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## SECOND COMPLIANCE MONITORING REPORT

*IFC Investments in Banco Financiera Comercial Hondureña, S.A., Honduras  
Project Numbers 26394, 27341, 29257, 35140*

**June 10, 2019**

*Office of the Compliance Advisor Ombudsman (CAO)*

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### **Executive Summary**

Banco Financiera Comercial Hondureña, S.A. (Ficohsa, the client) is a large Central American commercial bank with its main operations in Honduras. It has a broad environmental and social (E&S) risk profile with significant exposure to consumer finance, small- and medium-sized enterprises (SME), as well as project and corporate finance. In 2011, IFC made equity and loan investments in Ficohsa. As a result, Ficohsa agreed to enhance its environmental and social management system (ESMS) to implement IFC's Performance Standards (PS). In 2018, the client prepaid the loan and IFC sold its equity stake in the client.

In August 2013, CAO triggered a compliance review of IFC's investments in Ficohsa, citing concerns with IFC's approach to the management of E&S risk, and its exposure through Ficohsa to Honduran agribusiness conglomerate, Corporación Dinant (Dinant) in particular. In August 2014, CAO released its compliance investigation report. CAO found that IFC lacked assurance that the client was applying IFC's E&S requirements (which included the IFC Performance Standards) to higher risk business activities that it was funding. In response to the investigation report, IFC noted that it had agreed on an E&S action plan to address gaps in the client's ESMS.

This compliance monitoring report considers measures taken by IFC to enhance its client's ESMS in accordance with IFC requirements following CAO's 2014 investigation. It also considers IFC's supervision of Ficohsa's management of E&S risk through its lending to Dinant and the Indura Beach and Golf Resort (Indura). The Indura project is considered on the basis of a separate 2015 complaint to CAO regarding the environmental and social impacts of that project.

Following the release of CAO's investigation report, IFC committed to work with the client to improve its ESMS. IFC reports that the client: (a) developed an E&S policy reflecting IFC's Performance Standards; (b) hired a full-time E&S manager; (c) expanded its E&S team; (d) provided training to Board members and credit staff on the new E&S policy and procedures; and (e) in January 2015, commenced implementation of a revised ESMS. Following an IFC site visit to the client in 2015, IFC determined that the client was in material compliance with IFC's E&S requirements for financial intermediaries. After an IFC site supervision visit to the client in April 2017, IFC determined that there was sufficient information and evidence that the client was committed to implement IFC's E&S requirements, and again concluded that the client was in material compliance.

While acknowledging the progress reported by IFC, available documentation leads CAO to the conclusion that IFC has only partially addressed CAO's non-compliance findings in relation to its investment in the client. In particular, CAO concludes that IFC lacks assurance that the client is:

(a) categorizing prospective investments in accordance with IFC's requirements; (b) conducting and documenting E&S due diligence assessments of its higher risk loans in accordance with Performance Standards requirements; (c) including necessary covenants to require borrowers to operate in accordance with IFC's Performance Standards and Exclusion List as relevant; (d) monitoring the E&S performance of borrowers in a manner that is commensurate to risk; and (e) implementing a grievance mechanism which is "readily accessible...to affected communities" and about which affected people are informed.

CAO's compliance investigation also considered Ficohsa's exposure to Corporación Dinant, a Honduran agribusiness conglomerate to which IFC had a direct exposure. IFC's investment in Dinant was the subject of a 2013 CAO investigation which led to non-compliance findings. While IFC's direct financing of Dinant was contingent upon a corrective action plan developed following CAO's 2013 compliance investigation, IFC did not assure itself that the client's ongoing financing for Dinant was contingent on binding commitments to implement the Performance Standards. CAO further concludes that IFC lacked assurance that its client was monitoring Dinant's compliance with IFC's E&S requirements.

In October 2015, Organización Fraternal Negra Hondureña (OFRANEH), a non-governmental organization, filed a complaint with CAO on behalf of members of Garifuna communities in the Tela Bay area, including Barra Vieja, Miami, Tornabé, San Juan Tela, La Ensenada, and Triunfo de la Cruz. OFRANEH raised concerns about the E&S impacts of the Indura Beach and Golf Resort, a tourism infrastructure development along the Caribbean coast of Tela Bay, Department of Atlántida, Honduras. This included allegations of: (a) inadequate consultation and community benefits; (b) improper use of private security to deter community access to the beach; (c) involuntary land acquisition and economic displacement; and (d) environmental degradation.

IFC was exposed to the Indura project through its October 2011 equity and general loan investments in Ficohsa. Per these investments, Ficohsa was required to assess and monitor implementation of IFC's Performance Standards for any new investment Ficohsa made in Indura. Ficohsa reported to IFC that it made investments in Indura in 2013 and 2016. IFC PS requirements relevant to the social impacts alleged are PS1 (stakeholder engagement), PS5 (involuntary resettlement), and PS7 (Indigenous Peoples). Relevant to the environmental impacts alleged is PS6 (protected areas), particularly given the project location in an internationally protected (Ramsar) wetland.

Rather than conducting a separate compliance investigation in response to the Indura complaint, CAO decided to consider the issues raised by the Indura complaint as part of its ongoing monitoring of IFC's investment in Ficohsa. As a result, this monitoring report also considers IFC's supervision of Ficohsa as it relates to the issues raised in the Indura complaint.

