

E&S Risk Management of Financial Institutions at the IFC

Presentation to the Committee on Development Effectiveness
September 4th 2013

Context and Outline of the presentation

- On April 8th 2013, the Committee on Development Effectiveness met to discuss the CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries and the IFC Management Response.
- At the meeting the Members :
 - Acknowledged the advances IFC has made with performance standards through its risk-based approach and improvement in its internal processes, staff training and internal controls.
 - Agreed that the audit presents lessons to further improve IFC's development impact by identifying areas for attention, which could help to create a more contextual approach moving forward for enhanced E&S performance.
 - Stressed the need for greater emphasis on capacity building for sub-clients at all risk levels.
 - Emphasized the need for a sampling of sub-clients, with a balanced evaluative approach.
 - Emphasized that there is a need for clear communication to ensure common understanding among stakeholders.
 - Commented on a perceived disconnect between IFC's corporate message and demonstrated results, noting the importance of managing expectations and addressing the gap in perception.
 - Requested Management to return for a broader engagement within two months, to include an action plan setting out the cost implications for IFC and differentiated by client, taking into account the CAO's findings and the Committee's comments.
- This presentation is prepared in response to the above context and covers the following aspects
 - The key CAO findings
 - An overview of IFC's FI portfolio and E&S risk profile
 - A recap of the current approach to E&S risk management as outlined in the 2012 Sustainability Framework
 - A snapshot of the E&S performance of the FI program over the last few years
 - The Proposed Action Plan
 - Annexes
 - Links between the proposed action plan and the CAO findings
 - Details of the advisory services program proposal

CAO Audit Summary and Findings

- IFC does seek to play a leadership role in E&S risk management in the financial sector and has strengthened its internal capacity over the years.
- The sampled projects indicated a 90% compliance/success rate regarding the adoption of IFC's policy requirements by FI clients

CAO FINDINGS*

Related to IFC Strategy

- IFC's E&S processes and results do not fully correspond to IFC's corporate message
- IFC applies two different concepts of E&S risk: do no harm and credit risk
- IFC has three different types of E&S objectives

Related to Standards

- Despite interaction between IFC and other Development Finance Institutions, differing standards are a burden for clients
- IFC has further opportunities to encourage the adoption of a shared vision and industry standards

Related to the IFC Toolkit

- IFC's focus on the SEMS does not necessarily achieve a broader management and cultural change process
- IFC's E&S requirements have not been adapted for FM clients
- IFC's approach to E&S requirements has precluded a structured approach to assessing two key elements of a successful E&S program: client capacity and commitment
- Standardized implementation requirements do not accommodate different levels of E&S development

Related to Resources

- The quality of E&S assessment has improved
- The allocation of E&S resources is not cost-based

**See Annex 1 for the links between the action plan elements and these findings*

IFC's FI Network - Depth and Breadth of Market Penetration

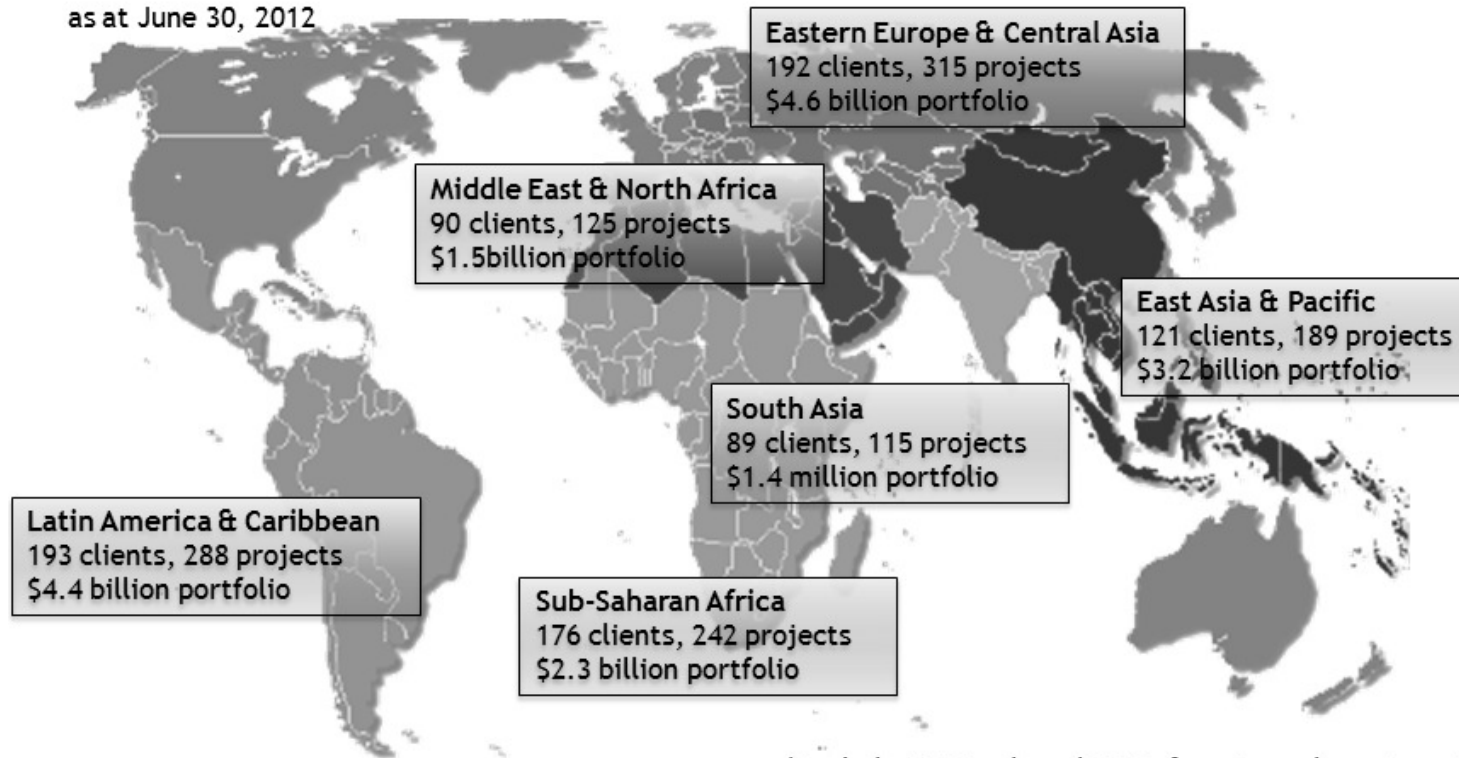
FIs are a key channel to expand IFC's reach and development impact in our target markets. It enables IFC to deliver financial resources to millions of SMEs, microenterprises and individuals that it would never be able to reach directly. This engagement has strengthened the capabilities of FIs to fund activities in vital economic sectors such as agriculture, housing, manufacturing, infrastructure and social services. Our work with these clients has supported an estimated 100 million jobs.

