THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

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TO: Meg Taylor, Compliance Advisor Ombudsman, CCAVP

FROM: Jyrki Koskelo, CFFVP

EXTENSION: 38929

SUBJECT: Final IFC Management Group Response to CAO's Audit Report on Wilmar

Executive Summary

IFC Management is responding to the CAO audit of four separate IFC investments in support of the Wilmar Group, one of the world's largest producers of palm oil and based in Indonesia. Two of these investments—both now closed—were in Wilmar Trading to support the company's capacity to trade palm oil, and two were in Delta Wilmar—an edible oil refinery located in Ukraine. These investments were approved by IFC's Board between 2003 and 2008.

IFC's management would like to acknowledge that IFC supports and appreciates the successful efforts of the CAO-led mediation effort in Indonesia between the affected communities and Wilmar that have led to a resolution of the issues raised in the first complaint to the CAO. Wilmar, as a result of its favorable experience with the CAO-led mediation efforts, has adopted a dispute resolution procedure for addressing community-based complaints which respects Indonesian laws and customs. With respect to its involvement in Delta Wilmar, IFC will continue to solicit information from the company and other stakeholders to ensure it is informed regarding the state of community relations generally, and any significant community disputes that may arise or prove difficult to resolve.

IFC believes that production of palm oil, when carried out in an environmentally and socially sustainable fashion, can provide core support for a strong rural economy, providing employment and improved quality of life for millions of the rural poor in tropical areas. However, the CAO audit raises legitimate questions about the environmental and social risk categorization of the Wilmar investments (category C in the case of the trading company and category B in the case of the refinery - Categorization signifying the degree of disclosure considered appropriate according to the environment and social risk of the project), the resulting level of environmental and social due diligence applied by IFC in assessing suppliers of palm oil to Wilmar, and the absence of a comprehensive strategy to guide IFC investments in the challenging palm oil sector in Indonesia. IFC Management accepts that there were shortcomings in each of the three areas identified by the CAO—project categorization, supply chain due diligence and a strategic framework for the palm oil sector.

Under IFC's Performance Standards environmental and social risk categorization of projects is used to reflect the magnitude of impacts understood as a result of the client's Social and Environmental Assessment prior to presenting projects to its Board of Directors for consideration. In the case of the Wilmar trading company investments, IFC Management acknowledges that this case illustrates a weakness in the current Environmental and Social Review Procedures (ESRP), with respect to trade facilities, which guides specialists through the categorization framework. The current ESRP does not differentiate between the environmental and social risk difference of a trade done by a regulated industry (banking) with a diversified portfolio from a trade done by a corporation in a single commodity (an instrument closer to working capital) such as Wilmar Trading. IFC has already notified its environmental and social specialists in regard to implementation of risk based categorization to trade facilities and will update its ESRP accordingly by August 15, 2009. It is anticipated that in the future, projects such as Wilmar Trading would be categorized as an "A" or "B" but this categorization will be made by the degree of the potential environmental and social impacts. In addition, categorization in general, will be examined as part of the upcoming review and update of IFC's Performance Standards

IFC Management agrees that supply chain performance should have received closer scrutiny. However, thoroughly and accurately assessing supplier environmental and social performance, especially when supply is sourced from a wide range of third parties over whom the buyer—Wilmar in this case—has varying degrees of influence and control is an ongoing challenge. IFC will solicit the views of other stakeholders in an effort to improve its approach to supply chain performance assessment and verification as part of its upcoming Performance Standard review and update process. Pending the outcome of this review, IFC will put renewed emphasis on supply chain management as part of the due diligence process, and provide templates to its environmental and social specialists for including this in their project screening and review responsibilities.

IFC Management recognizes that there is a need for developing a more strategically guided approach to agricultural sectors with difficult environmental and social issues such as palm oil while recognizing that comprehensive and effective strategies must be informed by investment experience. IFC is developing a comprehensive strategy to guide its future investments in the palm oil sector and believes that through continued engagement in the sector it can contribute to improving environmental and social performance. This strategy will be developed over the next three months and will incorporate input from key stakeholders participating in the Roundtable on Sustainable Palm Oil which includes NGOs, industry and other development institution representatives. In the meantime, IFC is committed to working only with quality sponsors who are committed to dealing with local communities in accordance with IFC's Performance Standards. In addition, IFC's Indonesia Advisory Services team is developing a program aimed at improving sustainability standards and encouraging more widespread adoption of these standards in the Indonesian palm oil industry.

The Performance Standards review and update, and consultative process associated with it, provide appropriate platform for any further revisions IFC will make to address the shortcomings with respect to environmental and social risk categorization and supply chain performance assessment and management identified in the CAO audit. IFC's Performance Standards have become the operative standard for most banks and public institutions financing private sector development. Therefore and necessarily, this process will take into account and be heavily influenced by the views of NGOs, other international financial institutions, industry, and the Equator Banks.

