



06

EVALUATION OF
IDB GROUP'S WORK
THROUGH
FINANCIAL
INTERMEDIARIES

ENVIRONMENTAL AND SOCIAL SAFEGUARDS

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ABBREVIATIONS AND ACRONYMS

1TFI	First-tier financial intermediary
2TFI	Second-tier financial intermediary
CABEI	Central American Bank for Economic Integration
CMF	Capital Markets and Financial Institutions Division, IDB
DEG	Deutsche Investitions- und Entwicklungsgesellschaft (German DFI)
DFI	Development finance institution
E&S	Environmental and social
ESG	Environmental, Social and Governance
ESMS	Environmental and social management system
FI	Financial intermediary
FMO	Financierings-Maatschappij voor Ontwikkelingslanden (Dutch Development Bank)
IDB	Inter-American Development Bank
IDBG	Inter-American Development Bank Group
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
LAC	Latin America and the Caribbean
MIF	Multilateral Investment Fund
NBFI	Non-bank financial institution
NDB	National development bank
NSG	Non-sovereign-guaranteed
OMJ	Opportunities for the Majority
OPIC	Overseas Private Investment Corporation (United States DFI)
OVE	Office of Evaluation and Oversight
PROPARCO	Société de promotion et de participation pour la coopération économique (French DFI)
SCF	Structured and Corporate Finance Department
SG	Sovereign-guaranteed
SMEs	Small and medium-sized enterprises
TC	Technical cooperation



I. INTRODUCTION

- 1.1 **This background paper on environmental and social (E&S) safeguards is part of the overall evaluation of the work of the Inter-American Development Bank Group (IDBG) through financial intermediaries (FIs).** It focuses on IDBG's E&S policy framework as it applies to FI operations, and IDBG's compliance with this framework. The scope of this assessment is in line with the scope of the overall evaluation, covering 466 FI operations approved for over \$17 billion between 2005 and 2014, representing 14% of total IDBG approvals during this period.¹
- 1.2 **This review derives most of its findings from illustrative case studies and from interviews with FIs and with E&S experts in IDBG and other development finance institutions (DFIs).** It also discusses broader trends on E&S policies in the financial sector, external factors affecting the achievement of E&S compliance goals, and results of a survey of FIs.
- 1.3 **This E&S review highlights the differences among IDBG windows and among various types of FI lending products.** IDBG's portfolio of FI operations is highly diverse, as are the associated E&S risks of FI operations. E&S management practices differ among the various windows of IDBG – CMF, which oversees sovereign-guaranteed (SG) FI operations, and SCF, IIC, OMJ, and MIF, which handle non-sovereign-guaranteed (NSG) operations.² E&S risks and IDBG compliance were reviewed for five relevant product profiles – small and medium-sized enterprises (SMEs), housing, trade finance, green investments, and leasing & factoring.

¹ However, the facility providing liquidity to FIs (6 operations, \$2.1 billion approved) was excluded from the scope of this E&S background review, as it provided only short-term liquidity and its utilization was very low (14%).

² Three of these windows – SCF, IIC, and OMJ – have been merged into one organization, IIC, as of January 1, 2016.

II. IDBG'S ENVIRONMENTAL AND SOCIAL POLICY FRAMEWORKS FOR FI OPERATIONS

A. E&S policy framework at IDBG

- 2.1 **IDBG's E&S policies require all operations, whether financed directly or through FIs, to be environmentally sustainable and in compliance with established safeguards.** IDB adopted its Environment and Safeguards Compliance Policy in 2006, and IIC adopted its Environment and Social Sustainability Policy in 2013. Both policies must be applied to all IDBG operations to help ensure that they will be environmentally sustainable, avoid harm to local communities, and generate E&S benefits.³ The first section of each policy discusses mainstreaming environmental sustainability in IDBG's own strategic direction and planning process. The second section provides the safeguard framework for IDBG operations.
- 2.2 **IIC's policy reflects its mandate to foster sustainable development in the private sector.** The policy covers both direct investments and investments through FIs. It also states clearly that all IIC operations must be environmentally sustainable.