897 clients, 1,320 projects, \$18.6 billion total portfolio*

692 Financial Institutions, 1,106 projects

205 Private Equity Funds

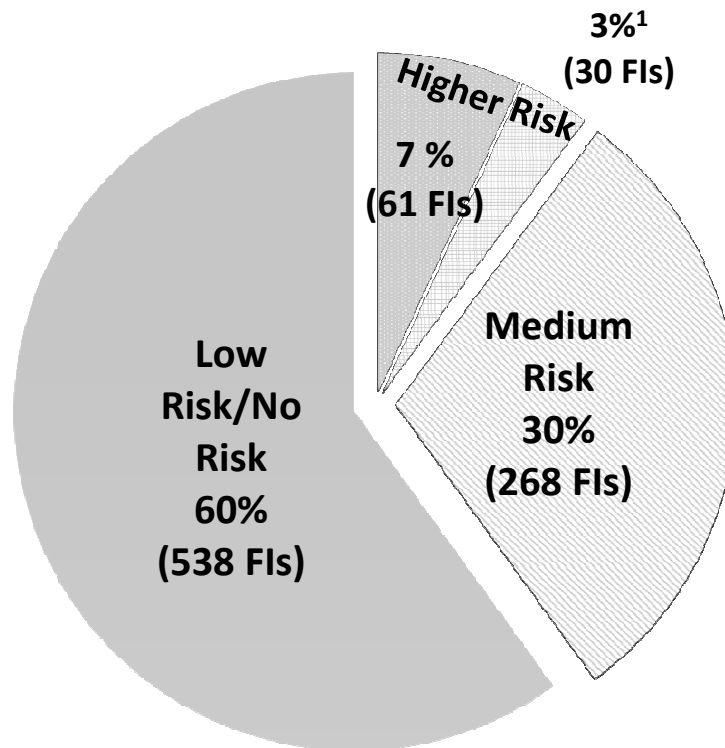
as at June 30, 2012



* Includes PE Funds and FMV of equity and quasi-equity

FI Portfolio by E&S Risk (Clients²)

The chart below shows IFC's FI portfolio broken down by E&S risk. As can be seen from the chart, the Higher risk FIs where, Category A and B projects are expected, represent a small minority of IFC's FI investments and the predominant focus is on access to finance to SMEs and microfinance clients. IFC's does not believe there is, or claim additionality on E&S risk management, for the Low/No risk FIs as well as some of the Medium Risk FI clients.



- Higher Risk - Financial Institutions that are substantially exposed to high - medium high risk and are required to apply Performance Standards to select sub-projects
- Medium Risk - SME funds and FIs that are required to comply with host country requirements.
- Low Risk - clients with Exclusion List requirement
- No Risk - clients with no E&S risk in their portfolio

Notes

1. Projects processed prior to the 2006 Sustainability Framework
2. The analysis is of clients as of June 2012. To enable comparison across the portfolio, FIs before 2012 have been conservatively reclassified given the absence of the FI-1,2 and 3 classification prior to 2012.

IFC's E&S Appraisal Approach

IFC's current appraisal process includes a number of steps outlined below:

- First IFC reviews the portfolio of FI business activities to identify areas where the FI could be exposed to potential E&S risks
- IFC then categorizes the FI based on the magnitude of E&S risks, ranging from FI-1 to FI-3. Specifically here, IFC considers the tenor, type, size, and sector exposure of the FI's existing or proposed portfolio in determining the categorization
- IFC then reviews the FI's E&S policies, procedures, sample of existing loans and assesses the capacity of the FI to deal with the E&S risks in their portfolio where present
- Based on the above review, IFC establishes the scope of the E&S performance requirements including any Corrective Action Plans, which are conditions for IFC financing
- A field appraisal is required for all high risk FI investments and clients with low capacity
- The appraisal findings are documented internally and there is an internal review as part of the project investment decision
- The appraisal findings, the categorization and its rationale and any Action Plan for the FI are disclosed in the SII on IFC's website
- The appraisal includes communication of appraisal findings and E&S requirements to the client. Where required, the IFC specialists also provide guidance materials such as training resources, template documents and guides on E&S Risk Management to clients

