



CAO COMPLIANCE

CAO Investigation of IFC

CAO Ref: C-I-R9-Y13-F190

August 6, 2014

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

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

Executive Summary

This report provides the findings of the Compliance Advisor Ombudsman (CAO) compliance investigation of IFC's investment in Banco Ficohsa (Ficohsa), the largest bank in Honduras.

IFC's Asset Management Company made equity and subordinated debt investments in Ficohsa totalling US\$70.1 million in October and November 2011. These investments followed earlier trade finance, housing and SME investments in Ficohsa.

Corporación Dinant (Dinant) is an integrated agribusiness company in Honduras which received a \$15 million loan from IFC in 2009. In response to allegations of violence against farmers on and around Dinant oil palm plantations in Honduras' Aguán Valley, CAO initiated a compliance audit of this IFC investment in August 2012.

In the course of CAO's compliance audit of IFC's investment in Dinant, CAO became aware that Dinant was one of Ficohsa's largest borrowers and, as a result, that IFC had significant exposure to Dinant through its equity stake in Ficohsa. In this context, CAO initiated a compliance process in relation to IFC's investment in Ficohsa in August 2013.

As required by the terms of reference for this compliance investigation CAO has considered whether IFC's equity and subordinated debt investments in Ficohsa were appraised, structured and supervised in accordance with applicable IFC policies, procedures and standards. CAO has also considered the adequacy of IFC's policies, procedures and standards in the context of its broader environmental and social commitments. Finally, CAO has considered the immediate and underlying causes for any non-compliance identified.

This report describes material shortcomings in the way that IFC discharged its environmental and social obligations in relation to the Ficohsa investment.

Prior to investment, CAO finds that IFC took insufficient measures to identify activities where Ficohsa was exposed to environmental and social risk through its existing portfolio. This is of particular concern given background E&S risk that emerges from the regulatory and governance context in which Ficohsa was operating. Further, CAO finds that IFC did not conduct an adequate review of Ficohsa's social and environmental management system (SEMS) or its capacity to implement IFC's environmental and social requirements. This weakness in analysis was compounded by the decision to structure the investment in a way which allowed disbursement to Ficohsa in advance of actions to close gaps in the SEMS.

As a result, IFC acquired an equity stake in a commercial bank with significant exposure to high risk sectors and clients, but which lacked capacity to implement IFC's environmental and social requirements. The absence of an environmental and social review process that was commensurate to risk meant that key decision makers (senior management of IFC's Financial Institutions department and members of the IFC Board) were not presented with an adequate assessment of the risks that were attached to this investment. This included additional exposure to Dinant, a company which IFC knew to be affected by a violent land conflict, as well as numerous other loans with potentially significant, but unassessed, E&S risk. It also meant that Ficohsa was not provided with the urgent and intensive support that it needed to upgrade its SEMS.

In relation to the decision to disburse, CAO finds that IFC's review of the applicable conditions of disbursement (CODs) did not comply with the requirement that E&S staff clear any

E&S conditions following a review of evidence of compliance. In particular, CAO finds that IFC cleared disbursement against its investment agreements, without assuring itself that Ficohsa had submitted the environmental and social information that was required as a COD. Further, CAO finds that IFC environmental and social staff did not review the ongoing validity of Ficohsa's environmental and social representations and warranties prior to disbursement.

In relation to project supervision, CAO finds that IFC did not assure itself in an adequate or timely manner that Ficohsa was operating the SEMS as envisaged at the time of appraisal or that Ficohsa was applying the Performance Standards to its sub-projects. At a more systemic level, CAO finds that there is a disconnect between the client reporting formats provided by IFC to Ficohsa and the environmental and social covenants and reporting requirements that were written into the investment agreements. In this context, CAO finds that the environmental and social reporting format as provided to Ficohsa by IFC was not fit for purpose in terms of the detail that it required regarding the performance of borrowers, in particular those with high environmental and social risks. As a result, IFC had and has, at best, a superficial understanding of the environmental and social risks that are attached to Ficohsa's client base.

These concerns notwithstanding, CAO finds that IFC's supervision of this investment has improved since late 2012 when the IFC E&S team working on Ficohsa became aware of the gravity of the issues regarding Dinant. At this point IFC conducted the gap analysis of Ficohsa's SEMS that was required at appraisal in 2010. As a result, IFC has supported the development of a corrective action plan for Ficohsa's SEMS. Despite these steps, CAO finds that capacity and country governance challenges mean that supervising compliance with the E&S requirements of the 2011 investment agreements presents a significant long term challenge.

In relation to Dinant, CAO finds that highly relevant information on the conflict and related E&S risks surrounding Dinant, that was held by members of IFC's Dinant investment team, was not shared with key members of its Ficohsa team, even though there were staff working across both teams. It is important to note that CAO finds no indication that IFC pursued its equity investment in Ficohsa with the intention to provide additional financing to Dinant. By waiving a key financial covenant and then taking an equity position in Ficohsa, however, IFC: (a) increased its exposure, and (b) facilitated a significant ongoing flow of capital to Dinant, outside the framework of its environmental and social standards; and this at a time when IFC management was aware of serious unmitigated environmental and social risks regarding its agribusiness client.

In relation to the underlying causes of the non-compliance identified in this report, CAO observes a primacy of financial considerations in IFC's decision making. As a result, it is not IFC practice to review the *E&S risk* attached to the portfolios of its banking clients in the same depth as portfolio *credit risk* is reviewed. CAO also notes a siloing of information with the result that relevant information was not shared among key members of IFC's Ficohsa team. In this context, IFC E&S staff did not ask about Ficohsa's exposure to high risk sub-clients and their regionally based investment colleagues, who were aware of the issues, did not tell.

In terms of the adequacy of IFC's policies, procedures and standards, CAO finds that the shortcomings identified in this investigation are inter-related. They are indicative of a system of support to FIs which does not support IFC's higher level environmental and social commitments. In a context where IFC maintains that this project was processed in accordance with prevailing practice, CAO's findings raise concerns that IFC has, through its banking investments an unanalyzed and unquantified exposure to projects with potential significant adverse environmental and social impacts. Absent disclosure of information related to these projects,

this exposure is also effectively secret and thus divorced from systems which are designed to ensure that IFC, and its clients are accountable to project affected people for delivery on their environmental and social commitments. The underlying fault lines thrown into relief by this investigation, resonate with the findings of CAO's 2012 Audit of IFC Investments in Third Party Financial Intermediaries, and suggest the need for a reassessment of IFC's approach to the identification and management of environmental and social risk in its financial institutions business.

About CAO

CAO's mission is to serve as a fair, trusted, and effective independent recourse mechanism and to improve the environmental and social accountability of the private sector lending and insurance members of the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

CAO (Office of the Compliance Advisor Ombudsman) is an independent post that reports directly to the President of the World Bank Group. CAO reviews complaints from communities affected by development projects undertaken by IFC and MIGA.

CAO compliance oversees investigations of the environmental and social performance of IFC and MIGA, particularly in relation to sensitive projects, to ensure compliance with policies, standards, guidelines, procedures, and conditions for IFC/MIGA involvement, with the goal of improving IFC/MIGA environmental and social performance

For more information about CAO, please visit www.cao-ombudsman.org

Acronyms

AEPR	Annual Environmental Performance Report
BTOR	Back to Office Report
CAO	Office of the Compliance Advisor Ombudsman
CEO	Chief Executive Officer
CES	Environmental and Social Development Department [at IFC]
COC	Corporate Operations Committee (IFC)
CODs	Conditions of Disbursement
DEG	Deutsche Entwicklungs Gesellschaft
E&S	Environmental and Social
ESAP	Environmental and Social Action Plan
ESMS	Environmental and Social Management System
ESRD	Environmental and Social Review Document
ESRPs	Environmental and Social Review Procedures
ESRR	Environmental and Social Risk Rating
ESRS	Environmental and Social Review Summary
ESRP	Environmental and Social Review Procedure
EVP	Executive Vice President (of IFC)
FI	Financial Intermediary
FIG	Financial Institutions Group
FMO	Netherlands Development Finance Company
IFC	International Finance Corporation
LESS	Lead Environmental and Social Specialist
MIGA	Multilateral Investment Guarantee Agency
PS	IFC Performance Standards
PS1	IFC Performance Standard 1: Social and Environmental Assessment
PS2	IFC Performance Standard 2: Labor and Working Conditions.
SEMS	Social and Environmental Management System
SEPR	Social and Environmental Performance Report
SME	Small and Medium Size Enterprise
SPI	Summary of Project Information
TOR	Terms of Reference

1. Overview of the CAO Compliance Process

CAO's approach to its environmental and social (E&S) compliance function is set out in its Operational Guidelines (March 2013).

When CAO receives an eligible complaint, the complaint first undergoes an assessment to determine how CAO should respond. If the CAO compliance function is triggered, CAO will conduct an appraisal of IFC's/MIGA's involvement in the project, and determine if an investigation is warranted. The CAO compliance function can also be triggered by the World Bank Group President, the CAO Vice President or senior management of IFC/MIGA.

CAO compliance investigations focus on IFC/MIGA, and how IFC/MIGA assured itself of project E&S performance. The purpose of a CAO compliance investigation is to ensure compliance with policies, standards, guidelines, procedures, and conditions for IFC/MIGA involvement, and thereby improve E&S performance.

In the context of a CAO compliance investigation, at issue is whether:

- The actual E&S outcomes of a project are consistent with or contrary to the desired effect of the IFC/MIGA policy provisions; or
- A failure by IFC/MIGA to address E&S issues as part of the appraisal or supervision resulted in outcomes that are contrary to the desired effect of the policy provisions.

In many cases, in documenting and verifying the performance of the project and implementation of measures to meet relevant requirements, it is necessary to review the actions of the IFC client and verify outcomes in the field.

CAO has no authority with respect to judicial processes. CAO is neither a court of appeal nor a legal enforcement mechanism, nor is CAO a substitute for international court systems or court systems in the countries where IFC operates.

Upon finalizing a compliance investigation, IFC/MIGA is given 20 working days to prepare a public response. The compliance investigation report, together with any response from IFC/MIGA is then sent to the World Bank Group President for clearance, after which it is made public on the CAO website.

In cases where IFC/MIGA is found to be out of compliance, the CAO keeps the investigation open and monitors the situation until actions taken by IFC/MIGA assure the CAO that IFC/MIGA is addressing the non-compliance. The CAO will then close the compliance investigation.

2. Investigation Framework

2.1 CAO Compliance Appraisal

On August 21, 2013 the CAO Vice President initiated a compliance appraisal of IFC's investment in Banco Financiera Comercial Hondureña S.A. (Ficohsa).

As requested by the CAO Vice President, the compliance appraisal considered:

- how IFC reviewed and supervised the Environmental and Social (E&S) risks associated with Ficohsa's portfolio and client base;
- how IFC assessed the commitment and capacity of its client to manage these risks; and
- whether E&S issues associated with Ficohsa's client, Corporación Dinant (Dinant), and known to IFC, were adequately communicated within IFC.¹

In December 2013 CAO issued a compliance appraisal which concluded that IFC's E&S performance with regard to the Ficohsa investments merited further enquiry.

2.2 Scope of Compliance Investigation

In January 2014 CAO published terms of reference (TOR) defining the scope of this Compliance Investigation.

In accordance with the TOR, this Compliance Investigation considers whether IFC's equity and subordinated debt investment in Ficohsa was appraised, structured and supervised in accordance with applicable IFC policies, procedures and standards.

More specifically it assesses:

- Whether IFC's E&S review was sufficient to identify activities where the financial intermediary (FI) could be exposed to environmental and social risk or determine whether Ficohsa was engaged in projects with potentially significant E&S risks;
- Whether IFC established an environmental and social management plan that was commensurate to the level of E&S risk in Ficohsa's portfolio;
- Whether IFC obtained adequate evidence of compliance with the agreed conditions of disbursement; and
- Whether IFC adequately assured itself that its client's E&S obligations, including reporting obligations, were being fulfilled

The investigation also considers whether IFC's Sustainability Policy, Performance Standards and Policy on Disclosure as applied to this investment provide an adequate level of protection. Finally, the terms of reference include in the scope of the investigation "developing an understanding of the immediate and underlying causes for any non-compliance identified by the CAO."²

¹ Dinant is a major client of Ficohsa and IFC. Background information on both Dinant and Ficohsa is provided in Section 3 below.

² CAO Terms of Reference for Compliance Investigation of IFC's investments in Banco Ficohsa.

2.3 Applicable Standards

As set out in its Operational Guidelines (2013),³ CAO oversees investigations of IFC's environmental and social performance, by ensuring compliance with IFC policies, Performance Standards, guidelines, procedures, and requirements whose violation might lead to adverse environmental and/or social outcomes (para 4.3).

Relevant policies, standards, guidelines and procedures in this case include IFC Policy on Social and Environmental Sustainability (2006 & 2012),⁴ IFC's Performance Standards (2006), IFC's Policy on Disclosure of Information (2006), the IFC Environmental and Social Review Procedures (as updated from time to time) and various legal agreements between Ficohsa and IFC.

Policy on Environmental and Social Sustainability (2006)

IFC's Policy on Social and Environmental Sustainability (Sustainability Policy) expresses the Corporation's mission in terms of promoting sustainable private sector development. The Sustainability Policy (2006) was applied to IFC's investment in Ficohsa at appraisal.