IFC Management Response to CAO Audit of Wilmar Trading and Delta Wilmar

Introduction

IFC acknowledges the substantial effort made and the significance of the issues reviewed by the CAO in its Audit Report on IFC's investments in Wilmar Trading and Delta-Wilmar. IFC welcomes this contribution by CAO to help IFC strengthen the development impact of its projects on the ground as well as reinforce the importance of systematically assessing and managing risks and issues in higher risk sectors and country contexts. IFC believes it must continue to engage in challenging sectors such as palm oil in Indonesia because the Corporation can make a positive difference through such engagement. The report identifies several areas in which IFC acknowledges the need to improve its policies and practices with respect to how it categorizes projects to ensure that environmental and social issues and concerns are comprehensively addressed, and that this is particularly important in terms of agriculture-related supply chains.

IFC has been fully supportive and acknowledges the successful efforts of the CAO-led mediation effort in Indonesia, between the affected communities and Wilmar that has resulted in a resolution of the issues raised in the first complaint. Wilmar as a result of its favorable experience with the CAO-led mediation efforts, has adopted a similar dispute resolution approach to dealing with these other cases which respects Indonesian laws and customs, and substantial progress is being made. IFC will continue to solicit information from the company and other stakeholders as necessary on a periodic basis as to the state of community relations generally and any significant community disputes that may arise or prove tough to resolve.

Palm oil is an important global agricultural commodity with a wide range of uses. IFC believes that production of palm oil, when carried out in an environmentally and socially sustainable fashion, can provide core support for a strong rural economy, providing employment and improved quality of life for millions of the rural poor in tropical areas. IFC believes that it has a central role to play in supporting willing industry players in this sector who are committed to following environmentally and socially-responsible practices which establish sustainability benchmarks for their peers.

Strategy for the Palm Oil Sector

IFC acknowledges a central finding of the CAO's audit that IFC did not have a comprehensive strategy to direct its investments in the Indonesian palm oil sector. Although IFC has for a number of years followed a guiding principle for its investments in palm oil-related enterprises which requires that we deal only with responsible clients who are willing to address sustainability issues, and that we also engage actively with industry bodies such as the Roundtable on Sustainable Palm Oil (RSPO), our approach has focused primarily on discrete investment opportunities.

While IFC has determined that it can play a constructive role in the global sustainability arena by applying the strengths of the private sector to address market and institutional failures in key sensitive sectors, we now recognize the need for a more formal approach which more clearly defines our role in the palm oil sector. As a result, IFC is now in the process of developing a detailed strategy for its global involvement in the sector, with particular reference to the specific challenges in Indonesia. The strategy will specify the context within which future investments should be developed, and the role of IFC Advisory Services, the World Bank, and other stakeholders. IFC anticipates developing this strategy over the next three months and will solicit input from stakeholders associated with the RSPO and others. IFC Management believes it is essential to include input from informed external stakeholders into the strategy. IFC will link this to other relevant strategies, such as that for the forest sector, which are also under development. IFC continues to believe its engagement in the palm oil sector is warranted and necessary given its potential to deliver multiple developmental and environmental benefits (see Annex A attached).

The strategy will seek to recognize the differing roles and needs of various business units in the palm oil supply chain. IFC's Advisory Services will play a critical role in implementing this strategy, and an Advisory program specifically developed to meet the sectoral challenges in Indonesia is nearing completion. The program being contemplated would seek to remove obstacles to more widespread adoption of sustainability standards such as those being promulgated by the RSPO, while also focusing on improving community investment and engagement by larger producers, and improving conditions for smallholders. Also, as an integral part of our strategy, IFC will work only with clients who recognize the environmental and social sensitivity of their operations, and who are committed to achieving internationally-recognized certification for their operations.

IFC believes that it is important to recognize the value that the RSPO provides in moving this sector to a more universally sustainable footing that reduces deforestation and protects the rights of communities and small-scale producers. As the CAO correctly notes, RSPO's sustainability certification system cannot and does not substitute for the application of IFC's Performance Standards. However, RSPO certification does address many of the environmental and social issues which are specific to palm oil plantations, particularly in Indonesia, and is therefore of considerable value in establishing a globally-recognized benchmark for the industry. Further, adherence to the standards developed through the RSPO process provides a basic level of reassurance to potential investors such as IFC regarding a company's commitment to good, sustainable management practices. Therefore, IFC strongly supports this multi-stakeholder initiative and believes it can play an increasing role in the future in addressing sustainability issues. In particular, IFC is currently supporting RSPO's biodiversity working group, as well as several projects which will inform the practical application of the requirements for biodiversity conservation on oil palm plantations. Assisting in further strengthening of RSPO will be an important component of IFC's palm oil sector strategy.