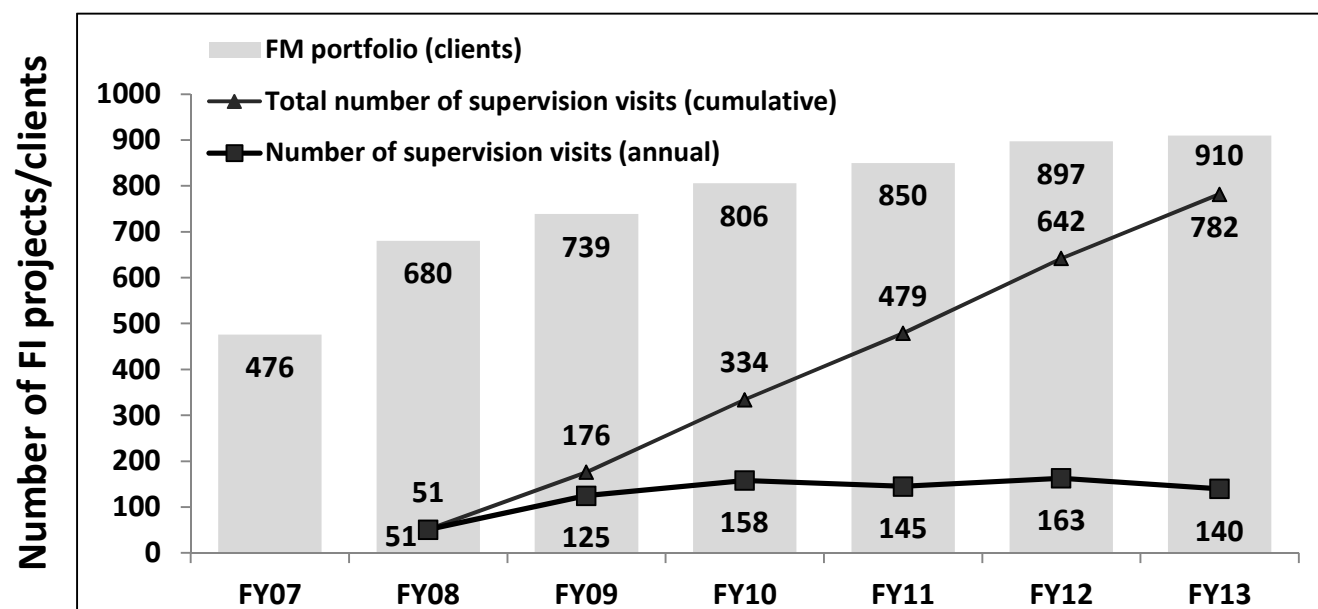
IFC's E&S Supervision Approach

IFC's E&S supervision process builds on the risk based approach followed at appraisal and follows the approach below:

- All clients with E&S risks (FI 1, 2 & 3) submit Annual Environmental Performance Reports (AEPRs). The AEPR is a template that is attached to legal agreements and includes the following sections:
 - Portfolio and performance
 - Status of ESMS implementation
 - Status of action plan, if any
- All AEPRs are reviewed by IFC and additional information sought where there are gaps. This review is a desk review
- IFC then follows a site visit protocol that is risk based and defined by FI categorization, the review of the AEPR, the previous year's ESRR score, and the findings of the last site visit. The protocol requires that:
 - All FI-1 projects are visited every year
 - All other FIs with E&S risk are visited at least once in three years
 - The site visit covers the following aspects:
 - Review of portfolio and risks
 - Review of ESMS and implementation including review of loan files and validation visits to sub-clients
 - Status of implementation of the action plan
- For high risk PE funds and other FIs, IFC seeks to validate the implementation and efficacy of the ESMS through:
 - IFC reviews a sample of the of FI's loan/investment files looking specifically at the E&S due diligence done by the FI
 - A sub-sample of these loans/investments are selected for site visits to validate the FI's E&S due diligence. This is currently undertaken primarily for PE funds
- The status and any updates to the Action Plan for the FI are updated in the SII on IFC's website
- For PE funds, the High risk sub-clients/projects are required to be disclosed by the PE fund on their respective websites

Evolution of the FI Program and E&S Risk Management

Since the adoption of the FY06 framework, IFC has significantly strengthened its E&S appraisal and supervision of FIs, resulting in qualitative and quantitative improvements. The chart below shows the increase in field supervision visits for FI clients. As the supervisions visits are scheduled annually for FI-1s but over 2-3 years for other FIs, the graph shows both the cumulative as well as the annual supervision visits. Also note that not all of the FM portfolio clients have E&S risks or E&S supervision. The table below the chart shows the IEG assessment of IFC's E&S appraisal and supervision work quality over the years.