The Sustainability Policy (2006) underscores IFC's commitment to ensuring that the "projects it finances are operated in accordance with the requirements of the Performance Standards."⁵ The Sustainability Policy also notes that IFC's efforts to carry out its investment operations in a manner that "do no harm to people and the environment" are central to its development mission.⁶ This, the Policy provides, means avoiding negative impacts wherever possible and ensuring that unavoidable negative impacts are reduced, mitigated or compensated for appropriately.⁷

IFC's E&S Requirements in relation to FIs are expected to be "proportional to the level of potential risk" associated with an investment.⁸ IFC requires its FI clients to "establish and maintain a Social and Environmental Management System (SEMS)⁹ to ensure that its investments meet IFC's [E&S] requirements."¹⁰ IFC monitors the performance of the FI client on the basis of the management system.

Performance Standards on Social and Environmental Sustainability

The Performance Standards (PS) detail IFC client E&S responsibilities. IFC's 2011 subordinated debt and equity investments with Ficohsa were prepared under the Performance Standards (2006), and Ficohsa's commitment to these standards was incorporated into its subordinated debt and shareholders agreements with IFC.

³ CAO Operational Guidelines (March 2013).

⁴ While IFC's investments in Ficohsa were agreed and disbursed under the Policy on Environmental and Social Sustainability (2006), as of January 1, 2012 the updated Policy on Environmental and Social Sustainability (2012) provides the framework for IFC's supervision of the project.

⁵ IFC, *Sustainability Policy* (2006), para. 5.

⁶ IFC, *Sustainability Policy* (2006), para. 8.

⁷ *Ibid.*

⁸ IFC, *Sustainability Policy* (2006), para. 28.

⁹ IFC uses the terms Social and Environmental Management System (SEMS) and Environmental and Social Management System (ESMS) interchangeably. CAO has used the abbreviation SEMS for both.

¹⁰ IFC, *Sustainability Policy* (2006), para 29.

Environmental and Social Review Procedures

The IFC's Environmental and Social Review Procedures (ESRP) outline the process through which IFC implements its commitments to social and environmental sustainability.

Unlike the Sustainability Policy and the Performance Standards, which are approved by the IFC Board, the ESRPs are issued at IFC Director level and are updated more regularly. IFC's appraisals of its first loan and trade finance agreement with Ficohsa were completed under ESRP v.2 (July 2007). The ESRPs related to appraisal and supervision of FIs were updated in August 2009 (ESRP v.4). While the ESRPs have been updated in subsequent years, the procedures as they relate to FIs have not changed significantly since August 2009. As such the 2009 ESRP applies to the appraisal and supervision of IFC's equity and subordinated debt investments in Ficohsa.

2.4 Methodology

This investigation was conducted by CAO in accordance with its Operational Guidelines (2013) under the guidance of an expert panelist. From January to April 2014, the investigation team reviewed a range of relevant documentation. The team conducted interviews with IFC management and staff who had direct knowledge of the project. The team also interviewed Ficohsa management and E&S staff. Secondary material was consulted where relevant.

In considering the adequacy of IFC's E&S performance in relation to this project, CAO has been conscious not to expect performance at a level that requires the benefit of hindsight; rather, the question in relation to each requirement is whether IFC staff exercised reasonable professional judgment and care in the application of relevant policies and procedures based on contemporaneously available sources of information.

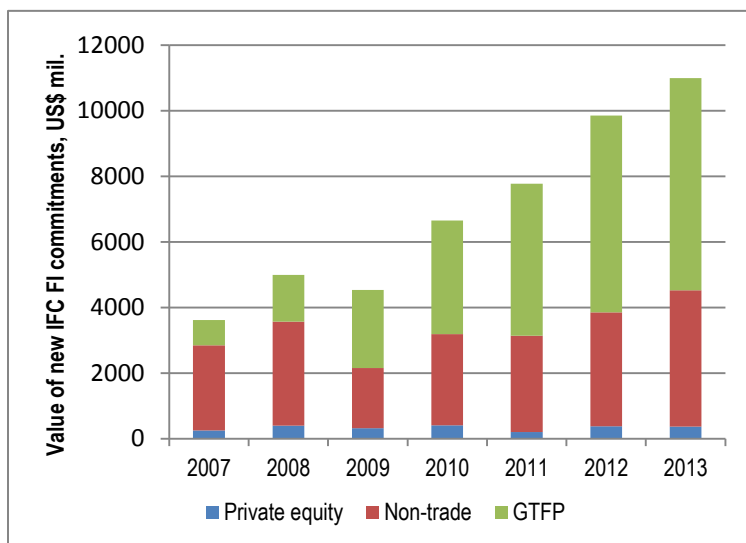
Given the requirements of the TOR, CAO determined that it was not necessary to conduct a field visit for the purposes of this investigation. As CAO's compliance mandate is focused on IFC's E&S performance, it should be emphasized this report makes no findings adverse or otherwise in relation to Ficohsa.

2.5 Background to the Investment

IFC's Financial Institutions Group

IFC's investments in Ficohsa are managed by its Financial Institutions Group (FIG). FIG investments account for almost half of IFC's new commitments each year. As set out in fig. 1 (right) this business has grown rapidly in recent years and amounted to US\$11 billion of new commitments in FY2013. IFC explains the importance of FI investments for development in that they "ensure efficient resource allocation, create jobs, and spur economic growth." As such FI investments are seen as "essential to building shared prosperity and eradicating poverty."

Figure 1: Trend in IFC FIG commitments.



From a sustainability perspective, IFC's approach to E&S risk management is emphasized as supporting "the capacity of our financial-institution clients to assess and mitigate their own E&S risks, in a manner commensurate with the level of exposure to such risks."¹¹

Ficohsa

Ficohsa is the largest bank in Honduras and one of Central America's top ten banks.¹²

IFC made its first investment with Ficohsa in May 2008 (project # 26394). The initial loan of US\$20 million supported Ficohsa's small and medium sized enterprise (SME) and middle to low income mortgage portfolio. In July 2008, IFC approved Ficohsa's inclusion in the Global Trade Finance Program (GTFP) with an initial credit line of US\$15 million (project # 27341).

In late 2009, IFC initiated discussions with Ficohsa about an equity and subordinated debt investment (hereafter the "equity investment"). In May 2011, the IFC Board approved a US\$32 million equity investment and a US\$38 million subordinated debt investment in Ficohsa. This investment was funded by the IFC Asset Management Company (IFC-AMC) through its Global Capitalization Fund.¹³ As a result IFC-AMC acquired a 10 percent equity stake in Ficohsa.

As a condition of its 2008 SME loan from IFC, Ficohsa was required to develop a Social and Environmental Management System (SEMS) to ensure that projects supported by IFC's investment were appraised and managed in accordance with Honduran social and environmental regulations and IFC's Exclusion List. With the assistance of third party consultants, Ficohsa developed a SEMS. Ficohsa's SEMS was initially approved by its Board in December 2008 and revised in May 2010.

As a condition of IFC-AMC's equity investment in October/November 2011, Ficohsa was required to upgrade its SEMS to ensure both its own operations and those of its clients would comply with Honduran social and environmental regulations, IFC's Exclusion List and IFC's Performance Standards. Ficohsa hired a full-time SEMS Officer for the first time in September 2013 and two further E&S staff in April 2014.

Prior to making its equity investment, IFC identified that Ficohsa provides corporate financing in sectors, which have significant potential E&S risk, such as energy, construction and agribusiness. As reported by Ficohsa in 2012, its portfolio included 64 Category A, 103 Category B and 164 Category C clients of which 48, 29 and 83% respectively were in compliance with its E&S policies.¹⁴ Reviewing information available through the media, CAO notes reports of E&S concerns in relation to a number Ficohsa clients operating in the agribusiness, tourism, construction and hydropower sectors.

¹¹ IFC Financial Institutions. <http://goo.gl/cnTevj> (Accessed May 3, 2014).

¹² See: *Businesswire* (April 7, 2014) <http://goo.gl/EKFkna> (Accessed June 10, 2014).

¹³ AMC is a wholly owned subsidiary of IFC, and invests alongside IFC. AMC established the Global Capitalization Fund in 2009. The Japanese Bank for International Cooperation (JBIC) committed US\$2 billion to the fund with IFC committing US\$1 billion from its own account.

¹⁴ Ficohsa, *Reporte de Sustentabilidad 2012*. Under the World Bank E&S categorization framework, Category A projects have "potential significant E&S risks;" Category B projects have with "potential limited adverse environmental or social risks; and" Category C projects have "limited or no potential adverse environmental or social risks."

CAO understands that Ficohsa operates in a regulatory and business environment in which application of national E&S law is inconsistent, and clients are not necessarily familiar with concepts of E&S risk management. In this context, Ficohsa management explained to CAO that it is seen as pioneer in relation to E&S standards in Honduras, while at the same time emphasizing that meeting the requirements of IFC's Performane Standards would be very difficult.

Corporación Dinant

Some background on Corporación Dinant (Dinant) is necessary at this stage, as it is the relationship between Ficohsa and Dinant that triggered CAO's concerns in relation to IFC's investment in Ficohsa.

Dinant is an integrated palm oil and food company with plantations totaling over 20,000ha in the north of Honduras. In 2009, IFC committed a US\$30 million loan to Dinant of which US\$15 million was disbursed in November 2009. A second disbursement of US\$15 million has been delayed due to concerns regarding security and conflict issues around Dinant's plantations in the Aguán Valley since mid-2010.

In April 2012, CAO triggered a compliance appraisal in relation to IFC's investment in Dinant. This process was initiated in response to allegations that violence against affiliates of a local campesino movement¹⁵ was occurring because of inappropriate use of security forces under Dinant's control or influence. CAO's audit report in relation to IFC's investment in Dinant was made public on January 10, 2014.¹⁶

CAO's Compliance Audit of IFC's Investment in Dinant notes a series of contemporaneous public allegations and negative perceptions in relation to Dinant of which IFC was or should have been aware prior to its investment in April 2009. Key events and IFC actions in relation to its investment in Dinant are set out the timeline below. Also of relevance, though not detailed in the timeline, are allegations linking a series of killings of persons affiliated with the campesino movement in the Aguan to Dinant properties, Dinant security guards or its third party security contractor. Allegations in relation to the killing of Dinant security personnel by affiliates of the campesino movement have also been made.¹⁷

In relation to Ficohsa's lending relationship with Dinant, CAO notes as follows:

- In March 2008, Ficohsa, in partnership with six other banks, provided Dinant with a loan of US\$77 million. Ficohsa's share was US\$16.6 million.¹⁸
- Over the period of IFC's relationship with Ficohsa from June 2008 to September 2010, (prior to the IFC-AMC equity investment) Ficohsa's aggregate exposure to Dinant almost doubled. Subsequently, Ficohsa's aggregate exposure to Dinant decreased.
- From the date of IFC-AMC's equity investment in November 2011 to March 2014, Ficohsa approved loans to the Dinant group of companies, totaling US\$39.4 million.
- The majority of loans processed since IFC's equity investment were considered short term, having a tenor of 12 months or less.

¹⁵ Members of the cooperative farming movement in the Aguan describe themselves as "campesinos."

¹⁶ For details see: CAO Dinant Audit Report (2013) <http://goo.gl/MuFpE9>

¹⁷ *Ibid.*

¹⁸ See *Centralamericadata.com*: <http://goo.gl/8wXsXz> (accessed April 29, 2014).

2.6 Project Timeline

Year	Events Related to Ficohsa	Events Related to Dinant
2007		
Aug.	European development Banks, FMO and DEG invest US\$30 million in Ficohsa preferred shares.	
2008		
Jan.	IFC Board approves SME loan to Ficohsa.	
Mar.	Ficohsa disburses US\$16.6 million to Dinant (as part of syndicated loan).	
Jul.	IFC trade finance investment in Ficohsa approved.	
Dec.		IFC - Dinant loan approved.
2009		
Feb	Ficohsa submits 2008 AEPR (due: March 31, 2009).	
Jul.	IFC updates ESRD Supervision record. Ficohsa rated as F2 (Satisfactory). IFC describes Ficohsa's SEMS as detailed & stringent but too early to judge effectiveness.	Dinant notifies IFC of land expropriation.
Nov.	IFC Concept Note on potential new equity and loan investments in Ficohsa.	IFC makes first disbursement to Dinant
Dec.		Dinant notifies IFC of large scale invasions of its land.
2010		
Mar. 12		Dinant appears on IFC Corporate Watch list. Significant social risks identified. Land invasions & violence mentioned.
May	IFC E&S staff conduct site supervision visit with the purpose of reviewing existing investments in Ficohsa.	
Jul.	IFC provides waiver to Ficohsa allowing its lending to 3 corporate groups (including Dinant) to exceed agreed levels.	
Aug.	IFC discloses equity & sub-ordinated debt investment in Ficohsa.	
Sep.	IRM Book circulated to IFC management. Book does not contain required E&S analysis with respect to the proposed investment.	
Sep. 21	Ficohsa submits 2009 AEPR (due: March 31, 2010). AEPR lists clients including Dinant, another agribusiness firm known by IFC to have properties in the Aguán, and other loans with potential high E&S risk. No discussion of E&S risks related to these loans.	
Sep. 22	IRM meeting. Occupation of Dinant land is mentioned in discussion of political context. No discussion of violent conflict.	
Nov. 15	IFC completes Appraisal ESRD. Ficohsa is rated as F2 (Satisfactory). IFC notes that "Ficohsa has a SEMS that is applied to all operations."	
Nov. 17		Rights Action (NGO) writes to WBG President, alleging Dinant security guards killed 5 farmers on Nov. 15. Letter forwarded to IFC EVP.
Nov. 22	Corporate Operations Meeting re. Ficohsa investment chaired by IFC EVP. Purpose of meeting was to discuss Ficohsa's corporate governance issues. No mention of risk re. exposure to Dinant.	

