



MONITORING REPORT

CAO Investigation of IFC

January 19, 2016

Monitoring of IFC's Response to:

**CAO Investigation of IFC Environmental and Social Performance in relation to:
Investments in Banco Financiera Comercial Hondureña S.A.**

First Monitoring Report

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

Introduction

1. The CAO compliance function oversees audits/investigations of IFC/MIGA's environmental and social (E&S) performance with a view to ensuring compliance with relevant requirements and improving the E&S performance of the institutions.
2. Following a CAO 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.
3. This report documents CAO's monitoring of its Investigation of IFC's E&S Performance in relation to: Investments in Banco Financiera Comercial Hondureña S.A. (the Ficohsa Investigation), published in August 2014.¹
4. The Ficohsa Investigation made findings in relation to IFC's performance at both a project and systemic level. In its response to the Ficohsa Investigation, IFC stated that it was addressing the systemic findings of the Ficohsa Investigation through the Action Plan it developed in response to CAO's Audit of a Sample of IFC Investments in Third Party Financial Intermediaries (the FI Audit), published in February 2013.² The systemic findings of the Ficohsa Investigation are thus addressed in CAO's monitoring of the FI Audit.³ This monitoring report considers actions taken by IFC in response to the project level findings of the Ficohsa Investigation.

Background

5. Between October and November 2011, IFC's Asset Management Company made an equity and subordinated debt investment in Ficohsa (the client) totaling US\$70.1 million. These investments followed earlier investments by IFC which targeted the client's Small and Medium Enterprise and Housing portfolio and trade finance support.⁴
6. CAO initiated its compliance process in relation to IFC's investment in Ficohsa in August 2013 citing concerns regarding IFC's approach to the management E&S risk in relation to Ficohsa's lending to Corporación Dinant (Dinant).⁵
7. CAO published the Ficohsa Investigation in August 2014. CAO's investigation report describes material shortcomings in the way IFC discharged its environmental and social obligations in relation to the Ficohsa

¹ CAO, Investigation of IFC's Investments in Banco Ficohsa. For further details see: <http://goo.gl/tsP0a9>

² CAO, Audit of a sample of IFC Investments in Third Party Financial Intermediaries (FI Audit). For further details see: <http://goo.gl/2GcPuh>

³ CAO Second Monitoring Report of FI Audit available at the following link <http://goo.gl/4k2ZuO>

⁴ For further details on these investments see IFC Disclosure website, <http://goo.gl/fWLHlv> and <http://goo.gl/2l9xCI>

⁵ Dinant is an IFC agribusiness client in Honduras. IFC's direct investment in Dinant was the subject of a 2013 CAO compliance audit following allegations of violence against farmers on and around Dinant oil palm plantations in Honduras' Aguán Valley. For further details, see <http://goo.gl/LULNW1>

investment. Of relevance in relation to the monitoring of IFC's project level response to the investigation, CAO identified gaps in IFC's pre-investment review of its client's environmental and social management system (ESMS). During supervision, CAO found that IFC did not assure itself in an adequate or timely manner that the client was "operating the ESMS as envisaged at the time of appraisal" or that the client had "applied the Applicable Performance Requirements (which included the IFC Performance Standards) to its sub-projects." In this context, CAO noted that IFC, through its investment in Ficohsa, facilitated a significant ongoing flow of capital to Dinant, outside the framework of its environmental and social standards. CAO also found that IFC did not supervise the requirements of Performance Standard 1 vis-à-vis Ficohsa itself; in particular the requirement to establish a grievance mechanism which is "readily accessible ... to affected communities" and about which affected people are informed.⁶

Action reported by IFC

8. This monitoring report is based on IFC's Official Response to the Ficohsa Investigation, documentation provided by IFC to CAO and ongoing discussions between CAO and IFC regarding IFC's response to the Ficohsa Investigation.
9. **Summary of actions reported that respond to CAO project level findings:**
 - IFC reports that the client has fully implemented an agreed E&S Action Plan. In particular, IFC notes that the client has: (i) developed an E&S Policy reflecting IFC's Performance Standards (2012); (ii) hired a full time E&S manager; (iii) expanded its E&S team; (iv) provided training to Board members and credit staff on the new E&S policy and procedures; and (v) commenced implementation of its revised ESMS in January, 2015.
 - As part of this process, IFC notes that it has supported the client by: (i) providing advice on hiring additional E&S specialists, (ii) recommending third party consultants to support the development of an ESMS and risk management tool, (iii) providing feedback on templates and procedures developed as part of the ESMS, (iv) providing feedback on the client's assessment of subproject E&S risks, and (v) conducting joint site supervision visits with the client's E&S staff as a form of capacity building.
 - IFC also reports that in 2014 the client received technical assistance to enhance its E&S procedures and conduct a pilot program that included the application of the Performance Standards to six loans.
 - IFC notes that the client's revised ESMS requires E&S review and application of the IFC Exclusion List and host country laws to all loans above \$500,000, with scope to include some loans below this amount. Further, IFC notes that the client applies the Performance Standards to high-risk loans and project finance (meaning that the Performance Standards are applied where defined loan term and value criteria are met).
 - IFC E&S staff conducted a supervision visit to the client in May 2015. The purpose of the visit included confirming ESMS implementation and providing guidance on E&S issues. During this visit, IFC reviewed

⁶ See Ficohsa Investigation Report, FN 1 above.

seven Environmental and Social Due Diligence (ESDD) reports for loans as prepared by the client.⁷ IFC noted that the ESDD process included examining national environmental and operational licenses, E&S compliance reports, land concession documentation, and stakeholder engagement plans. IFC also noted that the ESDD process led to the establishment of loan E&S requirements in some instances. In this context, IFC has expressed the view that while the client's ESDDs may not actually refer to the Performance Standards, they were considered consistent with IFC's requirements.