IFC was aware of community concerns regarding the Indura project. As part of a May 2015 site supervision visit, IFC reviewed Ficohsa's documentation in relation to the Indura project. Following the complaint to CAO, IFC commissioned a consultant review of the root causes and interests associated with the CAO complaint. In June 2018, IFC conducted a further review of client supervision documentation related to the Indura project. IFC's attention to the E&S risks and impacts associated with the Indura project reflected Sustainability Policy requirements for risk-based supervision of financial intermediary clients, and their exposure to high-risk subprojects. While IFC's consultant reached broadly positive conclusions regarding the project's social performance, the methodology employed did not provide sufficient evidence that IFC's FI client had properly: a) applied IFC's E&S requirements to Indura; or b) supervised PS compliance with regard to the issues raised in the Indura complaint. Upon review of available documentation, CAO concludes that IFC lacked sufficient evidence that the Indura project was prepared and implemented in accordance with PS1, PS5, PS6, and PS7 requirements.

Overall, CAO finds that IFC's response to this compliance investigation only partially addressed its compliance findings. Nevertheless, CAO has decided to close its monitoring of the investigation considering that IFC divested from its Ficohsa equity and corporate loan investments. IFC continues to have active investments with Ficohsa to support its housing and SME business lines. However, these investments are not of a nature that requires IFC to monitor the application of its E&S requirements to the client's corporate lending portfolio, which includes the loans to Dinant and Indura.

Findings from CAO's investigation that require a response at the level of IFC's policies, procedures, and practices will continue to be assessed via CAO's ongoing monitoring of IFC's response to CAO's Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries.

## 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 IFC and MIGA.*

CAO (Office of the Compliance Advisor Ombudsman) is an independent office that reports directly to the President of the World Bank Group. CAO reviews complaints from communities affected by development projects undertaken by the two private-sector arms of the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

For more information about CAO, please visit [www.cao-ombudsman.org](http://www.cao-ombudsman.org).

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## Acronyms

AEPR	Annual Environmental Performance Report
AMC	Asset Management Company (IFC)
CAO	Office of the Compliance Advisor Ombudsman (IFC and MIGA)
DTBT	Desarrollo Turístico Bahía de Tela, S.A. de C.V.
E&S	Environmental and social
ESAP	E&S Action Plan
ESMS	Environmental and social management system
ESRP	Environmental and Social Review Procedures
ESRR	E&S Risk Rating
FHIT	Fondo Hondureño de Inversión Turística
FI	Financial Intermediary
Ficohsa	Banco Financiera Comercial Hondureña, S.A.
FPIC	Free, prior, and informed consultation (PS7, 2006)
IFC	International Finance Corporation
IHT	Instituto Hondureño de Turismo
MIGA	Multilateral Investment Guarantee Agency
OFRANEH	Organización Fraternal Negra Hondureña (Black Fraternal Organization of Honduras)
PS	Performance Standards (IFC, 2006)
PS1	Performance Standard 1: Social and Environmental Assessment and Management System (2006)
PS5	Performance Standard 5: Land Acquisition and Involuntary Resettlement (2006)
PS6	Performance Standard 6: Biodiversity Conservation and Sustainable Natural Resource Management (2006)
PS7	Performance Standard 7: Indigenous Peoples (2006)
SEMS	Social and Environmental Management System (synonymous with ESMS)
SME	Small- and Medium-sized Enterprise

## Introduction

CAO's compliance function oversees investigations of IFC/MIGA's environmental and social (E&S) performance with a view to ensuring compliance with relevant requirements and improving the E&S performance of the institutions.

Following a CAO compliance investigation, CAO monitors actions taken by IFC/MIGA until such actions assure CAO that its compliance findings are being addressed.

CAO's monitoring considers IFC/MIGA's response to a compliance investigation at two levels:

- Firstly, CAO considers actions taken or proposed by IFC/MIGA that respond to CAO findings at the project level.
- Secondly, CAO considers actions taken or proposed by IFC/MIGA that respond to CAO findings at the level of IFC/MIGA policies, procedures, practice, or knowledge.

The first level of analysis is designed to ensure that project-level concerns identified by CAO are addressed. The second level is designed to document progress in the IFC/MIGA's approach to the identification and management of E&S risk as relevant to CAO's findings.

This is CAO's second monitoring report documenting CAO's assessment of IFC's response to the CAO investigation of IFC's investment in Banco Financiera Comercial Hondureña, S.A. (Ficohsa) ("the compliance investigation").<sup>1</sup> A first monitoring report was published in January 2016 and covered IFC's response in the period August 2014–December 2015.<sup>2</sup>

In October 2015, CAO received a complaint related to Indura Beach and Golf Resort (Indura, the project), a tourism infrastructure development along the coast of Tela Bay, Honduras. The complaint was determined eligible as IFC was exposed to Indura via its investments in Ficohsa. In June 2017, CAO released a compliance appraisal in relation to the complaint. While this complaint would ordinarily have merited a compliance investigation, given CAO had an open compliance monitoring process in relation to IFC's investment in Ficohsa, CAO decided that a separate compliance investigation in relation to the complaint was not required. Rather, CAO decided to consider the issues raised in the complaint as part of its monitoring.

In preparing this monitoring report, the CAO team: (a) discussed the investment with IFC staff; (b) visited the client in Tegucigalpa, Honduras; (c) visited Indura Beach and Golf Resort; (d) visited the complainant representatives in relation to Indura; and (e) reviewed documentation provided to CAO by IFC, the client, Indura, and the complainants. As part of this monitoring report, CAO hired an external expert with expertise in FI Environmental and Social Management Systems (ESMS). The CAO expert reviewed IFC and client documentation and participated in meetings with the client.