Year	Events Related to Ficohsa	Events Related to Dinant
2011		
Jan.		IFC CEO sends letter to President Lobo of Honduras regarding Aguán conflict.
May	IFC Board meeting re. Ficohsa equity investment. E&S section notes due to exposure to “energy, construction and agricultural sectors,” Ficohsa will be required to upgrade its SEMS to meet the Performance Standards.	
Jun.	IFC and Ficohsa sign subscription agreement.	
Sep. 23	Ficohsa submits 2010 AEPR (due: March 31, 2011). AEPR lists exposure to major clients including Dinant, another agribusiness operator known by IFC to have properties in the Aguán Valley, and loans with potential high E&S risk. No discussion of E&S risks related to these loans.	
Sep. 28	IFC and Ficohsa sign shareholders and subordinated debt agreements.	
Oct.	IFC disburses on equity investment.	
Nov.	IFC disburses on subordinated debt investment.	
Dec. 12	IFC updates ESRD (Supervision). Ficohsa rated 2 (Satisfactory). IFC notes Ficohsa has SEMS applied to all operations. No discussion of E&S requirements of equity investment.	
2012		
Apr.	Ficohsa submits 2011 AEPR (due: March 31, 2012).	CAO triggers Appraisal of Dinant investment.
Jul.	IFC updates ESRD (Supervision). Ficohsa rated 2 (Satisfactory). IFC notes Ficohsa has SEMS applied to all operations. No discussion of E&S requirements of equity investment.	
Aug.		Date of CAO Appraisal of Dinant investment.
Nov.	IFC conducts E&S site supervision visit.	
2013		
Feb. 13	IFC completes Site Supervision Report. Ficohsa rated 3 (Partly Unsatisfactory). IFC notes Ficohsa's SEMS not capturing risk to PSs; mentions Ficohsa's exposure to Dinant, however, the conflict around Dinant lands is not discussed.	
Feb. 18.	IFC receives E&S review documentation from Ficohsa in relation to a US\$5 million Category A loan to Dinant for working capital that was disbursed on Feb. 11.	
Aug.	CAO triggers Appraisal of IFC investment in Ficohsa – FI Senior Management aware E&S risks related to Ficohsa's exposure to Dinant.	
Sep.	Ficohsa appoints a full time SEMS officer for the first time.	
Nov.	Through the GTFP - IFC provides guarantee to Ficohsa on two trade finance transactions with Dinant	
Nov.	Ficohsa submits AEPR for 2012 (due: March 31, 2013).	
Dec.	IFC updates ESRD Supervision record. Ficohsa is rated as 3 (Partly Unsatisfactory); notes that "Ficohsa has implemented an ESMS but it does not apply the Performance Standards."	Date of CAO Audit of Dinant investment.
2014		
Apr.	Ficohsa submits 2013 AEPR (due: March 31, 2014).	
June	IFC purchases additional Ficohsa equity in the amount of US\$5.5 million.	

3. Analysis and Findings

The analysis and findings of this investigation are organized around the IFC project cycle and the four central questions set out in the CAO investigation TOR.

The first question applies to pre-commitment phase of the project up to and including IFC Board approval (May 2011). The second question covers the period from IFC Board approval up to and including the signing of the investment agreements. The third question addresses IFC's review of conditions of disbursement (October 2011). The fourth question covers the supervision phase of the project from the date of disbursement to the present.

In relation to each section below, CAO first presents a summary of IFC's E&S requirements (subsection 1); then a description of events in relation to relevant stage of the project cycle (subsection 2); and finally CAO's discussion and findings (subsection 3).

3.1 Environmental and Social Due Diligence

Summary of Findings

- IFC properly determined that Ficohsa would be required to screen projects against the Performance Standards as a requirement of the equity investment.
- IFC took insufficient measures "to identify activities" where Ficohsa was "exposed to social and environmental risk" prior to investing as required by the Sustainability Policy
- IFC did not conduct an adequate review of Ficohsa's SEMS or adequately identify actions that Ficohsa would need to undertake to address gaps in its SEMS.
- IFC did not require that gaps in Ficohsa's SEMS be closed as a condition of disbursement.
- These shortcomings, taken together, represent a material failure of IFC's pre-investment E&S review process.
- Causes of the non-compliance identified above include: (i) lack of guidance on when and how to conduct sub-project E&S review at appraisal; (ii) under-resourcing of E&S review at appraisal (compared to credit review); (iii) over-reliance on existing supervision documentation (which itself lacked robustness); and (iv) a lack of appropriate information sharing among team members and across departments.

This section addresses IFC's E&S due diligence in relation to its equity investment in Ficohsa up until the point of commitment. In this context, it addresses the adequacy of IFC's appraisal and structuring of its investment, as well as the following specific questions from the investigation TOR:

- whether IFC's E&S review was sufficient to identify activities where Ficohsa was exposed to environmental and social risk or determine whether Ficohsa was engaged in projects with potentially significant E&S risks; and
- whether IFC established an environmental and social management plan that was commensurate to the level of E&S risk that was present in Ficohsa's portfolio.

3.1.1 E&S Due Diligence of FI Investments - IFC Requirements

IFC's pre-investment due diligence includes an E&S review designed to ensure that IFC does not finance projects that cannot be expected to meet its E&S requirements over a reasonable

period of time.¹⁹ E&S review is designed to be integrated into what IFC terms its project appraisal process.²⁰

The project appraisal process leads to an Investment Review Meeting (IRM) when IFC management decides whether to authorize the completion of negotiations and the preparation of the project for Board approval.²¹ In advance of the IRM, staff prepare a decision book which should clearly identify the key issues and risks for discussion at the IRM.²²

Central to its pre-investment due diligence in relation to FI investments, IFC is required to review “the business of its FI clients to identify activities where the FI could be exposed to social and environmental risk as a result of its investments.”²³ Based on the “the magnitude of impacts understood as a result of the client’s Social and Environmental Assessment,” IFC categorizes a project as Category A, B, C or FI.²⁴

FI clients are required to implement IFC’s requirements “proportional to the level of potential risk” identified during IFC’s review.²⁵

Under IFC’s 2006 Sustainability Policy, where an FI’s business activities have minimal or no adverse E&S risk, it is considered Category C, with no specific E&S requirements. All other FI clients are considered as Category FI and are required to apply the IFC Exclusion List at a minimum. Where an FI is providing long term corporate finance or project finance, the FI is required to ensure that the recipient of such finance will: “(i) follow national laws, where the activity financed presents limited social or environmental risks; and (ii) apply the Performance Standards, where the activity financed presents significant social or environmental risks.”²⁶ An FI client is required to establish and maintain a SEMS in order to implement IFC’s E&S Requirements.

The applicable IFC ESRPs (v.4) detail IFC’s approach to the E&S review process. Where IFC is providing general finance to FIs that are engaged in “equity, loans, leasing, guarantee products, or other financing to corporate or legal entities other than individuals, or for other activities that are expected to have potential E&S impacts,” IFC’s E&S specialist is required to “categorize the project as Category FI, require the FI to develop a SEMS to apply IFC’s Exclusion List, applicable national E&S regulations and possibly the IFC Performance Standards....”²⁷

The ESRPs provide that the E&S specialist will “determine the significance of business activities that have potential E&S impact by reviewing the portfolio and sector information.... [and] where the portfolio review indicates that the FI’s investments could have potentially significant E&S impact, the FI will ensure that its sub-projects meet the relevant elements of IFC’s PSs in addition to applicable national E&S laws and regulations.”²⁸

¹⁹ IFC Sustainability Policy 2006, para. 17.

²⁰ *Ibid.*, para. 16.

²¹ IFC Operational Procedures (2013).

²² *Ibid.*

²³ IFC Sustainability Policy 2006, para 27

²⁴ See IFC Sustainability Policy 2006, para 18 for further details

²⁵ *ibid.*

²⁶ IFC Sustainability 2006, para. 28.

²⁷ IFC ESRP (v.4) Sept. 2010, para. 7.2.9.

²⁸ IFC ESRP (v.4) Sept. 2010, para. 7.2.15.

In addition, for FIs “where there are potential significant E&S risks associated with their financing activities ... [IFC will] apply the requirement that IFC will reserve the rights to review the FIs’ first few financing activities in such areas to ensure the FIs’ SEMS implementation is robust, in addition to other applicable performance requirements.”²⁹

In any case, the E&S specialist reviews the FI client’s SEMS, considering its adequacy to implement IFC’s E&S requirements.³⁰ In reviewing the adequacy of an FI’s SEMS, the ESRPs guide the E&S specialist to consider the following aspects of the client’s management system:

- a. E&S policies and procedures;
- b. The current organizational structure and staffing;
- c. Skills and competencies in E&S areas;
- d. Training and awareness of the client’s investment, legal, and credit officers on the organization’s E&S requirements and the SEMS;
- e. Performance monitoring procedure;
- f. Reporting of results to management; and
- g. Track record to date in SEMS implementation.³¹

On this basis the E&S specialist is to “identify any SEMS actions that the client would need to undertake to ensure compliance” with IFC’s requirements.³² Where an FI is “engaged in projects with either potentially significant E&S risks or risk exposure to IFC,” the ESRPs provide guidance that gaps in the SEMS “must be closed to ensure compliance with the Applicable Performance Requirements before IFC Commitment or as a condition of disbursement.”³³ On the other hand, “FIs with either relatively low E&S risks or no immediate financing activities in such risky areas” are permitted to close gaps in their SEMS as part of a time-bound Action Plan.³⁴

Where an FI is expected to implement the Performance Standards and where the E&S specialist considers it necessary to further review an FI’s SEMS or existing sub-projects, the ESRPs provide for the E&S specialist, in consultation with IFC investment staff, to visit the FI as part of IFC’s pre-investment due diligence.³⁵

“All material decisions and supporting analysis” from the E&S review are to be recorded in the Environmental and Social Review Document (ESRD). As a result an E&S Risk Rating for the project under appraisal (an Appraisal ESRR) is generated.³⁶

The final substantive step in the E&S review process is attendance by the E&S specialist at the IRM.³⁷

²⁹ IFC ESRP (v.4) Sept. 2010, para. 7.2.9.

³⁰ IFC ESRP (v.4) Sept. 2010, para. 7.2.18.

³¹ *Ibid.*

³² IFC ESRP (v.4) Sept. 2010, para. 7.2.19.

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ IFC ESRP (v.4) Sept. 2010, para. 7.2.17.

³⁶ IFC ESRP (v.4) Sept. 2010, para. 7.2.23.

³⁷ IFC ESRP (v.4) Sept. 2010, para. 7.2.25.

Thereafter IFC E&S staff prepare the project for commitment. This includes drafting E&S language for the Board Paper and providing inputs on relevant parts of the investment agreements.³⁸

3.1.2 IFC E&S Due Diligence in Relation to the Ficohsa Equity Investment

Initial E&S Review (before July 2010)

In early 2010 when IFC commenced its appraisal of the equity investment, IFC had two other active investments in Ficohsa: an SME and housing loan (committed February 2008) and a GTFP line (committed September 2008).

Incorporated as Action Plan items into the SME loan agreement, Ficohsa was required to: (i) nominate a SEMS Officer (prior to disbursement), (ii) establish a SEMS to ensure compliance with relevant national regulation and the IFC Exclusion List (within six months of disbursement), (iii) develop and incorporate guidance notes to enable SEMS implementation (within six months of disbursement); and (iv) ensure all staff responsible for SEMS implementation had been trained.³⁹ In addition, Ficohsa's inclusion in the GTFP required Ficohsa not to provide finance to any goods, commodities, or services listed on IFC's Trade Finance Exclusion List.⁴⁰

As part of the SME loan agreement, Ficohsa was required to submit an Annual Environmental Performance Report (AEPR)⁴¹ to IFC within 90 days of each financial year end.⁴² The report format was provided in an annex to the loan agreement.⁴³

Ficohsa's first AEPR was submitted on February 4, 2009 (due: March 31 2009). In reviewing it, IFC noted that Ficohsa's SEMS was developed with the support of a European development bank and a consulting firm with a focus on sustainable business strategies. IFC notes that the SEMS was approved by Ficohsa's Board of Directors in December 2008 and that the SEMS was detailed and stringent. However, IFC considered it too early to effectively evaluate implementation. IFC gave the client an environmental and social risk rating (ESRR) of 2 - Satisfactory.

In January 2010, as part of its appraisal for the equity investment, IFC E&S staff requested that Ficohsa complete a portfolio questionnaire. In April 2010, IFC E&S staff confirmed to the IFC investment team that this questionnaire had not been returned, but suggested that the 2009 AEPR (at that point also overdue) could replace the portfolio questionnaire if it covered Ficohsa's entire portfolio.