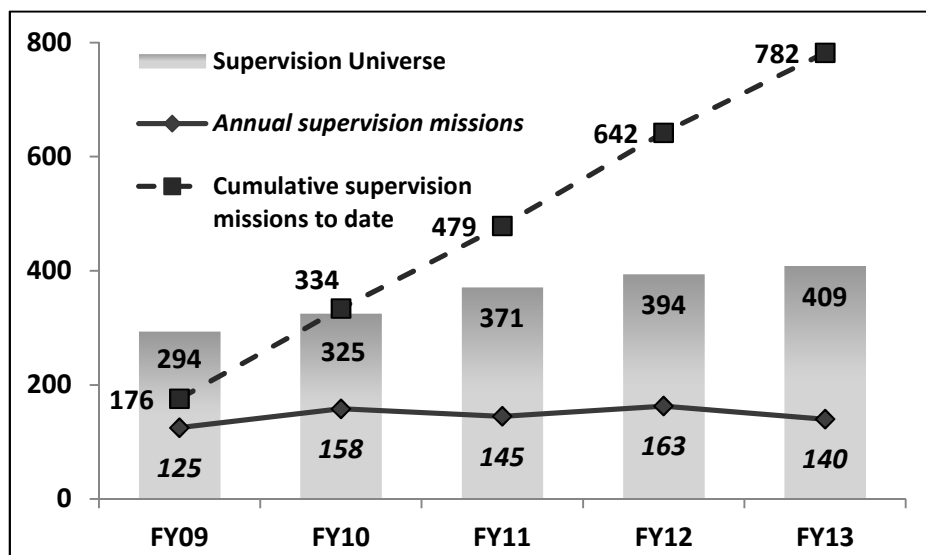
IFC E&S work quality for FI projects (IEG)

	FY05-07	FY06-08	FY07-09	FY08-10	FY09-11	FY10-12
Appraisal	92%	90%	80%	79%	78%	84%
Supervision	53%	61%	68%	72%	78%	84%
Role and Contribution	64%	65%	71%	68%	75%	74%

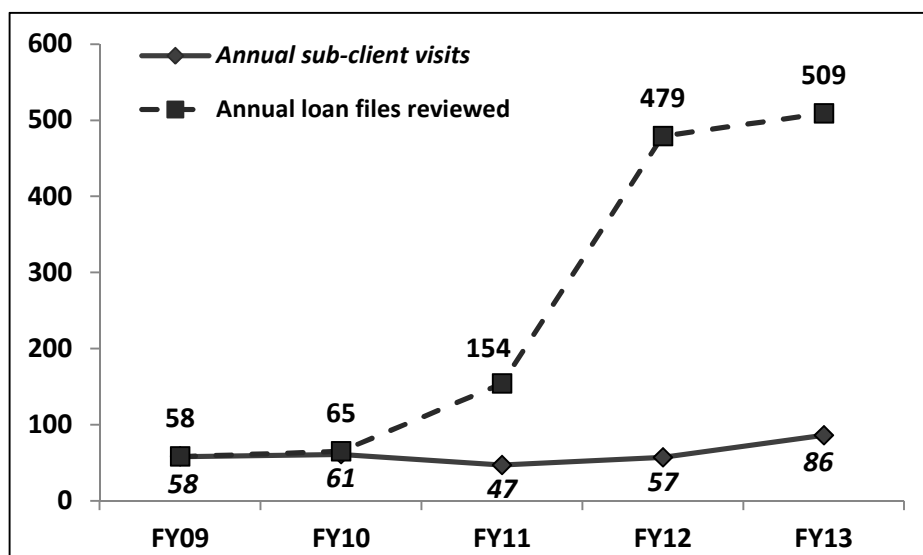
Annual FI Level Supervision and Validation of ESMS

IFC today actively supervises over 400 clients on E&S risk management and has conducted over 700 field supervision visits to FIs. In addition to ramping up the FI level field visits, IFC has introduced validation of the FI's ESMS through a review of the FI's loan files and sub-client field visits. IFC has, to date (cumulative) reviewed over 1200 loan/investment files and visited over 300 sub-clients as part of this validation process, focusing on higher risk FIs and their ESMSs.