This report provides: (a) background on CAO's previous compliance reports in relation to Ficohsa; (b) a summary of CAO's monitoring of IFC's response to the CAO investigation report; and (c) a summary of IFC's actions as relevant to the CAO complaint regarding Indura.

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<sup>1</sup> CAO's investigation report, IFC's response to the investigation, and related materials are available on the CAO website. See: <http://goo.gl/tsP0a9>.

<sup>2</sup> CAO First Monitoring Report of IFC's Response to CAO's Investigation of IFC's Investments in Banco Financiera Comercial Hondureña, S.A., Honduras, January 2016. See: <https://goo.gl/14mREH>.

## Background

This section provides background on IFC's investment in Banco Ficohsa and an overview of CAO's compliance process to date.

Banco Financiera Comercial Hondureña, S.A. (Ficohsa, the client) is the largest commercial bank in Honduras.<sup>3</sup> It has a lending portfolio covering consumer finance, small- and medium-sized enterprises (SME), as well as project and corporate finance.<sup>4</sup>

Between October and November 2011, IFC's Asset Management Company (AMC) made equity and subordinated debt investments in Ficohsa for US\$70.1 million. In June 2014, AMC made an additional equity investment of US\$5.5 million through a rights issue. These investments followed earlier investments by IFC which targeted the client's SME and housing portfolios, in addition to trade finance support.<sup>5</sup>

In August 2013, CAO initiated a compliance process in relation to IFC's investment in the client, citing concerns regarding IFC's approach to the management of E&S risk in relation to the client's lending to Corporación Dinant (Dinant).<sup>6</sup>

A CAO compliance investigation report was released in August 2014. The report describes material shortcomings in the way IFC discharged its E&S obligations in relation to the Ficohsa investment. CAO identified gaps in IFC's pre-investment review of its client's environmental and social management system (ESMS). During supervision, CAO found that IFC did not assure itself in an adequate or timely manner that the client was "operating the ESMS as envisaged at the time of appraisal" or that the client had "applied the Applicable Performance Requirements [IFC's E&S Requirements which included the IFC Performance Standards] to its subprojects."

CAO's compliance investigation also considered Ficohsa's exposure to Corporación Dinant, a Honduran agribusiness conglomerate to which IFC had a direct exposure. IFC's direct investment in Dinant was the subject of a 2013 CAO investigation which led to non-compliance findings.<sup>7</sup>

CAO's compliance investigation found that by investing in Ficohsa, IFC acquired an equity stake in a commercial bank with significant exposure to high-risk sectors and clients, which lacked capacity to implement IFC's E&S requirements. The absence of an E&S review process that was commensurate to risk, CAO found, 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 meant that Ficohsa was not provided with the support that it needed to upgrade its E&S management system. CAO also found that IFC did not supervise the requirements of PS1 vis-à-vis the client itself, in particular, the requirement to establish a grievance mechanism which was "readily accessible...to affected communities" and about which affected people are informed.<sup>8</sup> A summary of findings as presented in the August 2014 report is set out in Annex A.

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<sup>3</sup> Ficohsa also has other operations in Central America, however, IFC's investment relates to Ficohsa's operations in Honduras.

<sup>4</sup> Banco Ficohsa Annual Report (2015), pp. 140–141, available at: <https://goo.gl/iZYwP9>.

<sup>5</sup> For further details on these investments, see IFC Disclosure website: <https://goo.gl/s9z8PZ> and <https://goo.gl/807auh>.

<sup>6</sup> Dinant is an IFC agribusiness client in Honduras. IFC's direct investment in Dinant was the subject of a 2013 CAO compliance audit following allegations of violence against farmers on and around Dinant oil palm plantations in the Aguán Valley of Honduras. For further details, see: <http://goo.gl/LULNW1>.

<sup>7</sup> CAO 2013, Compliance Audit of IFC's investments in Corporación Dinant, available at <http://bit.ly/2Dh2WCG>.

<sup>8</sup> See CAO Investigation Report.

IFC's Official Response to the investigation,<sup>9</sup> released in August 2014, acknowledges shortcomings in IFC's appraisal and supervision of the investment. IFC noted progress in its work to strengthen Ficohsa's E&S risk management systems and practice as part of an agreed E&S Action Plan (ESAP). IFC also noted systemic changes it was implementing to improve the sharing of information between different IFC investment teams.

In January 2016, CAO released its first compliance monitoring report.<sup>10</sup> At this time, IFC reported that the client had fully implemented the ESAP. In particular, IFC reported that the client had: (a) developed an E&S Policy reflecting IFC's Performance Standards (2012); (b) hired a full-time E&S manager; (c) expanded its E&S team; (d) provided training to Board members and credit staff on the new E&S policy and procedures; and (e) commenced implementation of its revised ESMS in January 2015.

IFC conducted a site supervision visit to the client in May 2015 to confirm ESMS implementation. During this visit, IFC reviewed the client's approach to E&S risk management and examples of recent project-level E&S due diligence the client had completed. Following its supervision visit, IFC upgraded the E&S Risk Rating (ESRR) for the client from 3-Partly Unsatisfactory to 2-Satisfactory. This represents a determination by IFC that the client is in material compliance with IFC's requirements.

While welcoming the steps that IFC has taken to support the development of its client's ESMS, in its first monitoring report, CAO concluded that the measures taken by IFC to date only partially addressed its project-level non-compliance findings. In particular, CAO noted shortcomings in IFC's supervision of the client's performance against its agreed E&S requirements, namely to require the client's corporate borrowers to implement IFC's Performance Standards.