In May 2010, IFC E&S staff visited Ficohsa for the first time. The purpose of the visit was to supervise IFC's existing SME investment with a focus on implementation of the SEMS required by the SME loan.⁴⁴ The Back to Office Report (BTOR) from the mission does not discuss the

³⁸ IFC ESRP (v.4) Sept. 2010, para. 8.2.4. & 8.2.6.

³⁹ IFC Ficohsa Loan Agreement (project 26394), February 15, 2008, Schedule 10

⁴⁰ IFC, Trade Finance Exclusion, see <http://goo.gl/czYQYd>.

⁴¹ IFC uses the terms Annual Environmental Performance Report (AEPR) and Social and Environmental Performance Report (SEPR) interchangeably. For purposes of clarity, CAO has used AEPR throughout this report.

⁴² As Ficohsa's financial year end is December 31, the deadline for submitting an AEPR to IFC is March 31 of the following year.

⁴³ IFC AEPR report formats are available on *First for Sustainability*. See <http://goo.gl/e5otqa>.

⁴⁴ IFC, E&S Supervision Mission Report (June 2010).

pending equity investment. It does not discuss E&S risk in Ficohsa's portfolio in the context of the proposed equity investment, and it contains no discussion of Ficohsa's capacity or commitment to implement a SEMS in accordance with the Performance Standards.

Regarding Ficohsa's SEMS, the BTOR states that implementation was still in the pilot phase due to a change in the client's E&S policy. While noting that IFC had not yet received a copy of Ficohsa's revised E&S policy, the BTOR describes Ficohsa's approach to E&S risk management, highlighting the following points:

- All projects of tenor greater than 12 months and over HNL 5 million (approx. US\$250,000) which are considered medium to high risk require E&S analysis through a more detailed questionnaire.
- Based on the questionnaire, projects are provided with an E&S risk category of A, B or C.
- Category A or B projects undergo additional E&S due diligence and are analyzed by the pre-credit committee and potentially the company's board.
- Where gaps are identified through the E&S analysis, an Action Plan is required of the borrower.
- The company monitors all aspects of sub-projects through annual site visits.

On the basis of the supervision mission, and in advance of having received Ficohsa's overdue 2009 AEPR, its revised E&S policy, or documentation demonstrating implementation of the E&S policy, IFC assigned Ficohsa an ESRR of 2: Satisfactory.

A review of relevant documentation indicates that IFC investment staff working in the Honduras office were aware of both the serious nature of the conflict involving Dinant and Ficohsa's status as a major lender to Dinant at this time. As explained to CAO, neither:- (a) IFC staff conducting the E&S review in relation to Ficohsa equity investment, nor (b) FI department staff/management who had overall responsibility for the investment - were aware of the serious nature of the conflict involving Dinant as this time.

Appraisal Visit (May – June 2010)

IFC investment staff conducted an appraisal visit to Ficohsa in May 2010 with a follow up visit in June 2010. As part of this appraisal, three IFC staff, led by an experienced Banking Specialist, conducted a review Ficohsa's portfolio credit risk. The methodology involved reviewing the files of Ficohsa's 40 largest clients as well as a random selection of an additional 34 clients. This covered 71% of Ficohsa's non-retail credit risk exposure.

CAO understands that as part of the appraisal, and according to regular credit review practice, IFC reviewed documentation associated with each loan and discussed each loan with relevant Ficohsa staff. Each loan was then assigned a rating, which was aggregated to feed into IFC's assessment of Ficohsa's Credit Risk Rating and value its prospective equity investment.

The findings of this appraisal were written up in a 9 page report which, in addition to portfolio review information, includes a detailed and critical analysis of Ficohsa's credit approval process.

Financial Covenant Waiver (July 2010)

In the course of the appraisal process, IFC identified issues regarding the application of a financial covenant that was included in IFC's 2008 loan agreement with Ficohsa. This covenant required Ficohsa to limit exposures to single clients or corporate groups. Ficohsa's lending to a number of clients (including Dinant) was found to be in excess of this limit. As a result, in July

2010, IFC investment staff prepared a memorandum to management of the IFC FI department, requesting a waiver of the covenant.

In arguing for the waiver, the July 2010 memorandum provides reassurance to IFC management, referring to Dinant's positioning as a "regional leader" in important sectors including the production of crude palm oil. The memorandum notes that IFC provided a US\$30 million loan to Dinant in early 2009 and describes Dinant's owner as a "very respected businessman" with whom IFC has had a long term relationship through direct agribusiness investments.⁴⁵ The memorandum notes that Dinant is "in negotiations with the government for the sale of at least 3,000 ha of cultivated land with palm oil plantations," a factor which is described as providing an important cash inflow which would be utilized to pay down its debt. The memorandum concludes by describing Dinant as among the "top players" in a strategic sector for IFC "with a high developmental impact" in one of the least development countries in Latin America.⁴⁶ The memorandum also notes that Ficohsa envisages a gradual reduction in its exposure to Dinant with full compliance with the covenant expected by the end of 2011.

The July 2010 waiver memorandum does not mention the ongoing violent conflict over the Dinant plantations in the Aguán Valley, though IFC staff who were involved in the preparation of the memorandum had been aware of the conflict since at least February 2010. While mentioning the 2009 IFC loan to Dinant, the memorandum does not mention that the processing of the second disbursement of the loan was behind schedule, and subject to analysis of a number of issues including the land conflict.

Disclosure (August 2010)

According to its Disclosure of Information policy, IFC "makes available information concerning its activities that would enable its clients, partners and stakeholders (including affected communities), and other interested members of the public, to understand better, and to engage in informed discussion about, IFC's business activities, the overall development and other impacts of its activities, and its contribution to development."⁴⁷

In meeting this principle regarding its FI investments, IFC publishes a *Summary of Proposed Investment* (SPI) at least thirty days prior to the project's consideration by the IFC Board. Specifically for FIs, IFC is required to provide "a brief summary of any key enhancements to be made to the FI's social and environmental management system."⁴⁸ Further, if there are any significant changes to the project or to IFC's investment since its public disclosure and prior to its consideration by the IFC Board, IFC is required to update the SPI. Relevantly, such updates do not restart the minimum disclosure period (thirty days) prior to Board "unless IFC determines ... in the case of changes related to the summary of any key enhancements to be made to the FI's social and environmental management system ... the previously disclosed information would be materially deficient without the additional information."⁴⁹

In advance of the Investment Review Meeting, IFC publicly disclosed the project on its website on August 31, 2010.⁵⁰ In disclosing the project, IFC noted:

⁴⁵ IFC internal memo, July 2010.

⁴⁶ *Ibid.*

⁴⁷ IFC Disclosure of Information Policy, 2006, para. 8.

⁴⁸ IFC Disclosure of Information Policy, 2006, para. 14 b (xi).

⁴⁹ IFC Disclosure of Information Policy, 2006, para. 14 e.

⁵⁰ IFC, Statement of Project Information. See: <http://goo.gl/u4pqWq>.

“This project involves an equity investment in a middle market bank in Honduras and has been classified as a Category FI. Under an existing project (#26394) the client was required to implement a SEMS to ensure that its sub-borrowers comply with the IFC exclusion list and the environmental and social laws of Honduras. The client has implemented the SEMS and submitted an environmental and social report as required. This requirement will apply to all of the client’s sub-loans under the new project. The client will be required to: maintain or upgrade its existing SEMS; demonstrate commitment to applying the labor standards established by the IFC Performance Standard 2; and continue to submit a periodic report to IFC.”

Notable here is the omission of the requirement – later identified as necessary – that Ficohsa upgrade its SEMS to screen high risk investments against the Performance Standards. It is also notable that the client is described as having implemented the SEMS and submitted an E&S report as required - in circumstances where IFC E&S staff had reported that the client’s SEMS was not yet fully implemented and their E&S reporting was overdue.

Investment Review Meeting (September 2010)

On September 1, 2010, two days ahead of the deadline for circulating the Ficohsa IRM decision book to management, IFC investment staff requested E&S staff input on Ficohsa’s environmental and social performance. In response, E&S staff requested Ficohsa’s 2009 AEPR (at that point 5 months overdue). After acknowledging that the client had not provided necessary documentation, investment staff again requested E&S staff input to the IRM book. E&S staff provided their analysis in advance of the deadline while noting that this input was based on the supervision visit for the initial SME investment in May 2010 and a quick review of available documentation. At this point, E&S staff noted that as Ficohsa provided long-term project and corporate finance, it would be required to develop additional capacity to review projects of high E&S risk and ensure that they comply with the Performance Standards. Further, in this review, E&S staff indicated that the SEMS was not yet fully implemented due to changes in the policy and procedures.

The IRM decision book as circulated contains little E&S analysis. Information that is presented is contained in an attached draft Board Paper. This describes the status of the Ficohsa’s current SEMS in language similar to that which was disclosed in the SPI. The IRM book contains no analysis of project E&S risk, the adequacy of the client’s SEMS, or of the SEMS gaps that would need to be filled in order to meet IFC’s E&S Requirements.

At the IRM on September 22, 2010, IFC management and staff discussed the political situation in Honduras, the financial structure of the investment, development indicators to be monitored, among other issues.

Though IFC E&S staff assert that the meeting was informed that the E&S requirements would need to be upgraded as part of the equity investment, the IRM minutes contain no reference to a discussion of E&S issues.

In relation to Dinant, in the context of a discussion of the political situation in Honduras, the IRM minutes note “an illegal occupation of land belonging to Dinant (a client of both IFC and Ficohsa).”

This is the only mention of land or conflict issues around Dinant in the IRM briefing book or minutes.

CAO's discussions with IFC staff and a review of available audio recording from the IRM confirm that the occupation of the Dinant plantations was raised at the IRM, but that the connection between Ficohsa and Dinant was not discussed in this context. Further, there is no indication that the violent nature of the conflict over Dinant's plantations or the E&S risks associated with this exposure were discussed at the IRM.

CAO notes that representatives of IFC regional management and staff who were part of the Dinant direct investment team, were present at the IRM.

Senior IFC staff and management with direct responsibility for the Ficohsa investment confirmed to CAO that if Ficohsa's exposure to Dinant had been raised in the context of the ongoing violent conflict around Dinant's properties, they would have expected this to be one of the main topics for discussion at the IRM, which it was not.

E&S Review Document (September - November 2010)

Ficohsa submitted its 2009 AEPR on September 21, 2010. IFC completed its review of the 2009 AEPR on November 15, 2010. The Appraisal ESRD for the Ficohsa equity investment was updated the same day.

The Appraisal ESRD provides a brief description of the client's SEMS. It does not provide a gap analysis of the SEMS against the requirements of the proposed equity investment, other than to say that the client will be required to develop additional capacity to review projects of high E&S risk and ensure that they comply with the Performance Standards. In relation to SEMS implementation, the ESRD notes that IFC had reviewed one example of E&S due diligence submitted by the client which it found to be detailed.

In discussing Ficohsa's SEMS in the ESRD, IFC rates Ficohsa Satisfactory in relation to each of five criteria.⁵¹ These ratings, however, assess Ficohsa's SEMS against the IFC's requirements for the earlier SME loan rather than those for new investment, for which the ESRD was being prepared. As a result, Ficohsa is given an Appraisal ESRR of 2 – Satisfactory, although IFC E&S staff were aware that it did not have SEMS in place which would meet the applicable performance requirements of the equity investment. In this respect, the Supervision ESRR and the Appraisal ESRR seem to have been confused.

Letter to World Bank President re. Dinant (November 2010)

On November 17, 2010, NGO, Rights Action, wrote to World Bank President, Robert Zoellick, alleging that Dinant security guards had killed five campesinos when "Dinant security attempted to illegally evict the farmers from land in [their] possession" on November 15, 2010. The Rights Action letter was forwarded to the IFC Executive Vice President (EVP) for response, and on December 3, 2010 IFC agribusiness senior management wrote to Dinant's owner, referring to the November 15 events and asking for restraint. The events of November 15, 2010 were widely reported in the Honduran media at the time.

⁵¹ Policy & Management Commitment; Process & Implementation; Capacity and Quality; Reporting & Feedback; and AEPR reporting.

Corporate Operations Committee (November 2010)

On November 22, 2010 a meeting of the Corporate Operations Committee (COC) was convened to discuss issues relating to the Ficohsa investment.⁵² These related to corporate governance and did not include E&S issues or issues related to Dinant. The COC meeting was chaired by the IFC EVP and included IFC senior management, IFC investment staff working on the Ficohsa transaction, and IFC Honduras based staff. Minutes of the meeting note that the IFC EVP decided to refer the issues discussed to the World Bank Group President for consideration.⁵³ Processing of the project was thus put on hold pending feedback from the President. In April 2011, the IFC team was informed that preparation of the project could recommence.⁵⁴ There is no indication that issues related to Dinant were discussed in this context.

Board Approval (May 2011)

The Project was presented to the IFC Board for approval on May 19, 2011. The Board Paper noted that under an existing project, Ficohsa had implemented a SEMS. In discussing the appraisal of the project, IFC noted that it had reviewed Ficohsa's portfolio to identify E&S risks and due to its exposure to agricultural, construction and energy sectors, Ficohsa would be required to apply the Performance Standards to high risk transactions. In order to achieve this, it was noted that Ficohsa would be required to upgrade its SEMS.