Categorization of IFC Investments

Categorization of the investments in the Wilmar trade finance facilities was considered in detail by the CAO. The CAO found that the designation as category C was incorrect. The CAO audit further notes that commercial pressures prevailed in the categorization decision and that differences of opinion on categorization existed within IFC. It is true that there was vigorous internal debate related to the categorization issue. However, at the time these investments were being considered for financing by IFC, the rationale that prevailed for this category C designation was that these were purely financial mechanisms, providing a short-term guarantee to a participating bank for provision of working capital needs. We believed at the time of these investments (in 2004 and 2006) that this was an appropriate approach given that other trade finance facilities had been categorized equivalently.

IFC acknowledges that this case illustrates a weakness in the current categorization framework with respect to trade facilities. The current standards do not have the granularity to differentiate a trade done by a regulated industry (banking) with a diversified portfolio from a trade done by a corporation in a single commodity (an instrument closer to working capital) such as the Wilmar Trading case.

While IFC did recognize the sensitive nature of the palm oil sector and therefore conducted an overview of Wilmar's plantation operations as part of our due diligence for the Wilmar trade facilities, it is clear and acknowledged that the more thorough due diligence accorded an "A" or "B" categorized project was not undertaken. The conclusion reached by the CAO audit was that sensitivities inherent in the palm oil sector warranted a more robust level of due diligence and an "A" or "B" categorization. IFC Management agrees with this finding as it relates to single-commodity, single-company transactions where the company is vertically-integrated (like Wilmar Trading) and will take this into account in the upcoming review of the Performance Standards. This review process will be comprehensive, and will include reviewing and potentially recommending to the Board revised approaches to IFC categorization of potential investments with a clear separation of diversified trade activities with financial intermediaries governed by financial regulators and trade / working capital facilities for single -commodity single-company transactions. In the meantime, IFC has already notified its environmental and social specialists in regard to implementation of risk based categorization to trade facilities and will update its ESRP accordingly by August 15, 2009. Until the conclusion of the Performance Standard review process, it is anticipated that similar single-company, single-industry and vertically integrated company deals will be categorized either "A" or "B" depending on sector, country and supply chain risks identified, and appropriate due diligence applied.

Supply Chains

Given the relevance of supply chain due diligence to this audit, it is worth reviewing the realities and challenges in more detail. Social and environmental management in supply chains is key to assessing and reducing or eliminating negative impacts on the environment, employees and communities. Assuring sustainable supply chains is also of great importance in order to maintain brand integrity, market access and the ability to secure finance. Since management of supply chains is closely linked to procurement, companies can better manage risks and influence their supply chains by integrating social and environmental issues into their procurement and sourcing practices.

IFC recognizes the positive and negative impacts, related to biodiversity, labor standards, and community relations, generated by our projects' supply chains. However, the challenges to implement a sustainable supply chain in some of the industry sectors are enormous and have taken international institutions and multinational companies years to achieve limited positive results on the ground. Identification and application of successful management tools to address these challenges thus remains a work in progress and dynamic.

The Agribusiness sector inherently confronts the challenges of complex and variable supply chains in having to deal with issues related to chain of custody, land acquisition, child labor, health and safety, indigenous peoples, working conditions, biodiversity conservation, deforestation, and land use. IFC included reference to the need to consider supply chains in the Performance Standards implemented in 2006 but also recognized in the Sustainability Policy that our clients do not always have control or influence over the actions and behavior of third parties. The challenge ahead for IFC is to find ways for our clients to recognize where they can have appropriate influence on critical aspects of their supply chains.

With regard to the Delta-Wilmar refinery in Ukraine, IFC agrees that greater attention should have been given to the crude palm oil supply chain. Over the last year, in particular, there has been important progress in implementing a certification system for sustainable palm oil, and in the development of tracking systems for bulk crude palm oil shipments. Wilmar can now better track palm oil from its own plantations to its processing facilities, although it still remains difficult to do so from other independent sources. This situation is changing rapidly, though, especially as certified palm oil starts coming onto the market in increasing quantities.

Pending the outcome of the Performance Standards review process, IFC will put renewed emphasis on supply chain mapping as part of the due diligence process, and provide templates to its environmental and social specialists for including this in their project screening and review responsibilities.

IFC's three year review of the Sustainability Policy and Performance Standards

IFC will engage in external consultation on updating the Performance Standards. The Performance Standards review and update, and consultative process associated with it, provide the appropriate platform for any revisions IFC will make to address the shortcomings identified in the CAO audit. IFC's Performance Standards have become the operative standard for most banks and public institutions financing private sector development. Therefore and necessarily, this process will take into account and be heavily influenced by the views of NGOs, other international financial institutions, industry, and the Equator Banks.