## Summary of CAO Monitoring

This section provides a summary of: (a) IFC's requirements for financial intermediaries (FI); (b) IFC's monitoring of Ficohsa's implementation of these requirements; and (c) CAO's observations.

### *Summary of Requirements*<sup>11</sup>

IFC's approach to the management of E&S risk in its FI investments is focused on the requirement that the IFC FI client implement an environmental and social management system (ESMS).<sup>12</sup> Through this system, the FI is required to individually assess and monitor the E&S risks of the business activities that it supports. Depending on the E&S risk of the borrower, an FI is required to assure itself that activities it finances operate in accordance with IFC's Exclusion List, national law, and for higher risk activities, IFC's Performance Standards. As relevant, these requirements are incorporated as requirements in the legal agreements between the FI and its borrower. Where the FI identifies gaps in borrower performance, the FI agrees with the borrower an E&S action plan (ESAP) to resolve gaps. The FI is also expected to regularly monitor its borrowers to ensure they are operating in accordance with the agreed E&S requirements.

IFC monitors the FI based on its ESMS. Specifically, IFC seeks to assure itself there is sufficient evidence that the FI: (a) is operating the ESMS as envisaged at the time of IFC's investment; and

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<sup>9</sup> IFC's Official Response, July 2014. Available at: <http://goo.gl/tsP0a9>.

<sup>10</sup> CAO First Monitoring Report of IFC's Response to CAO's Investigation of IFC's Investments in Banco Financiera Comercial Hondureña, S.A., Honduras, January 2016.

<sup>11</sup> Summary based on IFC's Sustainability Policy (2006) (available at: <https://goo.gl/q6qPY2>), IFC's FI Interpretation Note (2012) (available at: <https://goo.gl/HPDgGS>), and IFC's Environmental and Social Review Procedures (2014) (available at: <https://goo.gl/fVNx5q>).

<sup>12</sup> ESMS is synonymous with Social Environmental Management System (SEMS).

(b) has applied the E&S requirements to its borrowers since IFC's investment. Where there are gaps in the FI's performance, IFC seeks to work with the FI to bring it back into compliance, and if the FI fails to reestablish compliance, exercises remedies as appropriate. During supervision, IFC's Environmental and Social Review Procedures (ESRP) require IFC staff to ascertain the quality of the FI's ESMS implementation including the FI's E&S due diligence (ESDD) and its application of IFC's E&S requirements to its borrowers, with a focus on high-risk subprojects. IFC's ESRPs provide for IFC staff to visit FI subprojects as needed.<sup>13</sup>

#### *IFC Supervision (January 2016–June 2018)*

Ficohsa submitted its 2015, 2016, and 2017 Annual Environmental Performance Reports (AEPR) to IFC in May 2016, April 2017, and February 2018, respectively. IFC completed reviews of these reports in April 2017, December 2017, and June 2018, respectively. In October 2016, IFC conducted a site supervision visit to the client to confirm ESMS implementation and provide E&S guidance to the client. During 2017 and early 2018, IFC staff noted that they maintained constant contact with the client's E&S team. IFC reported providing the client with training on PS6 (Biodiversity Conservation and Sustainable Natural Resource Management) in March 2018.

IFC's reviews concluded that Ficohsa had a well-developed ESMS framework, with assessment of E&S risk based on sector exposure, sub-loan amount, and tenor. More specifically, IFC reported that the client: (a) prepared E&S due diligence based on IFC's Exclusion List, national law, and applicable 2012 Performance Standards<sup>14</sup> as a function of the risk category of the transaction;<sup>15</sup> (b) developed E&S action plans (ESAP); (c) included E&S covenants in its legal agreements, and where relevant, references the PS; and (d) monitored borrowers based on E&S risk, ESAPs, and periodic visits.

IFC considered the client's ESMS implementation to be best practice in the following respects: (a) conduct of E&S peer review meetings; (b) provision of E&S guidance to borrowers; (c) documentation of E&S conclusion and its consideration in the credit decision-making process; (d) development of ESAPs and requirement of borrower commitment; (e) monthly monitoring of ESAPs; and (f) inclusion of E&S information in the internal staff newsletter. IFC reported that the client had adequate staff and resources to carry out their roles. IFC reviewed the client's documentation for seven loans in October 2016 and eight loans in June 2018. Together, this included five category A and ten category B loans. In its October 2016 review, IFC noted three included a PS clause in the legal agreement between client and borrower.<sup>16</sup> A similar analysis was not conducted in June 2018.

Following the June 2018 review, IFC noted that: (a) high-risk client borrowers were required to share E&S reports prepared for national authorities; (b) the client's reports referenced reputational risk review; and (c) all loans reviewed were correctly categorized for E&S risk. Based on these file reviews, IFC determined that the client's E&S staff have a good understanding of E&S regulatory requirements and the application of the PS. Further, IFC noted that its client took a proactive approach to E&S risk management.

At the conclusion of the review, IFC provided the client with an E&S Risk Rating (ESRR) of 2–Satisfactory, a determination by IFC that the client is in compliance with its E&S requirements.

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<sup>13</sup> IFC ESRP 9, (June 2014).

<sup>14</sup> IFC's investment requires Ficohsa to apply the 2006 version of IFC's Performance Standards. By applying the 2012 version of the Performance Standards to new investments, Ficohsa is going beyond IFC's investment requirements. This reflects good international industry practice.

<sup>15</sup> In some special cases, the client's procedures provide for detailed due diligence irrespective of loan size and tenor.