IFC Asset Management Company Approval (June 2011)

The IFC Asset Management Company (IFC-AMC) is a wholly owned subsidiary of IFC. It manages funds on behalf of a wide variety of institutional investors and invests alongside IFC.⁵⁵ IFC-AMC sub-contracts the origination, due diligence, and supervision of projects to IFC. Projects that are presented by IFC to IFC-AMC must meet a number of criteria (as established by each fund IFC-AMC manages) before IFC-AMC can consider investing. IFC-AMC only considers projects that have already been approved by the IFC Board.

IFC-AMC staff were present at key decision points in IFC's approval of this project. The Board of IFC-AMC considered and approved this investment in June 2011. Going forward, this meant that IFC-AMC would provide the finance for the investment and subcontract IFC to appraise and supervise it. Therefore, all investments proposed to IFC-AMC must meet IFC's requirements.

Investment Agreements and SEMS Plan (June – October 2011)

The legal basis for IFC-AMC's equity and subordinated debt investment in Ficohsa is established by a series of agreements entered into between June and September 2011. These incorporate the IFC Performance Standards as part of the E&S requirements of the investment.

⁵² The Corporate Operations Committee, comprises representatives of senior management and takes decisions on operational issues with strategic implications for IFC..

⁵³ IFC meeting minutes.

⁵⁴ IFC internal memo, April 29 2011.

⁵⁵ For further details see IFC – AMC webpage: <http://goo.gl/5O0rbW> (accessed March 28, 2014).

Relevantly the investment agreements contain provisions that Ficohsa will:

- Comply with E&S requirements (which include the IFC Performance Standards);⁵⁶
- Use all reasonable effort to ensure the continuing operation of the SEMS to identify, assess and manage all of its existing and future financing operations in accordance with the E&S requirements;⁵⁷ and
- Notify and (upon request) provide IFC with documentation when it commences due diligence in preparation for financing of any Category A activity or client.⁵⁸

The investment agreements also contain a “SEMS Plan” comprising two requirements, namely that Ficohsa will:

- Revise its SEMS to include screening projects against applicable IFC Performance Standards (within three months of disbursement); and
- Ensure all staff responsible for implementing the SEMS are trained at all times to ensure its effective implementation (at all times).⁵⁹

The E&S provisions of the investment agreements are discussed in more detail in section 3.3 below.

3.1.3 E&S Due Diligence: Discussion and Findings

In the course of its pre-investment due diligence, IFC identified that Ficohsa was exposed to high risk sectors (including agriculture, construction and energy). As a result, IFC properly determined that its client would be required to screen projects against the Performance Standards. IFC also properly included provisions in its investment agreements which provide for IFC to be notified, and upon request, review documentation, should Ficohsa consider financing projects or clients that present significant E&S risks.

At the same time, CAO finds a number of non-compliances with the Sustainability Policy, the ESRPs and the Disclosure of Information Policy in relation to IFC's pre-investment E&S review of Ficohsa. In particular, CAO finds that in its pre-investment due diligence, IFC:

- a. Took insufficient measures to identify activities where Ficohsa was exposed to social and environmental risk;
- b. Did not conduct an adequate review of Ficohsa's SEMS or adequately identify actions that the Ficohsa would need to undertake to address gaps in its SEMS;
- c. Did not require that gaps in Ficohsa's SEMS be closed as a condition of disbursement;
- d. Did not meet the requirements of the Disclosure Policy in that it did not ensure that material changes in client E&S requirements were made public at least 30 days prior to Board approval.

Each of these findings is elaborated below. Taken together they represent a material failure of IFC's pre-investment E&S review process.

⁵⁶ IFC-AMC – Ficohsa Shareholders Agreement, 2011.

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ IFC-AMC – Ficohsa Subordinated Debt and Shareholders Agreement, 2011.

IFC took insufficient measures “to identify activities” where Ficohsa was “exposed to social and environmental risk” as required by the Sustainability Policy.⁶⁰ In relation to these requirements, CAO finds that IFC E&S staff correctly identified that Ficohsa was providing corporate finance in relation to clients operating in high risk sectors. Though the ESRPs provide E&S staff with the discretion to “review further the client’s SEMS or existing sub-projects”⁶¹ in such circumstances, no further review was taken in relation to Ficohsa. As explained by E&S staff working on the project, more detailed analysis of the portfolio was not deemed necessary as Ficohsa was an existing client with a favorable E&S rating. Given the risk profile of Ficohsa’s business, E&S governance challenges at the country level, and the nature of the new investment (equity vs. SME), however, CAO finds that a more intensive E&S review was required. In particular, CAO finds that IFC relied overly on the results of prior supervision, and a rapid review of Ficohsa’s sectoral exposure, in assessing the E&S risk profile of the new investment. In this context, CAO notes E&S staff observations that there is no guidance on when more detailed due diligence at the sub-project level is required.

Further, CAO finds that the E&S review process failed to capture the risk attached to Ficohsa’s exposure to Dinant, even though IFC was aware of significant E&S risks attached to the agribusiness client at the time key decisions in relation to the FI investment were made. In terms of underlying causes, CAO notes the primacy of financial considerations in IFC decision making. In this context CAO notes that it was not IFC practice to review FI sub-client *E&S risk* in the same depth as sub-client *credit risk* was reviewed. Had IFC included a review of Ficohsa’s largest clients as part of its E&S review (as was done in relation to the credit review process), the E&S risk around Dinant would likely have been identified. CAO also notes a siloing of information with the result that relevant information was not shared among key members of the team. In this context IFC E&S staff did not ask about Ficohsa’s exposure to high risk sub-clients (including Dinant) and their regionally based investment colleagues, who were aware of the issues, did not tell.

IFC did not conduct an adequate review of Ficohsa’s SEMS or adequately identify actions that Ficohsa would need to undertake to address gaps in its SEMS. Documentation of IFC’s E&S review in relation to the Ficohsa equity investment suggests a process that was limited in scope and depth. Inputs prior to IFC’s key internal decision point, the IRM, were prepared on the basis of a quick review of outdated information. In contrast to the work of the Banking Specialist, whose 9 page appraisal and portfolio review was included in the IRM decision book, the IRM decision book contains no analysis of sub-client E&S risk, the adequacy of the client’s SEMS, or of the SEMS gaps that would need to be filled in order to meet IFC’s E&S requirements.

Subsequent to the IRM, IFC E&S staff updated the ESRD and language for the Board Paper for the project clarifying that an upgrade to the client’s SEMS would be required in order to meet the requirements of the Performance Standards. As a result, the legal agreements between IFC-AMC and Ficohsa included a SEMS plan which required Ficohsa to revise its SEMS to include screening projects against applicable IFC Performance Standards within three months of disbursement.

⁶⁰ IFC Sustainability Policy 2006, para. 27.

⁶¹ IFC ESRP (v.4) August 2009, para. 7.2.16.

The systematic analysis of the adequacy of the SEMS to “implement the applicable performance requirements”⁶² required by the ESRPs was not present. As described elsewhere, CAO finds that IFC lacked a structured approach to assessing its client’s commitment and capacity to meeting the SEMS requirements of the equity investment.⁶³ Accordingly, IFC was not in a position to adequately “identify SEMS gaps” or “identify SEMS actions” as required by the ESRPs.⁶⁴

IFC did not require that gaps in Ficohsa’s SEMS be closed as a condition of disbursement. In cases where an FI is “engaged in projects with either potentially significant E&S risks or risk exposure to IFC,” the ESRP provides that gaps in the SEMS should be closed prior to IFC Commitment or as a condition of disbursement.⁶⁵ In this case, IFC was aware of high risk exposures in the Ficohsa portfolio. IFC was also aware that Ficohsa’s SEMS was inadequate to manage these risks in accordance with the Performance Standards. Instead of requiring that gaps in the SEMS were closed prior to commitment or as a condition of disbursement, however, IFC required an upgraded SEMS only three months after disbursement. According to the ESRPs, this approach is only acceptable for FIs “with either relatively low E&S risks or no immediate financing activities in such risky areas.”⁶⁶

On this point, CAO notes feedback from senior IFC staff with direct knowledge of the project that the requirement to develop a SEMS appropriate to implement the Performance Standards within three months was impossible. When asked what length of time might be reasonable, one senior staff member opined that it would generally take no less than three years and given the particular difficulties of Honduras as an operating environment, no less than five.

As noted by CAO elsewhere, a bank which is in the initial stages of developing and implementing a SEMS, particularly in a challenging country context or where its portfolio carries high E&S risks, is likely to need extensive capacity building to develop and effectively introduce procedures and processes to manage E&S risk.⁶⁷ For FI’s with significant exposure to E&S risk, however, according to current IFC requirements, such support must be provided in advance of, and not concurrent with an equity investment.⁶⁸

IFC did not meet the requirements of its Disclosure Policy in that it did not ensure that material changes in client E&S requirements were made public at least 30 days prior to Board approval. IFC disclosed its SPI for this project on August 31, 2010. In the SPI as disclosed, IFC indicated that the client would be required to implement a SEMS to ensure that all sub-borrowers comply with the IFC Exclusion List and the environmental and social laws of Honduras. In September 2010, IFC E&S staff determined that the client would also be required to apply the Performance Standards to high risk projects. As per the Disclosure Policy, CAO finds that this represented a “significant change” to the information contained in the SPI, and as such, the SPI should have been updated. No such update was made. Further, CAO finds that absent this update, the E&S information contained in the SPI was “materially deficient.” As a

⁶² IFC ESRP (v.4) August 2009, para. 7.2.17.

⁶³ See: CAO (2012) Audit of a Sample of IFC Investments in Third Party Financial Intermediaries, p. 38.

⁶⁴ IFC ESRP (v.4) August 2009, para. 7.2.19.

⁶⁵ *Ibid.*

⁶⁶ IFC ESRP 7 v.4 para. 2.19

⁶⁷ CAO (2012) Audit of a Sample of IFC Investments in Third Party Financial Intermediaries, p. 38f.

⁶⁸ IFC ESRP (v.4) August 2009, para. 7.2.18.

result, 30 days should have been allowed from the date of an updated posting of the SPI before consideration of the investment by IFC's Board of Directors.

The above shortcomings, taken together, represent a material failure of IFC's pre-investment E&S review process. As a result IFC acquired an equity stake in a client with exposure to high risk sectors and clients. The client, however, lacked capacity to implement IFC's E&S requirements within agreed timeframes. The absence of an E&S review process that was commensurate to risk meant that key decision makers (senior management of IFC's FI department and members of the IFC Board) were not presented with an adequate assessment of the risks that were attached to this investment. This included additional exposure to Dinant, a company which IFC knew to be affected by a violent land conflict, as well as exposures to a number of other investments with potentially significant, but unassessed, E&S risk.

In relation to the above findings of non-compliance, CAO notes IFC's position that the project was processed according to prevailing practice.

3.2 Disbursement

Summary of Findings

- IFC's review of the CODs did not comply with the ESRP requirement that E&S staff clear any E&S CODs following a review of evidence of compliance with the CODs.
- IFC-AMC disbursed against its subscription and sub-ordinated debt agreements, without assuring itself that Ficohsa had submitted the E&S information that was required as a condition of disbursement.
- IFC E&S staff did not review the ongoing validity of Ficohsa's E&S representations and warranties prior to disbursement.

This section addresses IFC-AMC's decision to make disbursements to Ficohsa under its subscription and subordinated debt agreements. In particular, it considers whether IFC obtained adequate evidence of compliance with the agreed conditions of disbursement.

3.2.1 Review of Conditions of Disbursement - IFC Requirements

General Requirements

According to the ESRPs, the IFC E&S Specialist assigned to an FI investment should clear any E&S conditions of disbursement (CODs). When such clearance is sought, the ESRPs provide that "information will be obtained and reviewed as required to evidence [compliance with the CODs] and provide the clearance."⁶⁹ The E&S Specialist undertakes this review and informs the IFC team if any E&S conditions of disbursement have not been complied with. Any waivers of E&S CODs must be processed by a manager in the CES department and be documented in the ESRD.⁷⁰

For the purposes of the discussion below, IFC's general requirements for review of "conditions of disbursement" (in the case of a loan) are understood to apply equally to "conditions of obligation" to consummate the subscription (in the case of an equity investment). As a result CAO uses these terms interchangeably.

⁶⁹ IFC ESRP 9 v.4 para. 2.2

⁷⁰ *Ibid.*

Project Specific Conditions of Commitment and Disbursement

IFC-AMC's equity and subordinated debt investments in Ficohsa had two relevant types of CODs: (a) E&S reporting requirements; and (b) requirements that representations and warranties made by Ficohsa to IFC at commitment be true, accurate and not misleading as at the date of disbursement.⁷¹ As noted above, completion of the SEMS upgrade was not a COD.

IFC-AMC's Subscription Agreement with Ficohsa included a condition of disbursement that Ficohsa provide IFC with its pending AEPR, specifically it is a COD that:

"The Company [has] agreed in writing with IFC on the form of AEPR, and delivered to IFC a copy of a completed AEPR for 2010, including all relevant information with respect to Clients with Client Operations involving high environmental and social risks, in form and substance satisfactory to IFC."⁷²

In relation to the ongoing validity of representations and warranties, the Sub-Ordinated Debt Agreement contained the following representation:

(i) there are no material social or environmental risk or issues in respect of the Company Operations [which include all existing and future financing operations of the Company]...⁷³

3.2.2 IFC's Disbursement to Ficohsa

On September 23, 2011, Ficohsa provided IFC with its AEPR for 2010. On the same day, E&S staff informed the investment team that there were no pending E&S items preventing commitment.⁷⁴

In its 2010 AEPR, Ficohsa provides a sector breakdown relating to 73% of the portfolio. The report lists sub-projects which have a tenor longer than 12 months and outstanding exposure greater US\$1 million. In respect of its SEMS, Ficohsa's report notes that it is implementing a plan approved by its board in December 2008. The report also notes one material E&S issue involving a sub-project, a small oil spill. Ficohsa's report does not contain information on the E&S performance of Dinant or any other client.

