</i>
Sub-project reviews	<ul style="list-style-type: none"> Develop a guideline for the basis of sub-project sample selection, have it approved by CRKES management and included in the draft updates to the ESRP 	Completed
	<ul style="list-style-type: none"> Develop a Guidance Note on sub-project reviews 	Completed
Building internal capacity and culture	<ul style="list-style-type: none"> Prepare list of changes required for portfolio tracking sheets, ESRD II and iDesk to enable better data management 	Completed
	<ul style="list-style-type: none"> Set up a program that will include an ongoing internal communication initiative to deliver key messages from FIG department's senior management to staff on E&S issues 	Completed <i>(an on-going task)</i>
	<ul style="list-style-type: none"> Develop guidance materials and training for IOs 	Completed <i>(an on-going task with three workshops delivered in FY15 and two more planned for FY16)</i>
Ongoing engagement with CSOs	<ul style="list-style-type: none"> Post CODE meeting with CSOs in October 2013 during Annual Meetings in Washington, DC 	Completed <i>(meeting took place in October 2013 during Annual Meetings in Washington, DC)</i>
	<ul style="list-style-type: none"> Annual meetings with CSOs 	In progress <i>(an on-going task. There were two meetings organized in FY 15. First meeting took place in Myanmar in September, and second in DC during Spring Meeting)</i>

¹ Submitted

	<ul style="list-style-type: none"> IFC engagement with Oxfam and other CSOs in the context of their recent report on IFC investments in FIs. 	In progress (<i>we expect this dialogue, which has been positive, to continue</i>)
Continuous work in partnership / leadership with DFIs	<ul style="list-style-type: none"> Draft a Concept Note for Analysis and Coordination of DFI E&S Requirements for FI clients 	Completed
	<ul style="list-style-type: none"> Consultation with DFIs to seek their participation and cooperation on the analysis 	In progress
	<ul style="list-style-type: none"> Desktop IFC and DFI standards/procedures benchmarking and interviews 	In progress
Support the development of market and regulatory drivers	<ul style="list-style-type: none"> Establish the Sustainable Banking Network (SBN) for regulators and central banks to encourage a wider adoption of E&S risk management 	Completed
	<ul style="list-style-type: none"> Organize International Sustainable Banking Forum together with Central Bank of Nigeria 	Completed
	<ul style="list-style-type: none"> Organize International Sustainable Banking Forum together with Central Bank of Peru 	In progress (<i>Scheduled for 15th -17th September, 2015</i>)
	<ul style="list-style-type: none"> Work with banking regulators to develop E&S implementation guidelines, tools and M&E mechanisms 	In progress (<i>completed in China and Nigeria. Ongoing in Bangladesh until end of this year. We are assisting the central bank to revise the policy based on public consultation 2015</i>)
Support market capacity development	<ul style="list-style-type: none"> Adapt and roll-out the Train the Trainer (TOT) program for pilot testing in selected markets: China, Vietnam, Bangladesh, and Mongolia 	Completed
	<ul style="list-style-type: none"> Deliver 4-5 trainings for multiple FIs in each market by consultant firms and trainers 	In progress (<i>to be completed by December 2015</i>)
	<ul style="list-style-type: none"> Develop and pilot an Environmental and Social Management System (ESMS) diagnostic services with clients over FY14 	Completed (<i>IFC completed diagnostics for 12 banks in 8 markets: Bangladesh, Turkey, Honduras, Haiti, Mexico, Georgia, Vietnam and China vs target of 8 pilots</i>)
Direct engagement with FIs to help build their management systems and capacity	<ul style="list-style-type: none"> Enhanced client support (includes ESMS diagnostics, development and implementation as well as client capacity development) 	In progress (<i>an on-going task. As of today IFC completed diagnostics for 18 banks in 13 markets: Armenia, Bangladesh, Bhutan, China, Georgia, Haiti, Honduras, Mexico, Morocco, Oman, Philippines, Turkey, and Vietnam</i>)