<sup>16</sup> IFC noted that the other four borrower investments did not apply PS as they were committed prior to the implementation of the client's ESMS in 2014 or involved low E&S risks.

While the client has reported ongoing and new exposures to Dinant, IFC did not record any additional supervision in relation to this exposure.

Between March and May 2018, the client prepaid its corporate loan to IFC and IFC exercised a put option to sell its equity stake back to the client. IFC's trade finance support and loan to support the client's SME and housing portfolio remain active. However, given the nature of these ongoing exposures, IFC is no longer required to conduct E&S supervision of the client's higher risk corporate lending activities.

### *CAO Observations*

As part of IFC's equity investment, the client was expected to enhance its ESMS and apply the IFC Performance Standards in relation to new loans starting from January 2012. In late 2012, IFC identified gaps in the client's ESMS implementation. A corrective action plan was agreed between IFC and the client.<sup>17</sup>

In 2014, as part of the corrective action plan, the client updated its ESMS to apply IFC E&S requirements to its investments and increased its staff capacity to implement its ESMS. While IFC has determined that the client is meeting its E&S requirements, CAO's monitoring concludes that IFC's supervision was insufficient to support a positive compliance finding. In particular, CAO concludes that IFC lacks sufficient evidence that the client is systematically reviewing its higher risk investments to the requirements of the IFC Performance Standards or that it is correctly applying these requirements through its investment agreements. Examples of client appraisal and supervision documentation reviewed by CAO do not support IFC's finding that the client is reviewing E&S risks in accordance with IFC Performance Standard requirements. Rather, evidence reviewed by CAO indicate that the client:

- Prepares E&S assessments in consideration of national regulations and does not systematically review for PS requirements.
- Does not systematically finance medium- to high-risk projects contingent on binding commitments to implement the PS.
- Does not consistently require medium- to high-risk projects to report on compliance in accordance with PS requirements where these exceed national regulations. Rather, the client relies on borrower reporting to the national regulator.
- Does not periodically supervise borrowers' E&S performance. Rather, borrowers are reviewed when additional finance is provided.

IFC has not reported any action in response to CAO's finding that IFC did not supervise the requirements of PS1 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." Rather, IFC states that there is no requirement for Ficohsa to establish a grievance mechanism at the financial institution level. IFC further states that while not a requirement of its investment, Ficohsa is working to establish an external communication mechanism on a best efforts basis.<sup>18</sup> IFC's June 2018 supervision does not comment on whether the client's external communication mechanism was established or its effectiveness.

Taken together, CAO concludes that IFC's positive evaluation of the client's E&S performance is insufficiently substantiated.

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<sup>17</sup> CAO First Monitoring Report, January 2016.

<sup>18</sup> IFC note that as part of the 2012 Sustainability Framework, IFC started to require FIs to develop an external communication mechanism.

In response to CAO's monitoring of IFC's direct investment in Dinant, IFC acknowledged that Dinant operates in a fragile security environment and any financial investment would be categorized A (high risk). CAO's monitoring in relation to IFC's direct investment noted steps taken by IFC to address its non-compliance findings while at the same time concluding that IFC lacked assurance of full compliance with PS4 requirement on security.<sup>19</sup> In the course of this monitoring period, Ficohsa has reported ongoing and new lending to Dinant. Per IFC's 2011 equity and loan investments, Ficohsa was required to assess and supervise new lending to Dinant in accordance with IFC's Performance Standards. IFC has not documented any supervision of Ficohsa in relation to this known high-risk exposure. In these circumstances, CAO concludes that IFC lacks assurance of: (a) the inclusion of its client's additional financing to Dinant being contingent on binding commitments to implement the Performance Standards; and (b) adequate supervision of PS compliance in relation to this exposure.

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<sup>19</sup> CAO 2018, Compliance Monitoring Report of IFC investment in Corporación Dinant S.A.

## Summary of IFC's Actions in Response to Indura Complaint and CAO's Observations

In October 2015, Organización Fraternal Negra Hondureña (OFRANEH),<sup>20</sup> a non-governmental organization, filed a complaint with CAO on behalf of members of Garifuna communities<sup>21</sup> in the Tela Bay area, including Barra Vieja, Miami, Tornabé, San Juan Tela, La Ensenada, and Triunfo de la Cruz. They raised a series of E&S concerns regarding Indura Beach and Golf Resort, a tourism infrastructure development along the coast of Tela Bay, Honduras. IFC is exposed to Indura through its investment in Ficohsa. This section provides a summary of: (a) the Indura project; (b) IFC's exposure and application of IFC's standards; (c) the complaint to CAO; (d) IFC's monitoring in relation to Indura; and (e) CAO's observations. In reviewing this complaint, CAO has considered actions taken by IFC to assure itself that Ficohsa has applied and supervised implementation of IFC's E&S requirements at Indura, particularly in relation to the issues raised in the complaint.