IFC completed its review of the 2010 AEPR in December 2011, more than a month after IFC-AMC's first disbursement (the equity purchase). The review is captured in a Supervision ESRD which was updated on December 12, 2011. As part of its review, IFC rates Ficohsa's performance across each of five criteria (Policy & Management Commitment; Process & Implementation; Capacity and Quality; Reporting & Feedback; and AEPR Reporting). Of these the first four are rated Partially Unsatisfactory, and the last (AEPR Reporting) is rated Unsatisfactory. Nevertheless, overall Ficohsa is rated ESRR 2 – Satisfactory.⁷⁵ CAO is unclear as to the reason for the inconsistency between the component ratings and the overall ESRR.

⁷¹ IFC-AMC - Ficohsa Subscription Agreement, 2011). IFC AMC - Ficohsa Subordinated Debt Agreement, 2011.

⁷² IFC-AMC - Ficohsa Subscription Agreement (July 2011), Section 4.03 (f)(i).

⁷³ IFC-AMC- Ficohsa Subordinated Debt Agreement, 2011. IFC AMC - Ficohsa Subscription Agreement, 2011).

⁷⁴ IFC internal email (September 23, 2011).

⁷⁵ Supervision ESRD (December 12, 2011).

In terms of follow up actions, IFC requests that Ficohsa provide a total sector breakdown of its portfolio as the 2010 AEPR is incomplete and provides a sector breakdown related to only 73% of its portfolio. The ESRD also notes that it will be necessary to follow-up on the implementation of the SEMS enhancements agreed as part of the new IFC investment.

Ficohsa's disbursement requests were received by IFC on October 18, 2011. Relevantly, the requests include statements asserting: (a) the continuing validity of Ficohsa's representations and warranties, and (b) that other conditions of disbursement have been met.

Following clearance from relevant IFC investment and E&S staff, IFC-AMC subscribed to the equity investment on October 31, 2011 and disbursed the subordinated loan on November 21, 2011.

3.2.3 Disbursement: Discussion and Findings

In considering whether Ficohsa's CODs had been met, IFC E&S staff confirmed that the client had designated an E&S Officer, and that IFC had received Ficohsa's 2010 AEPR.

Based on available evidence it does not appear that IFC conducted a substantive review of the 2010 AEPR until after both investments were disbursed.

In these circumstances, CAO finds that IFC disbursed against its subscription and sub-ordinated debt agreements without assuring itself that Ficohsa had submitted the E&S information that was required as a condition of subscription. In particular, CAO finds that IFC did not assure itself that the 2010 AEPR contained "all relevant information with respect to ... Client Operations involving high environmental and social risks" or "described in reasonable detail, ... implementation and operation of the S&E Management System; and ... the environmental and social performance of the Clients." In making this finding, CAO notes that the AEPR format as provided to Ficohsa by IFC was not fit for purpose in terms of the detail that it required regarding the environmental and social performance of borrowers, in particular those with high environmental and social risks.

A more general discussion of the robustness or otherwise of Ficohsa's AEPR reporting and IFC's approach to the review of AEPRs is contained in section 3.3 below.

Further, CAO finds that IFC E&S staff did not review the ongoing validity of Ficohsa's E&S representations and warranties prior to disbursement. Specifically, there is no evidence that IFC E&S staff reviewed the client's representation that: "there are no material social or environmental risk or issues in respect of the Company Operations." Rather the continued validity of the representations and warranties COD was cleared on the basis of the client's Disbursement Request of October 18, 2011. CAO notes that IFC's clearance of disbursement was given at a time when Dinant (a major client of Ficohsa) was listed on IFC's Corporate Watch List,⁷⁶ and in the context of a worsening security environment in Aguán Valley, where Ficohsa had more than one major agricultural client.

⁷⁶ The Corporate Watch List is a list of high risk investments which is prepared by IFC's External Relations Department and circulated to senior management on a weekly basis.

For the reasons set out above, CAO finds that IFC's review of the CODs did not comply with the ESRP requirement that E&S staff clear any E&S CODs following a review of evidence of compliance with the CODs.⁷⁷

4.3 Project Supervision

Summary of Findings

- IFC's requirement to ascertain whether or not "there is sufficient evidence that the client has applied the Applicable Performance Requirements to their sub-projects," necessitates a more robust review of client performance than IFC conducted in relation to Ficohsa.
- In supervision, IFC did not assure itself in an adequate or timely manner that Ficohsa was "operating the SEMS as envisaged at the time of appraisal" or that Ficohsa had "applied the Applicable Performance Requirements to its sub-projects."
- IFC's June 2012 supervision documentation was deficient in that it did not address the E&S requirements of the 2011 equity investment, instead focusing on those of the earlier SME loan. As a result, IFC was able to rate Ficohsa's E&S performance "Satisfactory" meaning that Ficohsa was found to be in "material compliance" at a time when it was out of compliance with IFC's E&S requirements.
- IFC did not meet the requirement to review initial financing activities in relation to an FI client with potential significant E&S risks associated with its financing activities.
- IFC did not adequately 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 communities are informed.
- There is a disconnect between the client reporting templates that IFC provided to Ficohsa and the E&S requirements that were written into the investment agreements.
- The AEPR format as provided to Ficohsa was not fit for purpose in terms of the detail that it required regarding the environmental and social performance of borrowers, in particular those involving high environmental and social risks.
- IFC's engagement with the client has improved since late 2012 when the IFC E&S team supervising the Ficohsa investment became aware of the gravity of the concerns regarding Dinant.
- Despite steps forward, capacity and country governance challenges mean that supervising compliance with the E&S requirements of the 2011 investment agreements presents a significant long term challenge.

This section addresses IFC's supervision of its investment in Ficohsa, in particular whether IFC adequately assured itself that its client's E&S obligations including reporting obligations were being fulfilled.

3.3.1 Project Supervision - IFC Requirements

General Supervision Requirements

As per the Sustainability Policy, IFC monitors an FI client's performance on the basis of its SEMS.⁷⁸ In practice, the primary source of information for IFC FI project supervision is the

⁷⁷ IFC ESRP 9 v.4, para. 2.2

⁷⁸ IFC Sustainability Policy 2006, para. 29

client's AEPR. In addition, IFC E&S staff may determine the need for a supervision visit where it is considered necessary to further review the client's performance or verify compliance.⁷⁹

In reviewing a client's AEPR, IFC E&S staff are guided to focus on:

- The client's performance against the Applicable Performance Requirements as determined during project review and appraisal;
- The status of the client's implementation of the Social and Environmental Management System (SEMS) Action Plan and timeline if relevant;
- Performance against the performance indicators;
- Previous SEPR [AEPR] reviews and Environmental and Social Risk Rating (ESRR) scores;
- Key performance or information gaps relating to the client's performance and the SEMS;
- Key steps the client may need to take to improve performance; and Advising the Portfolio Officer on the pending issues to follow up with the client.⁸⁰

Based on this review, IFC E&S staff are required to determine whether or not:

- The nature of the client's business has changed significantly to indicate different performance requirements from IFC;
- There is sufficient evidence that the client is operating the SEMS as envisaged at the time of appraisal; [and]
- There is sufficient evidence that the client has applied the Applicable Performance Requirements to their sub-projects; ...⁸¹

IFC E&S staff then complete an AEPR Review and provide an E&S risk rating (ESRR) on a four point scale from F1- Excellent, F2 – Satisfactory, F3- Partly Unsatisfactory, and F4- Unsatisfactory. A summary of this review is provided to the client including any actions to address performance gaps and other issues of concern.

Project Specific Supervision Requirements

IFC-AMC's investment agreements incorporate Ficohsa's E&S commitments in an enforceable framework, setting out covenants and reporting requirements. These include the client's commitment to:

- a. Comply with the E&S requirements, which include the Performance Standards.
- b. Assess and manage all existing and future financing operations in accordance with the E&S requirements (which include the Performance Standards).
- c. Implement the SEMS Plan (which includes a requirement to revise the SEMS to screen projects against the Performance Standards within three months of disbursement).
- d. Ensure continuing operation of the SEMS to identify, assess and manage the E&S performance of its client in compliance with the E&S requirements. (All Category A and B projects are required to be reviewed, contracted and monitored to ensure compliance with the E&S requirements.)
- e. If any existing client becomes a Category A, ensure that the SEMS has sufficient capacity to review E&S issues as relate to that client.
- f. In instances where a client is not operating in accordance with the E&S requirements, agree on corrective measures to remedy the breach and if such action is not possible, use reasonable efforts to dispose of the investment

⁷⁹ IFC ESRP 9, para. 2.7.

⁸⁰ IFC ESRP 9, para. 2.6.

⁸¹ *Ibid.*

- g. Obtain, review and investigate any information available in the public domain that relates to potential negative E&S impacts associated with an investment.
- h. Provide IFC with an AEPR 90 days after the end of the financial year in order to confirm compliance with SEMS plan and E&S requirements. (This report should describe in reasonable detail the SEMS and the E&S performance of clients).⁸²
- i. On becoming aware of any E&S incidents related to a client that could have a material impact on a client's ability to operate in accordance with the Performance Standards, inform IFC within three days and note measures the client is taking in response.
- j. Notify IFC when considering financing any Category A Activity or client.
- k. Notify IFC when becoming aware of any E&S claim against any category A or B client.⁸³

3.3.2 IFC Supervision of Ficohsa

2011-12

Ficohsa was required to have revised its SEMS to include screening of projects against the IFC Performance Standards within three months of disbursement. As the disbursement under the subscription agreement was made on October 31, 2011, this action was due by January 31, 2012. There is no indication that IFC reviewed the status of Ficohsa's SEMS at this juncture.

Ficohsa submitted its AEPR for 2011 in mid-April 2012 (due: March 31, 2012). The AEPR was presented in the form that applied to the 2008 SME investment rather than that which was required by the 2011 equity investment. While there is a large degree of commonality between these two forms, the updated version required Ficohsa to detail the number of Category A and B projects in its portfolio, the number of projects providing Ficohsa with annual reports, and the number of projects where an E&S field visit by Ficohsa staff was conducted. This information was not included in the 2011 AEPR. The 2011 AEPR is also silent in relation to Ficohsa's progress against the updated SEMS Plan and the updated E&S covenants, both of which it was required to report against under the September 2011 Shareholders Agreement.

IFC's review of the 2011 AEPR is captured in a Supervision ESRD dated June 2012. The June 2012 Supervision ESRD notes that Ficohsa has a SEMS that is applied to all operations. In describing how the SEMS operates, the June 2012 ESRD uses the same text that was used in relation reviews of the client's 2009 and 2010 AEPRs (see summary in section 3.1.2 above).

In addition, the Supervision ESRD notes that according to the 2011 AEPR, 200 of Ficohsa's largest borrowers were in the process of being classified using the enhanced SEMS tools. Further, IFC notes the amount Ficohsa allocated for SEMS implementation across its almost US\$900 million portfolio. The amount reported as allocated for SEMS implementation represents a fraction of Ficohsa's publically reported total environmental expenditure for 2011 of \$68,227.26.⁸⁴

As follow up actions, IFC requested Ficohsa to provide a full sector breakdown of its portfolio (Ficohsa had provided information as it relates to 67% of its portfolio). IFC also requested a copy of Ficohsa's enhanced SEMS policy and procedures, and three samples of E&S due diligence related to SME clients.

⁸² IFC's standard AEPR template, as annexed to this agreement, is available at the following link <http://goo.gl/DTvO7s> (accessed April 15, 2014).

⁸³ IFC-AMC Ficohsa, Shareholders Agreement, para. 2011.

⁸⁴ Ficohsa, Reporte de Sustentabilidad 2011.

The June 2012 Supervision ESRD rates Ficohsa's performance as Satisfactory across each of five criteria (Policy & Management Commitment; Process & Implementation; Capacity and Quality; Reporting & Feedback; and AEPR Reporting). As a result Ficohsa maintained its overall ESRR of F2 – Satisfactory. By rating the client F2, IFC determined that the project was in material compliance with IFC E&S requirements. CAO notes that the 2011 Supervision ESRD contains no discussion of the SEMS revisions Ficohsa was required to have completed by January 2012, or to the updated E&S covenants under the September 2011 investment agreements.

IFC E&S staff conducted supervision mission to the client in late November 2012. The purpose of the mission was to confirm the inclusion and implementation of Performance Standards under the SEMS and to assess Ficohsa's implementation of PS2 (Labor and Working Conditions) to its own operations. During this visit, IFC E&S staff reviewed Ficohsa files related to three clients, including Dinant. As explained by E&S staff working on the project, it was considered prudent to request the Dinant files from Ficohsa once they learned about the CAO investigation into IFC's investment in Dinant.⁸⁵

2013

A BTOR from IFC's November 2012 Supervision Mission for Ficohsa was completed in February 2013. The BTOR noted that none of the files reviewed contained information on E&S risks, any action plans developed by Ficohsa or client reports on E&S issues. Based on this review IFC staff noted that SEMS implementation was limited to requesting copies of E&S licenses, permits and annual client visits. Further, IFC considered the current scope of the SEMS inadequate to assess projects against the Performance Standards.