B. Implementing E&S policies for FIs

- 2.3 **Operations through FIs are more challenging than direct investments because IDBG has to rely on the FI to mitigate E&S risks.** For all parts of the IDBG, the main approach is to rely on the FI's environmental and social management system (ESMS). IDBG transfers responsibility to the FI and relies on the FI to effectively implement the ESMS (see Box II.1 for elements of an ESMS). The FI has to demonstrate that it has appropriate E&S systems and procedures in place. Often this is done following approval; it is typically not a prerequisite for the approval of FI operations. An adequate ESMS is critical, especially for higher-risk operations, since IDBG delegates to the FI the responsibility for subprojects' meeting IDBG's safeguard standards.

³ The overall E&S safeguards framework at the IDBG consists of different policies, directives, and exclusion lists covering issues related to the environment, access to information, indigenous peoples, resettlement, disaster risk management, and gender equality. IIC also has its own Sustainability Policy and exclusion list. The policies apply to all operations. Only two of the policies, and their associated implementation guidelines, explicitly mention FI operations—IDB: OP-703: [Environment and Safeguards Compliance Policy](#) (2006) and [Implementation Guidelines for the Environment and Safeguards Compliance Policy](#) (2007); IIC: [Environment and Social Sustainability Policy](#) (2013) and [Environmental and Social Guidance Document](#).

Box II.1. Elements of an ESMS

In an appropriate ESMS for an FI, E&S risks (and ideally also opportunities) are considered throughout the credit cycle. At the initial screening, potential E&S risks are identified and categorized – e.g., as “low,” “medium,” or “high” risk. The risk classification is usually based on the size of the project and its inherent riskiness (e.g., considering the sector of operation and location), and, often, information drawn from a questionnaire completed by the enterprise seeking financing. Proper classification requires that the FI’s staff have sufficient expertise. An exclusion list may also be applied, under which the FI automatically excludes certain types of operations with E&S impacts it considers unacceptable.

On the basis of the risk classification, FIs apply different requirements: often an Environmental Impact Assessment conducted by external and independent experts, for high-risk operations, or specific action plans for lower-risk operations. Depending on the quality of a country’s institutions, checking whether appropriate permits are in place may suffice for low-risk operations. An ESMS typically includes a mechanism for supervision, monitoring, and reporting to ensure that risk mitigation mechanisms are being appropriately implemented by the client, again prioritized according to risk. The FI would usually have an E&S policy and appropriate procedures to ensure application of E&S requirements throughout the project cycle, as well as an officer with sufficient stature in the FI (e.g., a chief risk officer) with overall responsibility for E&S issues.

2.4 According to both IDB’s and IIC’s E&S policies, FIs are obliged to implement an effective ESMS just for subloans financed by IDBG. While FIs are obliged to classify subloans according to their potential risks and put in place requirements commensurate with the risk classification, they have to demonstrate to IDBG their capacity to mitigate E&S risks only for subprojects funded by IDBG. Table II.1 shows IDBG’s compliance requirements according to the different risk classifications. However, IDBG needs to first determine the likely overall risk of the FI operation, and different approaches to do that are applied across the IDBG.

Table II.1. Policy requirements for each risk categorization

Risk categorization of FI operations	Policy requirements
No or minimal E&S risks	Application of national laws and regulations, and IDB’s or IIC’s exclusion list.
Moderate E&S risks	Implementation of basic E&S risk mitigation procedures that are commensurate with the potential E&S impacts of the activities financed.
Significant E&S risks	Implementation of an ESMS that includes elaboration of an E&S policy and resources for the identification, assessment, mitigation, monitoring, reviewing, and reporting of E&S risks associated with projects financed with IDB or IIC funds through the FI. Environmental Impact Assessments are conducted by external and independent experts.

2.5 IDB’s E&S policy does not require IDB to preclassify FI operations according to the expected risk, but it does require assessment of the FI’s E&S management capacity. For FI operations, IDB applies the E&S risk categorization “B.13,” which refers to the policy directive chapter B.13. IDB does not screen the FI’s portfolio (either the relevant portfolio, such as the SME portfolio, or the total portfolio) to determine the likely risk of the operations to be financed. But at the time of approval, IDB’s management units and ESG are required to elaborate an E&S strategy and prepare an E&S Management Report, which assesses the status of the FI’s ESMS overall and the FI’s capacity, and identifies gaps that need to be closed.