### *Background on Indura Project*

In 1975, the Government of Honduras first proposed a tourism infrastructure project along Tela Bay, Honduras. Preparation of the project stalled until 1997 when the project received an environmental license. The project was redesigned in 2002 due to the then project developer's inability to obtain project finance. In 2003, the Indura Beach and Golf Resort<sup>22</sup> (Indura, or the project) was launched. Desarrollo Turístico Bahía de Tela, S.A. de C.V. (DTBT, project developer), a public-private partnership, was formed to develop the project. The Instituto Hondureño de Turismo (IHT, a government agency) holds 49 percent equity in DTBT, with private investors holding 51 percent. In order to make the development financially viable for private investors and banks, DTBT was structured as a holding company for all tourism infrastructure assets in Indura. This consolidates the risk involved in each individual asset of Indura.<sup>23</sup>

The project occupies 311.85 hectares within the Jeannette Kawas National Park which is also an internationally protected area under the Ramsar Convention on Wetlands.<sup>24</sup> The project area represents approximately 0.4 percent of the national park and is located in the park's buffer zone. It consists of a five-star hotel with 120 rooms and a future four-star hotel with 250 rooms, residential area with 250 villas in various parts of the complex, an eighteen-hole golf course, and other recreational facilities. Construction commenced in 2006 and the first phase, a hotel and golf course, was opened in 2014.<sup>25</sup> A second phase of the project is currently under construction.

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<sup>20</sup> Fraternal Black Organization of Honduras (OFRANEH) was created in 1978 as a federation of Garifuna people in Honduras working together for the defense of their cultural rights, with the aim of surviving as a separate culture. See <https://ofraneh.wordpress.com/about/>.

<sup>21</sup> Per the World Bank's 2007 Inspection Panel report: "The Garifuna are descendants of the original Carib and Arawak Indian populations of the Amazon and Eastern Caribbean who intermarried with enslaved Africans – both those who ran away from Europeans on neighboring islands, and those who had escaped from shipwrecks and were captured by the Indians themselves. Succeeding generations retained their own language, culture and religion, and established a new identity for themselves, which aided in their survival.... [Garifuna communities are] mainly dispersed along the northern coast of Honduras.... The Garifuna maintain their ancestral language as well as specific religious beliefs and festivals which denote their strict connection with their land and territory. They also maintain traditional communal uses of the land and other patterns of work and activity that reflect their origins, home along the northern coast of Honduras, and unique culture." For further details see <https://goo.gl/S8l0Vm>.

<sup>22</sup> Formerly called Los Micos Beach and Golf Resort; name was changed in 2013.

<sup>23</sup> IADB, National Sustainable Tourism Program, HO0195. Available at: <https://www.iadb.org/en/project/ho0195>.

<sup>24</sup> Ramsar 2013, The Annotated Ramsar List: Honduras. Available at <http://bit.ly/2GiubxH>.

<sup>25</sup> Part of the first phase was financed by the IADB. Through a US\$14 million loan provided by the IADB, IHT constructed basic infrastructure in Indura and its immediate vicinity, which was completed in 2010. This included the provision of:

### *IFC Exposure and Application of IFC's Standards*

IFC is exposed to the project through its 2011 Ficohsa investments. In March 2011, Ficohsa organized a syndicated loan of US\$24 million (with US\$10 million provided by Ficohsa) to DTBT to support the second phase of project construction. In 2013 and 2016, Ficohsa provided additional financing to the project.

According to IFC's legal agreement, Ficohsa was required to assess E&S risk of the project to the requirements of IFC's Performance Standards when it provided financing in 2013 and 2016. If this assessment identified E&S risks, Ficohsa was required to apply the IFC Performance Standards to the project. Where providing financing to a project already under construction, Ficohsa would be required to review project E&S assessments and actions by the project developer to date in accordance with Performance Standards requirements. If this review identified gaps, it would be required to agree an action plan with the project developer to ensure the project was developed and operated to IFC's Performance Standards (PS1, para. 16) as a condition of additional financing. Thereafter, Ficohsa would be required to supervise the project's implementation of the action plan and general compliance with the Performance Standards.<sup>26</sup>

### *Complaint to CAO*

The complainants raise concerns about several environmental and social issues arising from the project:

- Inadequate consultation and community benefit sharing (PS1 and PS7). In particular, they allege a lack of a consultation process that was compatible with national regulations and that ensured free, prior, and informed consultation (FPIC). In addition, they claim that a commitment by the Government of Honduras to provide Garifuna communities with seven percent of equity in the project has not been implemented.
- Use of private security to deter community access to the beach which has traditionally been used as a right-of-way and for gathering common-pool resources (PS4/PS5).
- Involuntary land acquisition impacting the Barra Vieja community and parts of Tornabé community as well as economic displacement, as the project area was known to be a productive area used by local community members for subsistence (PS5).
- Impacts on marine ecology and protected species, especially regarding plants and animals used by the community for subsistence (PS6).

CAO completed a compliance appraisal in relation to the complaint in June 2017.<sup>27</sup> CAO decided to consider issues raised in the complaint as part of its ongoing monitoring of IFC's investment in Ficohsa.

### *Summary of IFC Supervision (May 2015–June 2018)*

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a) paved roads; b) drinking water for Indura and local communities of Miami and Tornabé; c) wastewater disposal system for Indura as well as Miami and Tornabé; d) electric power system; e) rainwater drainage system; and f) solid waste disposal system for Indura as well as Miami and Tornabé. In return for providing the above infrastructure to the project, IHT received equity in DTBT. IHT also provided land to DTBT for the project, for which DTBT incurred a debt of US\$19 million to IHT to be repaid over five years. As part of its wider tourism program, IHT planned to improve public access and environmental quality of 13 km of beaches in the communities of Tornabé, San Juan, and in the city of Tela. IADB, National Sustainable Tourism Program, HO0195, Available at: <https://www.iadb.org/en/project/ho0195>.