Further, the BTOR notes that Ficohsa's SEMS does not consider assessment of corporate sub loans and high risk project finance against the Performance Standards. As a result, it was noted that the Ficohsa would be required to (i) hire an E&S specialist to provide support with the enhancement of the SEMS and the application of the Performance Standards, (ii) formalize and document the enhanced procedures; and (iii) conduct staff training. At this point, IFC rated the client F3 – Partly Unsatisfactory. By rating a client F3, IFC determined that the project was not in material compliance with IFC's E&S requirements.

While Ficohsa's E&S due diligence with regard to Dinant is discussed in the February 2013 BTOR, it is notable that neither the conflict around Dinant's properties or the CAO investigation regarding Dinant is mentioned. In explaining why the Dinant conflict was not discussed in the BTOR, IFC E&S staff working on the project explained that it was not necessary to do so as Dinant exposure preceded the IFC investment or was through trade finance and IFC E&S Department management was already familiar with the CAO Dinant investigation.

The result of this approach, however, was that the gravity of the allegations regarding Dinant was not brought to the attention of FI department management until seven months later when CAO triggered its appraisal of Ficohsa in August 2013.

Following the November 2012 site supervision visit, IFC agreed with FMO and DEG, who also hold investments in Ficohsa, that IFC would lead discussions on the development of a SEMS Action Plan for Ficohsa. From discussions with IFC staff, CAO understands that IFC has engaged with Ficohsa on at least a monthly basis since.

⁸⁵ CAO's decision to conduct a compliance investigation of IFC's investment Dinant was announced in August 2012.

IFC staff prepared an E&S Action Plan with Ficohsa in March 2013. Specifically, this Action Plan required Ficohsa to:

- Hire a qualified E&S specialist;
- Enhance its SEMS to ensure that financing is consistent with the Performance Standards;
- Formalize SEMS procedures to ensure incorporation of E&S Action Plans and covenants into loan agreements
- Enhance compliance monitoring; and
- Train staff to support SEMS implementation.⁸⁶

Ficohsa submitted its AEPR for 2012 in November 2013 (due: March 31, 2013). Information is presented in the form required by the 2011 investment agreements. However, key information is not reported, for example in relation to the number of high risk projects in Ficohsa's portfolio, the number of projects providing Ficohsa with annual reports, and the number of projects where a E&S field visit by Ficohsa staff was conducted. The 2012 AEPR lacks responses to questions on "details of any material E&S issues associated with borrowers," "transactions rejected" on E&S grounds, and budget for SEMS implementation. The 2012 AEPR is also silent in relation to Ficohsa's progress against the updated SEMS Plan and the updated E&S covenants, both of which it was required to report against under the September 2011 Shareholders Agreement.

IFC's next Supervision ESRD update was completed in December 2013. The December 2013 Supervision ESRD notes that Ficohsa has implemented a SEMS but that it does not apply the Performance Standards. It notes that Ficohsa has developed a new ESAP to address existing E&S performance gaps and hired a full time environmental specialist, who will be in charge of implementing the revised procedures and assisting the bank in monitoring its high risk clients. It also notes that the client is updating its SEMS to incorporate review of high-risk projects to the Performance Standards. As a result IFC rated the client F3 – Partly Unsatisfactory.⁸⁷

2014

Ficohsa's 2013 AEPR was submitted in mid April 2014 (due: March 31, 2014). Reporting is improved compared to previous AEPRs. In particular, CAO notes the following from the 2013 AEPR:

- A statement that the SEMS is in the process of being revised to incorporate the Performance Standards;
- Acknowledgement of the difficulties that exist in ensuring client compliance with National Law in a context where government agencies do not always enforce the law and where clients do not have required permits but operate without problems;
- Acknowledgement of the work that is needed for Ficohsa (as the first local bank to implement E&S risk management) to create an understanding of the process and its value among clients; and
- A count of Category A and Category B clients.

At the time of writing, IFC had not filed a review of the 2013 AEPR.

In March 2014 the IFC team informed the Corporate Operations Committee of a potential option to acquire additional Ficohsa equity through a rights issue. In April 2014 IFC approved

⁸⁶ Draft Ficohsa ESAP, March 2013

⁸⁷ IFC Supervision ESRD (December 2013).

participation in the rights issue, with IFC-AMC approval following in May 2014. In June 2014 IFC-AMC paid US\$5.5 million for additional Ficohsa shares.⁸⁸

IFC Supervision of Global Trade Finance Program Investment

Through the Global Trade Finance Program (GTFP), IFC guarantees trade-related payment obligations of approved banks in emerging markets.⁸⁹

IFC conducts due diligence on banks seeking to join the GTFP. The ESRPs require IFC E&S staff to classify GTFP projects as Category C. Therefore, such projects are considered to involve minimal or no adverse E&S risks or impacts.⁹⁰ Banks participating in the GTFP are required to abide by the IFC Trade Finance Exclusion List for transactions supported by the program.⁹¹

As noted in section 3, Ficohsa was incorporated into the GTFP in July 2008. Since then, IFC has approved over 150 trade transactions involving Ficohsa. The nature of these transactions relate to the import and export of Textiles, Apparel and Leather, Agricultural Goods, Oil and Gas, and Automotive Parts. CAO notes that IFC approved two guarantees permitting Ficohsa to provide pre-export funding for the export of Food Stuffs from Dinant Honduras to Dinant Guatemala in November 2013. The two transactions were for duration of 3 and 6 months with a total value of US\$5.3 million. In explaining why trade finance would be sought for an intra-firm trade, it was explained to CAO by IFC staff with direct knowledge of the project, that that trade financing is cheaper than general unsecured short term debt and that the finance received is fungible.

3.3.3 Project Supervision: Discussion and Findings

IFC's supervision of its investments in Ficohsa was out of compliance in key respects. IFC's procedures require E&S staff to ascertain whether or not "there is sufficient evidence that the client has applied the Applicable Performance Requirements to their sub-projects."⁹² Such a requirement necessitates a more robust review of client performance than IFC conducted in relation to Ficohsa.

CAO finds that IFC did not assure itself in an adequate or timely manner that Ficohsa was "operating the SEMS as envisaged at the time of appraisal" or that Ficohsa had "applied the Applicable Performance Requirements to its sub-projects." As indicated by the more detailed

⁸⁸ As IFC's participation in the Ficohsa rights issue was completed during the final stages of the CAO investigation process, this report does not consider E&S compliance issues associated with the rights issue.

⁸⁹ As explained to CAO, the GTFP works as follows; an importing company places an order with an exporting company. The importer's bank issues a letter of credit to the exporter's bank. The exporter's bank requests IFC to guarantee (in partial or full) the payment risk of the importer's bank. In requesting an IFC guarantee, the exporter's bank provides IFC with the following details: name of issuing bank, name of exporting and importing company, size and tenor of the transaction, and description of the goods. Based on this information, IFC staff review the transaction. IFC screens goods supported in the transaction against IFC's Trade Finance Exclusion List, the participants to the transaction against the United Nations List of known or suspected terrorists, the World Bank Debarred list, and determines if the transaction meets IFC's anti-money laundering requirements.⁸⁹ IFC aim to response with approval/denial of guarantee requests within 24-48 hours of receiving the request. For further background information on the GTFP see: IEG (2013) Evolution of the International Finance Corporation Global Trade Finance Program 2006-12. <http://goo.gl/4hjTIX> (accessed April 28, 2014).

⁹⁰ ESRP 7 (2009) para 2.7.

⁹¹ IFC's Trade Finance Exclusion list is available here <http://goo.gl/Cf65uH> (accessed April 28, 2014).

⁹² IFC ESRP 9, para. 2.6.

disclosures in Ficohsa's most recent AEPR, CAO notes that even implementing the requirement of compliance with national E&S law represents a significant challenge in Honduras. Beyond this, Ficohsa staff explained to CAO that meeting the requirements of the Performance Standards in the Honduran context would be very difficult.

In particular, CAO finds that IFC's June 2012 supervision ESRD was deficient in that it did not address the E&S requirements of the 2011 equity investment, instead focusing on those of the earlier SME loan. As a result, IFC was able to rate Ficohsa's E&S performance as Satisfactory meaning that Ficohsa was found to be in material compliance at a time when it was out of compliance with IFC's E&S requirements.

By way of contrast, engagement with the client has improved since the IFC E&S team supervising the Ficohsa investment became aware of the gravity of the concerns regarding Dinant. Since early 2013, IFC has in effect conducted the gap analysis of Ficohsa's SEMS that was required at appraisal in 2010. As a result, IFC has also been able to support the development of a corrective action plan to upgrade Ficohsa's SEMS. This again should have been done at appraisal in 2010. Despite these steps, CAO finds that capacity and country governance challenges mean that supervising compliance with the E&S requirements of the 2011 investment agreements presents a significant long term challenge.

At a more systemic level, CAO finds that there is a disconnect between the client reporting structures provided by IFC for Ficohsa and the covenants and reporting requirements that were written into the investment agreements. Thus, for example, IFC has not developed a reporting protocol in relation to the requirement that Ficohsa inform its shareholders when it commences due diligence in relation to a Category A activity or client in accordance with the investment agreements. As a result, while IFC went beyond what was required in terms of negotiating a right to review E&S documentation regarding high risk sub-projects prior to approval,⁹³ a lack of follow up has meant that this requirement has not been implemented. Ensuring prior reporting and review in relation to high risk exposures would have been most relevant in relation to the ongoing financing provided by Ficohsa to Dinant, and to ensuring adequate E&S risk management across Ficohsa's significant portfolio of high risk projects and clients.

Similarly, CAO notes that Ficohsa itself was required by the Shareholders Agreement to comply with the E&S Requirements (which include the Performance Standards).⁹⁴ As interpreted by IFC, this led to supervision of Ficohsa's labor practices against the requirements of PS2. The broader application of the Performance Standards to Ficohsa's business was, however, not supervised. As a result, CAO finds that Ficohsa's PS1 obligations were not adequately supervised. Of particular relevance here is the requirement to "establish a grievance mechanism" which is "readily accessible ... to affected communities" and about which affected communities are informed.⁹⁵ As noted by CAO elsewhere, disclosure of investment related information is a central tenet of accountability in development finance.⁹⁶ The lack of disclosure of information about projects financed by IFC Banking clients, such as Ficohsa, is thus a matter of concern. In making these observations, CAO notes IFC's view that there are regulatory constraints preventing public disclosure of information regarding projects that IFC's commercial banking client's finance. As part of this compliance process, CAO requested information from

⁹³ As set out in the ESRPs, where an FI client is exposed to potential significant E&S risks associated with its financing activities, IFC reserves the right to review the FI's "first few financing activities" to ensure SEMS implementation is robust (ESRP 7 (2010) para. 2.10).

⁹⁴ IFC-AMC Ficohsa, Shareholders Agreement.

⁹⁵ IFC PS1 (2006), para. 23.

⁹⁶ CAO (2012) Audit of a Sample of IFC Investments in Third Party Financial Intermediaries, p.25f.

IFC on regulatory constraints to disclosure that would apply in the Honduran context. At the time of writing CAO had not received a response on this point. CAO notes that Ficohsa has on occasion, for marketing purposes, disclosed the identity of its largest clients.⁹⁷ In this context, it is unclear to CAO why IFC cannot require regular disclosure in relation to FI sub-projects, in accordance with PS1.

Also of concern, CAO finds a lack of robustness to the AEPR reporting that IFC used as the basis for its regular supervision of Ficohsa. This reporting did not meet IFC's requirement that the client describe in "reasonable detail" its "implementation and operation of the SEMS; and the E&S performance of its clients." As noted above, CAO finds that IFC's AEPR reporting format was not fit for purpose in terms of the detail that it required regarding the environmental and social performance of borrowers. In particular CAO notes the absence of a structure that requires the FI client to provide even the most basic data on borrower E&S performance, for example: E&S categorization; E&S risk rating; information on whether the client has agreed to the Performance Standards as a condition of the loan; or information on whether relevant disclosure requirements have been met in relation to the loan.

Absent more substantive documentation requirements and increased accountability (both downwards to affected communities and upward to the IFC as a financier) CAO finds that SEMS reporting can become what CAO has described elsewhere as a "mechanistic" or "box ticking" exercise rather than a means for enhancing E&S outcomes.⁹⁸ A system that relies on self-reporting without robust ground-truthing, even in relation to high risk projects, CAO finds is at risk of generating an environment in which IFC clients, and sub-clients, perceive E&S risk management to be a formulaic exercise.

In relation to GTFP supervision, CAO notes that IFC does not generally consider the circumstances under which the goods being exported are produced. Through limiting the E&S review to a screening of goods against the IFC Trade Finance Exclusion List, IFC opens itself to trade finance in relation to goods, the production of which has significant unmitigated E&S risks and impacts. As such, it was possible for IFC to approve trade transactions through Ficohsa with Dinant as late as November 2013. As is indicated in relation to Ficohsa's financing of Dinant, CAO finds IFC's blanket categorization of trade finance transactions as low-risk to problematic.