FI Level Supervision

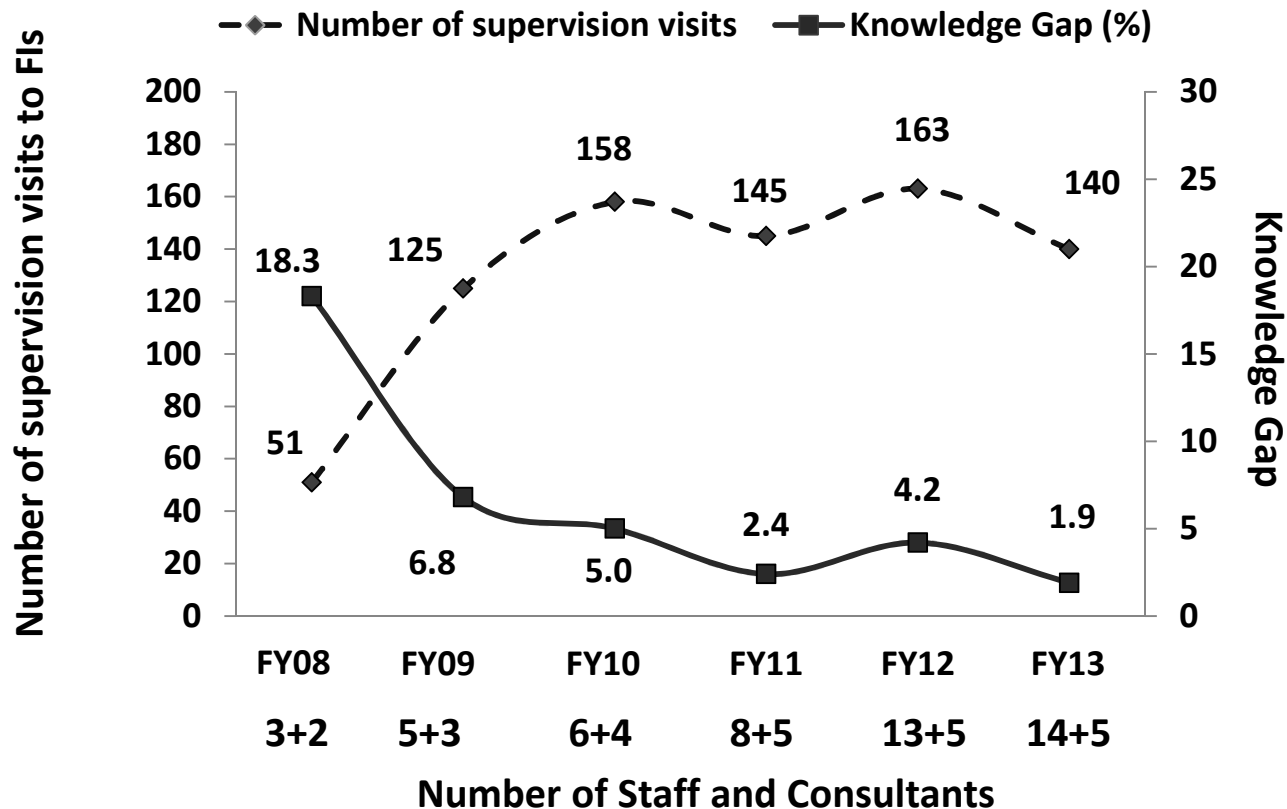


ESMS Validation



Evolution of Knowledge Gap

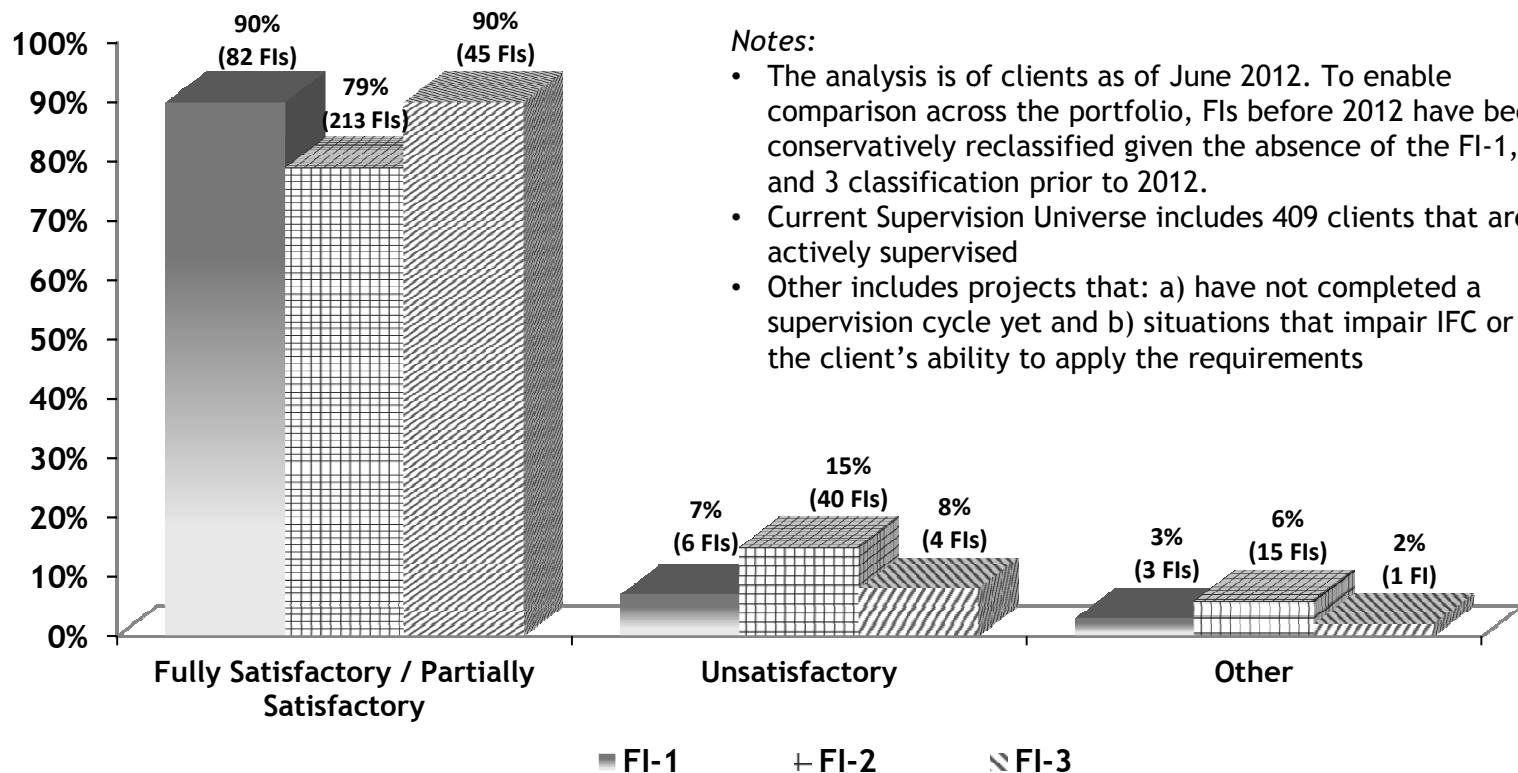
IFC estimates its own knowledge of the situation on the ground with the FI and its implementation of the ESMS. The portion of the FI portfolio where IFC does not have current reports or information about the client's ESMS implementation where applicable, is referred to as the knowledge gap. As also noted in the CAO report, the concerted strengthening of IFC's capacity and implementation over the years (shown in the chart below) has resulted in significant improvements in IFC's knowledge of the E&S risks in its portfolio and its resultant ability to manage these and focus on problem areas.