<sup>26</sup> IFC, Performance Standard 1, IFC Financial Intermediary Interpretation Note, available at <http://bit.ly/2Q05Y3H>

<sup>27</sup> CAO compliance appraisal of IFC's exposure to the Indura Beach and Golf Resort, June 2017. Available at <https://goo.gl/ZKphJw>

As part of a 2015 supervision visit to Ficohsa, IFC reviewed Ficohsa's E&S due diligence and supervision in relation to the Indura project. In its review, IFC recorded that the project had been categorized as A, indicating that it involved potential significant adverse E&S impacts that are diverse, irreversible, or unprecedented. IFC noted that the client: (a) included an environmental clause in its agreement with the project developer; and (b) required the project developer to provide an annual report prepared for the regulator. IFC noted the client had on file project E&S assessments and that the project had an ESMS. IFC did not provide analysis of whether these met PS requirements. IFC's review of the project did not document any concerns in terms of the client's E&S due diligence for the project.

In its review of the client's 2016 AEPR, IFC noted that the client reported environmental issues at the project. IFC noted that the client had conducted a supervision visit to the Indura site and agreed an ESAP with Indura. IFC's AEPR review included a conclusion that most of the issues raised in the complaint to CAO were political and were outside of Ficohsa's control. The basis on which this conclusion was reached is not clear. IFC's supervision documentation did not describe the nature of the environmental issues reported.

In 2017, IFC commissioned a third-party consultant (henceforth IFC's consultant) to analyze the root causes, stakeholder dynamics, perceptions, and interests associated with the Indura complaint to CAO. IFC received the final report from its consultant in February 2018.

In preparing the report, the consultant reviewed publicly available information and interviewed 35 people, including staff of the project developer, investors, community representatives, NGOs, and local and national authorities.

While the consultant review was commissioned as a stakeholder mapping exercise, the consultant also provided conclusions on E&S compliance issues. The consultant concluded the project was prepared and constructed with a high degree of alignment to the Performance Standards, that it had not led to involuntary resettlement, and that it had not unfairly restricted community access to or use of environmental services. The consultant also concluded that the CAO complaint did not truly represent the interests or will of the Tela Bay Garifuna communities.<sup>28</sup>

In June 2018, IFC completed a review of client documentation with regard to the project. Specifically, IFC reviewed an ESAP agreed between the client and the project developer in 2017, a summary of a client site supervision visit from February 2017, and a client-prepared E&S compliance status report from August 2017. IFC noted that information was summarized by applicable PS, with PS gaps recorded. IFC recorded the client's conclusion that Indura had provided the client with information requested in the ESAP and Indura is required to submit to the client a copy of its annual report to the national regulator.

### *CAO Observations*

The complaint to CAO included allegations relevant to a range of PS requirements, including consultation and community benefit sharing (PS1/PS7); use of private security to deter community access to the beach (PS4/PS5); involuntary land acquisition and economic displacement (PS5); and environmental degradation (PS6).

The purpose of IFC supervision is to obtain information to assess the status of an FI client's compliance with agreed E&S requirements. IFC's role is to determine the effectiveness of the FI client's ESMS and to consider whether there is sufficient evidence that the FI client is applying IFC's E&S requirements to the projects it is financing. In relation to the Indura loans Ficohsa made

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<sup>28</sup> Note CAO has provided only a limited summary of the conclusions of the consultant report given confidentiality and security concerns raised by IFC.

following IFC's equity investment, these requirements included IFC's Performance Standards. The frequency and focus of IFC supervision visits, including visits to FI subprojects is expected to be risk based.<sup>29</sup>

As a Category A subproject, Indura was properly included in IFC's E&S supervision of Ficohsa. In 2015 and 2018, IFC reviewed the client's E&S documentation related to the Indura loans. While noting that Ficohsa's loan agreement with Indura included an environmental clause, IFC did not confirm that this included a requirement to apply IFC's Performance Standards. CAO's review of client documentation determined that the applicability of IFC's Performance Standards to the project was unclear.

In 2017, IFC commissioned a consultant review of the root causes and interests associated with the Indura complaint to CAO. Commissioning a third-party review was an appropriate step given the claims of adverse impact contained in the CAO complaint and IFC's requirements for risk-based E&S review of FI subprojects during supervision. As described below, while the conclusions of the consultant's report were generally favorable to the project, methodological limitations meant that it provided IFC with limited assurance that Ficohsa had properly applied IFC's Performance Standards to the project.

Specifically, CAO notes that neither IFC's own supervision nor the consultant review included an analysis of project E&S documentation against IFC requirements. Without such analysis, it is difficult to reach robust conclusions as to the application of IFC's E&S requirements to the project.

In this context, CAO concludes that IFC supervision did not generate sufficient evidence to support a conclusion that the client properly applied IFC's Performance Standards to the Indura project. Relevant to the issues raised in the complaint, IFC lacks sufficient evidence whether the following Performance Standards were correctly applied to the project:

- a. PS1 (Stakeholder Engagement) and PS7 (Indigenous Peoples): The Bank Group's Indigenous Peoples policies have previously been applied to Garifuna people in the project area<sup>30</sup> and IFC's consultant concurs that PS7 is applicable. In projects with adverse impacts on Indigenous Peoples (IPs) PS7 includes requirements for free, prior, and informed consultation (FPIC) on matters that affect the IPs, such as proposed mitigation measures and the sharing of development benefits. Where a project is located on lands under customary use by IPs, PS7 requirements include assessment of indigenous land use, informed participation of affected indigenous communities, compensation for loss of access, and the provision of culturally appropriate development opportunities.<sup>31</sup> IFC's consultant notes that project preparation did involve consultation with neighboring communities and concludes that Indura has included the promotion of Garifuna identity and benefits for the members of this community as part of its core values. However, this does not provide assurance of compliance with the above PS7 requirements.
- b. PS5 (Land Acquisition and Involuntary Resettlement): While there are competing claims regarding the land tenure history and occupation of the project area, available evidence, including project E&S assessment documentation, supports a conclusion that the project

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<sup>29</sup> IFC ESRP 9 (June 2014). Sustainability Policy, para. 45.