⁹⁷ See for eg. Ficohsa, *Prospecto Bonos de Inversión* (no date). <http://www.ficohsa.hn/wp-content/uploads/Prospecto-de-Emission-Banco-Ficohsa.pdf> (Accessed May 1, 2014).

⁹⁸ CAO (2012) Audit of a Sample of IFC Investments in Third Party Financial Intermediaries p.37.

4. Conclusion

This compliance process was initiated by the CAO Vice President in response to concerns regarding IFC's review and supervision of its investments in Banco Ficohsa, particularly in the light of Ficohsa's exposure to Corporación Dinant.

As required by the terms of reference for this compliance investigation CAO has considered whether IFC's equity and subordinated debt investment in Ficohsa was appraised, structured and supervised in accordance with applicable IFC policies, procedures and standards. CAO has also considered the adequacy of IFC's policies, procedures and standards in the context of IFC's commitments to 'do no harm' principles. Finally, CAO has considered the immediate and underlying causes for any non-compliance identified.

This concluding section summarizes CAO's findings and places them in the context of CAO's Audit of IFC Investments in Third Party Financial Intermediaries completed in October 2012.

This report describes material shortcomings in the way that IFC discharged its environmental and social obligations in relation the Ficohsa investment.

Prior to investment CAO finds that IFC took insufficient measures to identify activities where Ficohsa was exposed to environmental and social risk through its existing portfolio. This is of particular concern given background E&S risk that emerges from the regulatory and governance context in which Ficohsa was operating. Further, CAO finds that IFC did not conduct an adequate review of Ficohsa's social and environmental management system (SEMS) or its capacity to implement IFC's environmental and social requirements. This weakness in analysis was compounded by the decision to structure the investment in a way which allowed disbursement to Ficohsa in advance of actions to close gaps in the SEMS.

As a result IFC acquired an equity stake in a bank with significant exposure to high risk sectors and clients, but which lacked capacity to implement IFC's environmental and social requirements. The absence of an environmental and social review process that was commensurate to risk meant that key decision makers (senior management of IFC's Financial Institutions department and members of the IFC Board) were not presented with an adequate assessment of the risks that were attached to this investment. This included additional exposure to Dinant, a company which IFC knew to be affected by a violent land conflict, as well as numerous other loans with potentially significant, but unassessed, E&S risk. It also meant that Ficohsa was not provided with the urgent and intensive support that it needed to upgrade its SEMS.⁹⁹

In relation to the decision to disburse, CAO finds that IFC's review of the applicable conditions of disbursement did not comply with the requirement that E&S staff clear any E&S conditions following a review of evidence of compliance. In particular, CAO finds that IFC cleared disbursement against the subscription and sub-ordinated debt agreements, without assuring itself that Ficohsa had submitted the environmental and social information that was required. Further, CAO finds that IFC environmental and social staff did not review the ongoing validity of Ficohsa's environmental and social representations and warranties prior to disbursement.

⁹⁹ IFC Sustainability Policy, 2006, paras 9 & 38.

In relation to project supervision, CAO finds that IFC did not assure itself in an adequate or timely manner that Ficohsa was “operating the SEMS as envisaged at the time of appraisal” or that Ficohsa had “applied the Applicable Performance Requirements to its sub-projects.” At a more systemic level, CAO finds that there is a disconnect between the client reporting format provided by IFC to Ficohsa and the environmental and social covenants and reporting requirements that were written into the investment agreements. In this context, CAO finds that the AEPR format as provided to Ficohsa by IFC was not fit for purpose in terms of the detail that it required regarding the environmental and social performance of borrowers, in particular those with high environmental and social risks. As a result, IFC had and has, at best, a superficial understanding of the environmental and social risks that are attached to Ficohsa’s client base.

These concerns notwithstanding, CAO finds that IFC’s supervision of this investment has improved since late 2012 when the IFC E&S team working on Ficohsa became aware of the gravity of the issues regarding Dinant. At this point IFC conducted the gap analysis of Ficohsa’s SEMS that was required at appraisal in 2010. As a result, IFC has supported the development of a corrective action plan for Ficohsa’s SEMS. Despite these steps, CAO finds that capacity and country governance challenges mean that supervising compliance with the E&S requirements of the 2011 investment agreements presents a significant long term challenge.

In relation to Dinant, CAO finds that highly relevant information on the conflict and related E&S risks surrounding Dinant, that was held by members of IFC’s Dinant investment team, was not shared with key members of its Ficohsa team, even though there were staff working across both teams. It is important to note that CAO finds no indication that IFC pursued its equity investment in Ficohsa with the intention to provide additional financing to Dinant. By waiving a key financial covenant and then taking an equity position in Ficohsa, however, IFC: (a) increased its exposure, and (b) facilitated a significant ongoing flow of capital to Dinant, outside the framework of its environmental and social standards; and this at a time when IFC management was aware of serious unmitigated environmental and social risks regarding its agribusiness client.

In relation to the underlying causes of the non-compliance identified in this report, CAO observes a primacy of financial considerations in IFC’s decision making. As a result, it is not IFC practice to review the *E&S risk* attached to the portfolios of its banking clients in the same depth as portfolio *credit risk* is reviewed. CAO also notes a siloing of information with the result that relevant information was not shared among key members of IFC’s Ficohsa team. In this context, IFC E&S staff did not ask about Ficohsa’s exposure to high risk sub-clients and their regionally based investment colleagues, who were aware of the issues, did not tell.

In terms of the adequacy of IFC’s policies, procedures and standards, CAO finds that the shortcomings identified in this investigation are inter-related. They are indicative of a system of support to FIs which does not support IFC’s higher level environmental and social commitments. In a context where IFC maintains that this project was processed in accordance with prevailing practice, CAO’s findings raise concerns that IFC has, through its banking investments an unanalyzed and unquantified exposure to projects with potential significant adverse environmental and social impacts. Absent disclosure of information related to these projects, this exposure is also effectively secret and thus divorced from systems which are designed to ensure that IFC, and its clients are accountable to project affected people for delivery on their environmental and social commitments. The underlying fault lines thrown into relief by this investigation, resonate with the findings of CAO’s 2012 Audit of IFC Investments in Third Party Financial Intermediaries, and suggest the need for a reassessment of IFC’s approach to the

identification and management of environmental and social risk in its financial institutions business.

Annex 1: Key Findings

Pre-Investment E&S Due Diligence
IFC properly determined that Ficohsa would be required to screen projects against the Performance Standards as a requirement of the equity investment.
IFC took insufficient measures “to identify activities” where Ficohsa “was exposed to social and environmental risk” prior to investing as required by the Sustainability Policy.
IFC did not conduct an adequate review of Ficohsa’s SEMS or adequately identify actions that Ficohsa would need to undertake to address gaps in its SEMS.
IFC not require that gaps in Ficohsa’s SEMS were closed as a condition of disbursement;
IFC did not meet the requirements of the Disclosure Policy in that it did not ensure that material changes in client E&S requirements were made public at least 30 days prior to Board approval of the investment.
These shortcomings, taken together, represent a material failure of IFC’s pre-investment E&S review process.
Disbursement
IFC’s review of the CODs did not comply with the ESRP requirement that E&S staff clear any E&S CODs following a review of evidence of compliance with the CODs.
IFC-AMC disbursed against its subscription and sub-ordinated debt agreements, without assuring itself that Ficohsa had submitted the E&S information that was required as a condition of disbursement.
IFC E&S staff did not review the ongoing validity of Ficohsa’s E&S representations and warranties prior to disbursement.
Supervision
IFC’s requirement to ascertain whether or not “there is sufficient evidence that the client has applied the Applicable Performance Requirements to their sub-projects,” necessitates a more robust review of client performance than IFC conducted in relation to Ficohsa.
In supervision, IFC did not assure itself in an adequate or timely manner that Ficohsa was “operating the SEMS as envisaged at the time of appraisal” or that Ficohsa had “applied the Applicable Performance Requirements to its sub-projects.”
IFC’s June 2012 supervision documentation was deficient in that it did not address the E&S requirements of the 2011 equity investment, instead focusing on those of the earlier SME loan. As a result, IFC was able to rate Ficohsa’s E&S performance “Satisfactory” meaning that Ficohsa was found to be in “material compliance” at a time when it was out of compliance with IFC’s E&S requirements.
IFC did not meet the requirement to review initial financing activities in relation to an FI client with potential significant E&S risks associated with its financing activities.
IFC did not adequately 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.
There is a disconnect between the client reporting templates IFC provided to Ficohsa and the E&S requirements that were written into the investment agreements.
The AEPR format as provided to Ficohsa was not fit for purpose in terms of the detail that it required regarding the environmental and social performance of borrowers, in particular those involving high environmental and social risks.
IFC’s engagement with the client has improved since late 2012 when the IFC E&S team supervising the Ficohsa investment became aware of the gravity of the concerns regarding Dinant.
Despite steps forward, capacity and country governance challenges mean that supervising compliance with the E&S requirements of the 2011 investment agreements presents a significant long term challenge.

Annex 2: CAO Investigation TOR

[...]

Background

IFC's made its first investment with Ficohsa in May, 2008 (project # 26394). The initial loan of US\$20 million supported Ficohsa's small and medium sized enterprise (SME) and middle to low income mortgage portfolio. This investment was combined with an IFC Advisory Service project to support Ficohsa's credit risk management, market segmentation and management information systems, and improve the housing and SME business lines in areas such as product management, underwriting, monitoring and collections. In July 2008, IFC approved Ficohsa's inclusion in the Global Trade Finance Program (GTFP) with an initial credit line of US\$15 million which was subsequently increases to US\$35 million (project # 27341).

IFC entered discussion with Ficohsa about a potential equity and subordinated debt investment in late 2009. In May 2011, IFC Board approved a 10 percent equity (US\$32.1m) and subordinated debt (US\$38m) investment (project # 29257). This investment was financed by the IFC's Asset Management Company (AMC) through its Global Capitalization Fund.

Corporación Dinant (Dinant) is an integrated palm oil and food company in Honduras which received a loan from IFC in 2009. CAO has an ongoing compliance process in relation to IFC's investment in Dinant.

In the course of CAO's compliance process in relation to Dinant, CAO became aware that Dinant is one of Ficohsa's largest borrowers and as a result that IFC had a significant exposure to Dinant through its equity stake in Ficohsa. As a result the CAO Vice President initiated a compliance appraisal of IFC's investment in Ficohsa.

Scope of the Compliance Investigation

The focus of Compliance Investigations is on IFC, and how IFC assured itself of project environmental and social performance at appraisal and during supervision.

The approach to the Compliance Investigation is described in the CAO Operational Guidelines (March 2013), and states that the working definition of Compliance Investigations adopted by CAO Compliance is as follows:

An investigation is a systematic, documented verification process of objectively obtaining and evaluating evidence to determine whether environmental and social activities, conditions, management systems, or related information are in conformance with the compliance investigation criteria.

The Compliance Investigation will consider whether IFC's equity and subordinated debt investment in Ficohsa was appraised, structured and supervised in accordance with applicable IFC policies, procedures and standards. It will also consider whether IFC's Policy and Performance Standards on Environmental and Social Sustainability and Policy on Disclosure of Information as applied to this project provide an adequate level of protection.

More specifically the Investigation will consider whether:

1. IFC's E&S review was sufficient to identify activities where the financial intermediary could be exposed to environmental and social risk or determine whether Ficohsa was engaged in projects with potentially significant E&S risks;
2. IFC established an environmental and social management plan that was commensurate to the level of E&S risk that was present in Ficohsa's portfolio;
3. IFC obtained adequate evidence of compliance with the agreed conditions of disbursement; and
4. IFC adequately assured itself that its client E&S obligations including reporting obligations were being fulfilled

The scope of the Compliance Investigation includes developing an understanding of the immediate and underlying causes for any non-compliance identified by the CAO.

Compliance Investigation Process and Timeline

CAO aims to have a draft Compliance Investigation report ready for IFC's factual review and comment by April 2014. IFC will have a period of 20 working days for factual review and comment.

Upon receiving comments from IFC/MIGA on the consultation draft, CAO Compliance will finalize the report. The final report will be submitted to IFC/MIGA senior management for official response. A notification will be posted on CAO's website. IFC/MIGA has/have 20 working days to submit a written response to CAO. CAO will forward the Investigation Report and the IFC/MIGA response to the President. The President has no editorial input as to the content of the compliance Investigation Report, but may take the opportunity to discuss the investigation findings with CAO.

Once the President is satisfied with the response by IFC/MIGA senior management, the President will provide clearance for the Investigation Report and the response. The President retains discretion over clearance. After clearance, CAO will disclose the Investigation Report and the IFC/MIGA response to the Board. CAO will also alert relevant stakeholders of the disclosure of both documents on CAO's website, and in cases where the investigation was initiated by a complaint, share the documents with the complainant.

External Panelist

As per its established practice CAO will engage one or more external experts to work with it on this task. For this particular Compliance Investigation, CAO considers the following as necessary for the Compliance Investigation panel:

- Significant expertise in relation to the structure of IFC investments with Financial Intermediary clients
- Identification and management of E&S risks around Financial Intermediary clients.
- Knowledge of IFC's Performance Standards, as well as applicable Environmental and Social Review Procedures.
- Experience and knowledge of compliance investigations.
- Demonstrated ability to analyze policies and practices and develop proposals for reform in complex institutional contexts.