FI Portfolio E&S Performance

The second aspect of IFC's approach to the E&S risk in its portfolio is the performance gap, given that the knowledge gap (previous slide) is now <2%. The performance gap is the status of the shortcomings/gaps in E&S implementation by the FI. IFC E&S specialists score the risk adjusted performance of our FI portfolio (409 clients who have E&S risks and are being supervised).

As the chart below shows, around 90% of our higher risk FIs and 79% of our medium risk FIs have either already met or are on a trajectory to meet IFC's E&S requirements. Around 12% of our total portfolio is considered unsatisfactory and steps are being taken to remedy these with options that are available.





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Proposed Action Plan

Key Areas of Focus

As illustrated in the previous slides, IFC has been strengthening implementation and is seeking to continually improve performance starting with the trajectory established with the 2006 Sustainability Policy.

IFC's 2012 policy update included a number of changes to strengthen practice and implementation. To further build on this foundation, IFC is proposing to adopt a number of steps at this time, under the following three initiatives:

1. Formalize a Continual Improvement Framework for managing the E&S performance of the FI business. The objective here would be to focus on strengthening implementation of the 2012 policies and promoting best practices where feasible and required.
2. Establish a formal ongoing process of outreach, consultation and dialogue with key stakeholders on IFC's FI business.
3. Strengthen IFC's advisory services to support regulatory, market and client level capacity building to help raise the standard of E&S risk management in the Financial Sector in emerging markets.

These initiatives are elaborated upon in further detail in the following slides.

1. Continual Improvement Framework

IFC endeavors to continually strengthen implementation of its policies and procedures. Based on the CAO report, stakeholder engagement and given the recent changes in the 2012 framework, IFC proposes the following:

- Client capacity and commitment is an important factor to the overall management of the E&S risks and IFC proposes to accord greater attention to alignment of values with clients on E&S during appraisal.
- There is scope for increasing coverage of FI level site visits given the success of the enhanced supervision that has been in place for FI-1 projects. IFC proposes to cover all FI-2 clients with PS requirements, which will entail about 30 additional clients to be visited annually
- There has been a call for enhanced disclosure for IFC's FI portfolio and there were substantive changes made in the 2012 AIP within the constraints of host country regulations in the financial sector. Even as the results of these policy changes are expected in the coming year, IFC is proposing to adopt the following steps :
 - To expand the disclosure of investee companies by PE funds to cover all investments, and not just Category A investments. This will be initially done on a best efforts basis to test operational feasibility and client implications, before formalizing the same
 - With the 2012 Sustainability framework update, IFC requires its FI clients to establish a communication mechanism to receive and register external communications and complaints from the public at large. The FI is required to screen and assess any issues raised, track and document responses, and adjust the ESMS as appropriate. IFC proposes to have FI-1 and FI-2 clients communicate the presence of this mechanism and the way the public can access the same in their annual reports, as their commitment to good corporate citizenship and openness to stakeholder engagement.
 - IFC will also continue to explore and promote other market best practices that are feasible in the financial sector

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1. Continual Improvement Framework (continued from previous slide)

- As presented earlier, IFC has a practice of validating the FI's ESMS through reviews of sub-project level information and site visits, having covered over 1200 sub-clients for higher and medium risk FIs. IFC proposes to document this practice as a formalized and systematized protocol for sub-client reviews as a basis of the FI's ESMS validation. IFC will share this protocol as has been requested by many stakeholders.
- IFC has strengthened the E&S legal provisions for PE funds and will disclose the revised approach to PE funds to the public.
- The core of strengthening implementation requires ensuring that internal data and performance tracking systems remain efficient and appropriate to the growth of the business. IFC will seek to review and strengthen internal data tracking and MIS, and strengthen internal coordination mechanisms to ensure active portfolio management and client engagement for effective E&S risk management.

- Performance implications of the above:
 - Continual improvement framework is the foundation that enables course correction and evolution of operational practice to ensure that the E&S risks are managed efficiently and effectively. The specific steps proposed above are considered suitable at this time. IFC will continue to review outcomes and performance, evolving its operational practices and addressing gaps as they arise.
- Cost/Resource implications of the above:
 - Additional FI field visits and supervision enhancement will require 3 additional full-time specialists to be hired requiring additional head count and budget
 - Staff costs, travel and communication estimated at US\$ 1.2 million annually

Continual Improvement Framework: Comparison with Current Practice

Activity	Current (2012 framework)		Proposed	
	FI-1	FI-2	FI-1	FI-2
Client reporting and Action plan	100% ²		No change proposed : 100%	
FI level field visits	Annual	At least every 3 years	Annual	Annual for all FI-2 clients with PS requirement. At least every 3 years for other FI-2 clients.
Sub-client validation ¹	For all PE funds and some FIs based on risk	Some PE funds based on risk	To cover all FI-1s and higher risk FI-2s as per sub-client review protocol to be documented and shared	
IFC disclosure	Action plan at appraisal and during the life of the project		No change proposed : Action plan at appraisal and during the life of the project	
Disclosure by FI	PE funds for Cat A	PE funds where Cat A present	PE funds disclose all projects starting on a best efforts basis to establish feasibility and client implications, before formalizing. Other FIs disclose means to access their public communication mechanism in their annual reports.	