<sup>30</sup> In 2007 the World Bank's Inspection Panel's investigation report concerning the Honduras Land Administration Project, the Panel found significant shortcomings in the World Bank's policy compliance related to adequate consultation with Garifuna communities and appropriate measures to protect indigenous peoples' land rights (<https://goo.gl/S8l0Vm>).

<sup>31</sup> PS7, para. 9.

area was used by neighboring Garifuna communities for traditional harvesting and hunting and that the beach was used as a right-of-way between Garifuna settlements along the coast. While IFC's consultant concluded that these harvesting activities were unlikely to be fundamental to the community's livelihood, PS5 requires a Livelihood Restoration Plan whenever a project limits access to land that people use to support their livelihoods.<sup>32</sup> It is thus not apparent from the material available to CAO, that potential economic displacement arising from the project was assessed or mitigated in accordance with the requirements of PS5.

- c. PS6 (Biodiversity Conservation and Sustainable Management of Living Natural Resources): Considering that the project involved the construction of a hotel and golf course in a nationally and internationally protected wetland area, an assessment of PS6 compliance would require a review and gap analysis of the client's environmental impact assessment, environmental management plans, and biodiversity monitoring programs. This would include an assessment of potential project impacts on critical habitats as defined in PS6.<sup>33</sup> Neither IFC's supervision documentation nor its consultant report recorded a review of the client's environmental documentation or offered a conclusion on the project's application of PS6.

## Conclusion

Since identifying gaps in the client's ESMS in late 2012, CAO acknowledges that IFC has worked actively with the client to implement corrective measures through an agreed action plan with IFC. In 2015, IFC determined that the client was in material compliance with IFC's E&S requirements for financial intermediaries. After an IFC site supervision visit to the client in April 2017, IFC determined that there was sufficient information and evidence that the client was committed to implement IFC's E&S requirements, and again concluded that the client was in material compliance.

While acknowledging the progress reported by IFC, available documentation leads CAO to the conclusion that IFC has only partially addressed CAO's non-compliance findings. In particular, CAO concludes that IFC lacks assurance that the client is: (a) categorizing prospective investments in accordance with IFC's requirements; (b) conducting and documenting E&S due diligence assessments of its higher risk loans in accordance with Performance Standards requirements; (c) including necessary covenants to require borrowers to operate in accordance with IFC's Performance Standards and Exclusion List as relevant; (d) monitoring the E&S performance of borrowers in a manner that is commensurate to risk; and (e) implementing a grievance mechanism which is "readily accessible...to affected communities" and about which affected people are informed.

CAO's compliance investigation also considered Ficohsa's exposure to Dinant. IFC's investment in Dinant was the subject of a 2013 CAO investigation which led to non-compliance findings. While IFC developed a corrective action plan with Dinant, as part of IFC's direct investment in Dinant, following CAO's 2013 compliance investigation, IFC did not assure itself that the client's ongoing financing for Dinant was contingent on binding commitments to implement the Performance Standards. CAO further concludes that IFC lacks assurance that its client is monitoring Dinant's compliance with IFC's E&S requirements.

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<sup>32</sup> PS5, para. 11-13.

<sup>33</sup> PS6, para. 4-13.

As part of a May 2015 site supervision visit, IFC reviewed Ficohsa's documentation in relation to the Indura project. Following the complaint to CAO, IFC commissioned a consultant review of the root causes and interests associated with the CAO complaint. In June 2018, IFC conducted a further review of client supervision documentation related to the Indura project. IFC's attention to the E&S risks and impacts associated with the Indura project reflected Sustainability Policy requirements for risk-based supervision of financial intermediary clients and their exposure to high-risk subprojects. However, the methodology employed in this instance did not provide sufficient evidence that the FI: a) had applied the E&S requirements to Indura; and b) supervised PS compliance with regard to the issues raised in the Indura complaint. Further, upon review of available documentation, CAO concludes that IFC lacks sufficient evidence that the Indura project was prepared and implemented in accordance with PS1, PS5, PS6, and PS7 requirements.

Overall, CAO finds that IFC's response to this compliance investigation only partially addressed the compliance findings. Nevertheless, CAO has decided to close its monitoring of the investigation considering that IFC divested from its Ficohsa equity and corporate loan investments. IFC continues to have active investments with Ficohsa to support its housing and SME business lines. However, these investments are not of a nature that require IFC to monitor the application of its E&S requirements to the client's corporate lending portfolio, which includes the loans to Dinant and Indura.

Findings from CAO's investigation that require a response at the level of IFC's policies, procedures, and practices will continue to be assessed via CAO's ongoing monitoring of IFC's response to CAO's Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries.<sup>34</sup>

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<sup>34</sup> For further details, see CAO's Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries, IFC's responses and CAO's monitoring reports. Available at <https://goo.gl/3AnGdM>.

## Annex A: Summary of Key Investigation Findings

<b>Pre-Investment E&amp;S Due Diligence</b>
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 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.
<b>Disbursement</b>
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 subordinated 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.
<b>Supervision</b>
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 E&S performance of borrowers, particularly those involving high E&S 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 signify that supervising compliance with the E&S requirements of the 2011 investment agreements presents a significant long-term challenge.