- From its review, IFC concluded that the client's ESDDs were conducted in accordance with its ESMS and had adequate E&S risk categorization. Following its supervision visit, IFC upgraded the E&S Risk Rating (ESRR) for the client from 3-Partly Unsatisfactory to 2-Satisfactory. This represents a determination by IFC that the client is in material compliance with IFC's requirements.
- At the same time, IFC has advised CAO that the client does not apply the Performance Standards in the same manner as IFC. To expect a client to do so, IFC notes, would be unreasonable given the different institution's mandates, types of relationships with sub-clients, regional context and E&S management resources. The client's implementation of the Performance Standards, IFC notes, is consistent with other private banks with good E&S capacity and is beyond current market practice. IFC also notes that the client faces major challenges in ESMS implementation, some of which are outside its control. These include challenges related to: (a) the regulatory environment and (b) reluctance of clients to accept E&S requirements in a market where these are not the norm.
- In relation to Ficohsa's lending to Dinant, IFC reports that the client has provided additional financing to Dinant during the monitoring period. IFC also reports that client E&S staff visited Dinant in January 2015 and joined IFC staff in conducting a joint supervision visit to Dinant in March 2015. Further, IFC notes that it worked closely with Ficohsa in developing an ESAP which was agreed between Ficohsa and Dinant in March 2015 and included a commitment to provide Ficohsa with progress reports in relation to the ESAP as agreed between Dinant and IFC.⁸

Conclusion

10. IFC first disbursed on this investment in October 2011 with the expectation that the client would have in place an ESMS sufficient to manage the risks of its portfolio in accordance with the Performance Standards (2006) by January 2012. IFC first reviewed the client's upgraded ESMS in November 2012, at which point IFC identified gaps in its application of the Performance Standards.
11. Commencing in 2013, CAO notes that IFC has worked actively with the client to implement corrective measures through an agreed Action Plan. As of May 2015, IFC reports that the client has implemented the

⁷ The seven ESDD loans reviewed were for Category B and "special category" loans. No Category A loans were reviewed. According to its 2014 Sustainability Report Ficohsa conducted an E&S review of 350 corporate clients in 2014 (48% of its corporate portfolio). Of these clients 33 (9%) were categorized A - high risk; 152 (44%) were categorized B - moderate risk; and 165 (47%) were categorized C – low risk. <http://www.ficohsa.hn/wp-content/uploads/memoria-2014-r.pdf>

⁸ See: IFC Updates Related to Corporación Dinant's E&S Action Plan. <http://goo.gl/rH6ogi>

Action Plan in full, that the client has a well-developed ESMS reflecting the Performance Standards, and as a result that its E&S performance is satisfactory.

12. While welcoming the steps that IFC has taken to support the development of its client's ESMS, CAO concludes that the measures taken by IFC to date only partly address its project level non-compliance findings. CAO's monitoring suggests shortcomings in IFC's supervision of client's performance against the E&S requirements agreed with the client when IFC invested.⁹ Based on the agreed E&S requirements, additional active supervision by IFC is indicated, in particular in relation to:
 - a. The requirement that the client apply the Performance Standards to all Category A and Category B loans;
 - b. The capacity of the client to conduct E&S due diligence in accordance with the requirements of the Performance Standards, particularly in relation to high risk projects;
 - c. The requirement that the client report all new Category A projects to IFC prior to financing;
 - d. The extent to which the client is monitoring, responding to and reporting on Performance Standards compliance issues in its portfolio; and
 - e. The establishment of a grievance mechanism which is "readily accessible ... to affected communities" and about which affected people are informed.
13. CAO's investigation also found that IFC, through Ficohsa, supported a significant flow of capital to the Honduran agribusiness conglomerate, Corporacion Dinant, outside the framework of its environmental and social standards. IFC has addressed this issue in part. Positively, CAO notes that in March 2015, following a joint site visit to Dinant, IFC supported Ficohsa to develop a new ESAP for Dinant. To date, however, IFC has not assured itself that Ficohsa's ongoing financing for Dinant is contingent on binding commitments to implement the Performance Standards, either through its loan agreements or the ESAP.
14. Further supervision is required in order to ensure that CAO's compliance findings are addressed in full. As a result, CAO will continue monitoring IFC's supervision of this investment and release a follow up monitoring no later than December 2016.

⁹ See Ficohsa Investigation Report, pp. 31-32.