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**IFC Management's Response to the CAO Monitoring Report—Audit of Sample of IFC Investments in Third-Party Financial Intermediaries**

Dear Mr. Gratacós:

Please find below an update on IFC’s Management of E&S Risks in its Financial Intermediary (FI) Business in response to the CAO’s Monitoring Report, following the recent meetings with our Board.

**Background**

At the September 29, 2014 meeting of the Committee on Development Effectiveness (CODE), IFC presented an update on the Action Plan developed in response to the 2012 CAO Audit of IFC’s Financial Intermediary Investments. IFC has been in dialogue with the CAO regarding their monitoring report, which was publicly disclosed by CAO on October 26, 2014.

**Actions taken**

Overall we appreciate the push for continual improvement and the value that CAO has brought to our work, including the Monitoring Report. Over the last year, IFC has taken a number of steps outlined in the Action Plan, a few of which are mentioned here:

- We now review top sub-client exposures of selected FI projects against our list of high risk clients, and are making this practice part of our operational procedures;
- We have fully integrated our investments and advisory services into single client-facing teams, to provide more comprehensive support and solutions. We also now have a new Risk and Sustainability Vice-Presidency, that will consider environmental and social risk alongside financial risk; and
- We have also engaged with civil society and stakeholders in Washington, DC, Europe and in Asia in this spirit of openness and continual improvement. Where we have made mistakes, we have taken action to learn from them and make corrections.
Overall, we are happy to note that the CAO Monitoring Report recognizes and acknowledges many of the key steps IFC has taken in line with the Action Plan, including the recognition that IFC has made improvements that go above and beyond the findings of the CAO Audit. Specifically, we note CAO’s acknowledgement of the following:

- Improvements IFC has made over the years, both on strengthening the Policy framework as well as enhancing implementation capacity;
- The more detailed guidance provided to all operational staff and the steps being taken by IFC Management to prioritize E&S issues;
- Increased review by IFC of FI clients’ portfolios, particularly sub-client information to validate the effectiveness of respective Environmental and Social Management Systems (ESMS) of FIs;
- Greater disclosure of private equity sub-projects; and
- IFC’s advisory services interventions to build capacity in the financial sector.

There are, however, points where we have differed from CAO since the time of the CAO Audit Report and IFC Action Plan in September 2013, and these differences remain. These include views on the adequacy of IFC’s approach as well as the merits of a cost-based approach to client supervision as against the current IFC practice of a risk based one. We remain in dialogue with the CAO on these points and with other stakeholders to see how we can bridge these differences and improve our effectiveness.

There were also some inaccuracies in the CAO Monitoring Report that require some clarification. In particular, CAO’s statement that the Performance Standards are only applicable in the case of project finance is incorrect. IFC’s Sustainability Policy is clear in that it requires application of the relevant requirements of the Performance Standards to higher risk business activities financed by FIs, and the application of the Performance Standards is triggered both in cases of project finance and corporate loans.

There were also some questions about the suitability of applying guidelines for the tenor and project size. The use of thresholds has been part of the implementation of the Performance Standards since 2006 and is standard practice across many Development Finance Institutions (DFIs) and Equator Principles Financial Institutions (EPFIs), with the IFC thresholds being one of the most conservative. These are provided to ensure that the Performance Standards are not applied to small and medium enterprises and smaller transactions. To do so would be impractical, and contrary to the intent of the Board-approved Sustainability Policy. IFC has disclosed these guidelines to ensure transparency and improve consistency in implementation.

**Conclusion**

IFC invests in FIs as a means to achieve the twin goals of ending extreme poverty and boosting shared prosperity, and not as an end in itself. Working with FIs allows IFC to support far more
micro, small, and medium enterprises than we would be able to on our own. It is the primary and most effective means for IFC to enable access to financial services so as to achieve the goal of universal access to finance that President Kim has set the World Bank Group to reach by 2020.

In order to achieve the essential and primary development imperative of financial inclusion, IFC deploys the management system approach to manage the E&S risks associated with the FI business. This systems approach is universally accepted as best practice and has been adopted by all DFIs.

When working through FIs, and the implicit delegation that the business model entails, we need to consider how we can influence the FIs behavior, consistent with the management system approach, to manage the potential E&S risks better. This continues to be the focus of our E&S risk management approach.

We remain committed to learning and improving our effectiveness and efficiency, managing E&S risks effectively, and making course corrections where necessary, as we work towards the important goal of providing universal access to finance to the 2.5 billion individuals who don’t have a bank account and 200 million formal and informal businesses that lack access to credit.

Sincerely,

Morgan Landy
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Marcos Brujis
Director
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