1. Includes loan file reviews or a combination of loan file reviews and field visits to sub-client sites
2. This is the goal and is typically lower depending on the knowledge gap

2. Stakeholder Outreach and Dialogue

There is recognition for a need for more information sharing and engagement with IFC's stakeholders on the nature of the FI business and how we manage different aspects of the same. In this regard IFC is proposing to take the following steps :

- IFC will engage, at least annually, in a dialogue with civil society organizations (CSOs), covering various aspects of IFC's FI business. IFC initiated this process in December 2012 with a meeting with CSOs in Brussels. Since then, IFC has held meetings in Washington, D.C. and most recently in London. IFC is also exploring a meeting in Asia later this year, as requested by some of the CSOs. Interest at these meetings has been on:
 - The development impact and objectives of IFC's FI program
 - Management of risks, including E&S risks
 - Transparency and governance
 - Opportunities and constraints
 - Other issues based on stakeholder expressions of interest
- IFC will continue to work in partnership/leadership with DFIs and market players to refine and harmonize E&S frameworks and evolve and disseminate best practices in the market

- **Performance implications of the above:**
 - Increasing awareness of IFC's FI operations
 - Building of trust and surfacing of new ideas and suggestions from stakeholders
- **Cost implications of the above:**
 - Can be managed within existing budget and resources

3. ESRM for FIs - Advisory Services

In addition to direct guidance and support provided to higher and medium E&S risk investment clients by the IFC E&S specialists, IFC believes that strengthening market drivers and capacity is essential to improve E&S risk management in emerging markets. With this in mind, IFC proposes to scale up its advisory services program with the following elements:

- **Supporting the development of market and regulatory drivers (already underway). Key highlights include:**
 - IFC has been actively working with a number of key banking regulators on E&S guideline development. This has included Bangladesh, Brazil, China, Nigeria, Peru and Vietnam
 - Based on the progress, a number of other banking regulators have expressed an interest, including in Colombia, Indonesia, Mongolia, Philippines, Thailand, South Africa, Turkey and Pakistan
 - IFC has established the Sustainable Banking Network for Regulators to make this a global initiative and to share knowledge and resources across markets.
- **To support market capacity development, IFC proposes to build capacity in the markets, through third party providers, to support the financial sector with improvement of E&S practices (already initiated). The steps include:**
 - Adapt and roll-out Train the Trainer modules for pilot testing in selected markets: Bangladesh, Brazil, China, Nigeria and Vietnam
 - Develop partnerships and plan for rolling out in priority markets after pilot

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3. ESRM for FIs - Advisory Services (continued from previous slide)

- IFC also plans to engage directly with leading FIs in the various markets to help build their capacity (new offering). It is expected that these FIs will be lighthouse institutions and will help shift market behavior. The steps include:
 - Developing a strong articulation of the business case for E&S risk management for FIs. This is proposed for FY14
 - Developing FI ESMS diagnostic services that will enable FIs to identify E&S risk areas and also enable benchmarking. This will be launched as a pilot over FY14 and will be rolled-out thereafter
 - Pilot ESMS implementation support planned over CY14, and roll-out from CY15
 - As the demand for this offering is as yet untested and as this initiative has strong value for reputation risk management for IFC and the FIs, IFC will explore pricing options during the pilot phase to arrive at a suitable approach to ensure success of the initiative.
- In addition to the above, IFC proposes to integrate E&S risk management aspects into other relevant FI Advisory programs such as SME banking, Banking on Women, Agri-business financing and Risk Management.

- Development implications of the above:
 - A strengthened business case for E&S risk management in the financial sector, stronger market drivers for E&S risk management, and better market capacity to support the financial sector to help create a market shift
- Cost and Resource implications of the FI level support:
 - It is estimated at approximately \$5 million over a three year period to be able to deliver on this program
 - Up to 30% of these costs can be covered through donor funds and client contributions.
 - The other 70% are for staff costs for E&S specialists dedicated to advisory work to be met from budget increases
 - 2 additional staff in FY14; 1 additional staff in FY15, and; 3 additional staff in FY16 to count towards a total increase of 6 staff by FY16.

Summary

- **We believe that IFC's Sustainability Framework**
 - Seeks to be current best practice and is considered robust and appropriate to the nature of the business
 - It seeks to balance effectiveness with operational feasibility
 - The 2012 update made substantive changes to the Sustainability and AIP Policies, and projects processed are only now entering their supervision cycle
- **IFC's action plan has three elements**
 - The Continual Improvement Framework
 - On going stakeholder outreach and dialogue
 - Scaling up Advisory services for E&S risk management
- **There is commitment to on-going improvements in work quality and effectiveness as well as for creating channels for dialogue and engagement with stakeholders**



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Annex 1 : Links to the CAO Audit findings

Specific links to the CAO findings

Findings Related to IFC Strategy	Aspect of Action plan that covers this
IFC's E&S processes and results do not fully correspond to IFC's corporate message	To be addressed through Stakeholder Outreach with a better shared understanding of IFC's business model as well as IFC calibrating its messaging and managing the expectations of stakeholders
IFC applies two different concepts of E&S risk: do no harm and credit risk	While IFC differed with the CAO on this point, some aspects of this will be addressed through the Advisory Services program . IFC will focus on building a stronger business case including making the links between the various types of risks as part of this business case development
IFC has three different types of E&S objectives	Stakeholder outreach and steps taken by IFC to sharpen articulation of its objectives should create greater alignment between the market perceptions and IFC practice and also help clarify the E&S objectives articulated in the IFC Sustainability Policy.