Key areas for the consultation and the review will include, examining standards of performance up and down supply chains, and categorization of different investment business lines and the use of categorization overall. In addition to any revision of the Policy and the Performance Standards, we will also develop more guidance and tools to clarify our standards. The IFC team leading the review is already in contact with the CAO and looks forward to the CAO's contribution to the review through its own independent assessment. The findings of this audit will be taken into consideration by the review together with the findings of other CAO engagements.

Conclusions

IFC appreciates the CAO's efforts to improve the development impacts of IFC's investments and recognizes the importance of rigorous and systematic environmental and social assessment in higher risk sectors and challenging country contexts. IFC recognizes the deficiencies identified in the CAO report and that there are lessons to be learned for future investments in the palm oil sector. As indicated above, IFC is already moving to improve its practices to ensure that the issues in the palm oil and other agricultural commodity sectors are more fully addressed.

IFC remains committed to application of its Performance Standards and to ensuring sustainability of the palm oil sector, including through our longstanding commitment to the RSPO process. We also remain convinced that the sector can, if properly and sustainably managed, have highly positive development impacts through economic growth and employment generation, which reduces rural poverty while producing an internationally-valued commodity.

We look forward to working cooperatively with the CAO and with other stakeholders, including the World Bank, national and local government agencies, civil society, industry bodies, and multi-stakeholder initiatives such as the RSPO, in achieving our shared goals of poverty alleviation and sustainable development.

Attachment:

Annex A: Development Impacts of the Palm Oil Sector

[1] Studies On Smallholder Tree Crops Production And Poverty Alleviation, ASEM Grant TF. 024891 The Performance Analysis of Palm Oil, Central Research Institute For Estate Crops, In Cooperation With The World Bank, 2002

Annex A: **Development Impacts of the Palm Oil Sector**

Employment generation. Palm oil production is labor intensive, and is centered in rural areas where 75% of the world's poor reside. Labor ratios typical of the industry are about 4 ha per head of family in Asia, 2 ha for smallholders; an assessment of World Bank investments in oil palm in Indonesia estimated 0.4 paid labors per ha. Malaysian estimates indicate that an additional 1.5 jobs are generated in the supply chain for each plantation job. These figures applied to Indonesia would result in direct employment of 4 to 6 million persons, financially supporting a population estimated at about 36 million.

Linkages to SMEs and farmers. Palm oil plantations generate business opportunities for SMEs involved in the supply of goods and services to companies (e.g. Fresh Fruit Bunches/product transportation, fertilizer, agrochemicals, fuel sales, rice, machinery, spares) or their employees (retail, food service, passenger transportation, etc). Ancillary activities such as contractor services for road maintenance, bridging, house construction, mill technical services, power services, and cultivation, harvesting and transport of the fruit bunches will also develop beyond the border of the plantation. In addition, plantations encourage the development of rural transport, retail, roads, jetties, schools, health clinics, mosques, churches and local government infrastructure and services. Although IFC recognizes there are issues here, such as reported adverse productivity differentials with plantations, palm oil provides excellent opportunities and demand for smallholder participation either in formal or informal schemes.

Economic growth. As a 2002 report on World Bank involvement in the tree-crop sector stated, unlike most sector and sub-sectors, the estate crop sub-sector, dominated by smallholders, has demonstrated its strength and resilience during the economic crisis. The lesson that can be derived from this phenomenon is that the sub-sector can be used as one of [the] leading sub-sectors not only when the economy i[s] booming . . . but also in crisis. In addition, various studies also indicate that the sub-sector has played an important role in [the] Indonesian economy as a source of economic growth as well as improvement of income distribution."[i]

Consumer benefits accrue to lower income households in particular. Palm oil is the cheapest major vegetable oil. Historically, palm oil has traded at a discount to soybean oil, the second most widely traded vegetable oil, and to others such as rapeseed, sunflower, etc. Because of its low cost and availability relative to alternatives, palm oil is much used by Base of the Pyramid households/food outlets in Indonesia (and in many other low income/IDA countries in Asia, Africa and Latin America) as cooking oil. It is also used in the production of lower cost food products, such as instant noodles and bakery items, which are popular among lower income households in Indonesia.

Land use relative to other oils. Palm oil production is a land efficient source of vegetable oil when compared with other sources. Palm oil yields on average 4.5mt/ha (Crude Palm Oil + Palm Kennel Oil) in Indonesia, compared to less than 0.5mt/ha for soybean oil and sunflower oil and less than 0.7mt/ha for rapeseed oil. Increased planting to palm in the context of increasing demand for vegetable oils, will make a strong contribution to global supply of oils and fats while using fewer land resources than other types of vegetable oil.

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