Specific links to the CAO findings (continued)

Findings Related to Standards	Aspect of Action plan that covers this
Despite interaction between IFC and other Development Finance Institutions, differing standards are a burden for clients	IFC has shown a fair amount of leadership in this area and has also indicated that it will continue to push for harmonization. The continued engagement with other DFIs is covered under Stakeholder outreach .
IFC has further opportunities to encourage the adoption of a shared vision and industry standards	IFC has devoted significant attention to this including the market regulatory work and the support for the Equator principles. IFC has indicated that this will continue to be a focus area and this is covered under Stakeholder outreach .

Specific links to the CAO findings (continued)

Findings Related to the IFC Toolkit	Aspect of Action plan that covers this
IFC's focus on the SEMS does not necessarily achieve a broader management and cultural change process	This is the goal of the current framework that focused on the FI's ESMS. The scaling up of the advisory services work to support the market drivers and capacity, and the continued strengthening of IFC's implementation is expected to lead to improvements in this area over time. The sections on Continual Improvement Framework and Advisory Services speak to this point.
IFC's E&S requirements have not been adapted for FM clients	IFC did not agree with is finding. Given the enhancements of the 2012 framework, the IFC requirements have been designed specifically for FIs and are considered adequate. IFC will continue to focus on strengthening implementation through the Continual Improvement Framework exploring opportunities for course correction where results indicate a need.
IFC's approach to E&S requirements has precluded a structured approach to assessing two key elements of a successful E&S program: client capacity and commitment	IFC believes that this structured approach is incorporated into the current practice. The expectation is that the proposed Advisory Services program should improve and leverage market level capacity and the Continual Improvement Framework should help further improve the establishment of individual client capacity and commitment.
Standardized implementation requirements do not accommodate different levels of E&S development	IFC's approach does seek to balance flexibility with consistency and the new categorization framework introduced in 2012 enables this differentiation.

Specific links to the CAO findings (continued)

Findings Related to Resources	Aspect of Action plan that covers this
The quality of E&S assessment has improved	IFC's focus on both the framework and on implementation since 2006 has clearly demonstrated this progress and with the additional proposed actions, this should continue to improve with the Continual Improvement Framework
The allocation of E&S resources is not cost-based	IFC's approach is risk-based which is considered more conservative than a cost-based approach. While IFC does not propose to move to a cost-based resource allocation, IFC is presenting notional costs associated with the proposed enhanced supervision which addresses the principle of the CAO findings to some extent.



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Annex 2 : Roll out Plan for ESRM Advisory Program

Resource and Cost Implications and Benefits

1. What is the offer?

- **ESRM diagnostics:** to be tested with 6-8 clients over FY14 and to be rolled out from early 2014 to end of 2016 (when the ESRM product development phase is completed).
- **ESRM implementation support (post-diagnostics):** to be offered from 2014 to end of 2016 with the assumption that half the clients with diagnostics results will require implementation support (the other half undertaking enhancements on their own or with their consultants).

2. How much will it cost?

- The direct costs of ESRM diagnostics are estimated at **\$37,750** per client.
- The direct costs of implementation support are estimated at **\$67,500** per client.
- For each delivery, we estimate 10 man days of a senior E&S Specialist and a local Operations Officer plus travel.

3. How many clients could we reach from July 2013 to Dec 2016?

- Sep 2013 - Mar 2014: 6 clients with diagnostic services.
 - Jan - Dec 2014: 12 clients with diagnostics and 6 clients with implementation support.
 - Jan - Dec 2015: 24 clients with diagnostics and 12 clients with implementation support.
 - Jan - Dec 2016: 24 clients with diagnostics and 12 clients with implementation support
-
- **Total: 66 clients with diagnostics, and 30 of them with implementation support.**
 - **Focus on low-capacity, high and medium risk FIs and lighthouse market players**

Resource and Cost Implications and Benefits (continued)

4. What additional resources (full time equivalent staff) and budgets will we need to deliver the above?

- FY14 - 1 additional specialist and 1 program officer : annual cost \$ 1.0 million
- FY15 - 1 additional specialist deployable globally : annual cost \$ 1.4 million
- FY16 - 3 additional specialists deployable globally : annual cost \$ 2.6 million

5. How much budget does this translate into?

- For 3 years with the above level of client reach and estimated resources, we will need approximately **\$5 million**. Up to 30% of these costs can be covered by the A2F regional/country projects from donor and client contribution (if clients are from those regions where A2F have ESRM operations). The other 70% of the costs are for E&S specialists costs (either reassigned from CES existing pool, or new recruits), staff travel, product and training development and communication and would need to be covered through budget enhancements.

6. Which clients to target?

- CES and FM portfolio team are developing a list of FIs taking into account criteria including poor E&S performance, limited capacity, and potential for high impact and demonstration effect. This will be reviewed with the Steering Committee and Regional teams to develop a prioritized list.
- Selection of clients for AS services may be constrained by the AS pricing requirement. The FY14 pilot will be used to arrive at recommendations for pricing to ensure delivery of maximum impact.