- 2.6 **IIC's E&S policy requires FI operations to be preclassified by screening the relevant existing portfolio against potential E&S risks.** IIC has preclassified all of its FI operations since the 2013 approval of its Sustainability Policy, which requires IIC's ESG department to screen the FI's relevant portfolio against potential E&S risks. For this risk assessment IIC takes various factors into account: the type of FI and investment, the sector, the composition of the relevant portfolio, and the size and the physical context of the subprojects in the relevant portfolio. IIC classifies the E&S risk of the FI operation into three categories — FI-1, FI-2, and FI-3 — representing low-, medium-, and high-risk portfolios, respectively. Specific risk mitigation requirements are associated with the risk categorization.
- 2.7 **For FI operations, IDB's guidelines on E&S compliance do not provide sufficiently clear guidance, while IIC's E&S guidelines clearly describe the required procedures.** IDB's Implementation Directives do not properly address the complexity of FI operations. Chapter B.13 states that IDB will review its existing guidelines and past experience with FI operations and will check compatibility and revise its guidelines accordingly by 2007.⁴ No revised guidelines for FI operations have been approved, so that it is unclear what specifically applies. IIC has guidelines for its E&S policy in which the procedures regarding FI operations are clearly described.
- 2.8 **IDB's safeguard policy requires the application of the ESMS only to the specific use of proceeds.** IDB's approach to apply E&S safeguards solely to the use of proceeds (i.e., a list of projects selected by the FI that notionally are funded by IDBG), combined with no ex-ante risk classification of the FI's operations, allows the FI to select subprojects with low E&S risk to present to the IDB. The FI can thus systematically exclude subloans with high E&S risks (which it finances anyway), circumventing the more demanding E&S requirements. If the list of subloans involves just low-risk subprojects, the FI is obliged only to apply national laws and IDB's exclusion list, and it has neither the obligation nor the incentive to implement an ESMS. OVE observed that FIs sometimes swapped high-risk projects for low-risk projects over time. If the FI has medium- or high-risk operations in its relevant portfolio, but not on the list presented to IDB, the FI is not obliged even to report this to IDB, nor to develop an ESMS and apply it to these operations.
- 2.9 **Because IIC follows IDB's safeguard policy as applicable to private sector investments, it has to ensure the application of E&S requirements for the specific use of proceeds; but it often goes beyond that.**⁵ IIC typically encourages FIs to apply the ESMS to the relevant portfolio (but this is not mandatory) and screens the relevant portfolio against potential E&S risks during due diligence. The risk classification is thus based on the whole relevant

⁴ IDB's Safeguard Policy: "In 2007 the Bank will review its existing guidelines and past experience in the implementation of environmental safeguards for FI operations, will check compatibility with the Policy Directives, and will revise guidelines accordingly, as required."

⁵ IIC's sustainability policy also refers to World Bank Group / IFC guidelines and Performance Standards for assessment of potential environmental and social risks and impacts but states clearly that when there is a difference between IDB and IFC standards, IIC abides with IDB's safeguard policies.

portfolio, not on a self-selected list of projects. Furthermore, when it comes to equity investment or subordinated loans, IIC clearly requires the application of an ESMS to the whole FI portfolio, while IDB lacks a similar provision.

- 2.10 **Previously MIF had its own E&S guidelines for FI operations, but it dropped them when the IDB's new policy was introduced.** MIF's older guidelines included the application of E&S requirement to the whole FI portfolio and the systematic exclusion of high-risk operations. MIF now follows IDB's safeguard policy, and therefore its E&S requirements apply just to the use of proceeds. Furthermore, OVE found that MIF's legal agreements did not have adequate provisions to mandate E&S compliance. And when MIF takes an equity stake, one would expect that ESMS requirements would be even broader (i.e., covering the FI's whole operations), but OVE did not find such provisions in legal agreements. However, MIF often finances very small-scale investments with relatively low E&S impacts (e.g., microfinance), for which IDB or IIC would typically only require the use of an exclusion list.
- 2.11 **Both IDB's and IIC's exclusion lists provide that similar activities and operations must be excluded for financing with IDBG's funds, but IIC's list has two additional elements not in IDB's list:** (i) production, trade, storage, transport, or commercial usage of significant volumes of hazardous chemicals; and (ii) production or activities that impinge on the lands owned, or claimed under adjudication, by indigenous people, without such peoples' full documented consent. IDB has its own Indigenous Peoples Policy, but this policy does not explicitly exclude projects affecting indigenous peoples. At the IDB the concept of consent is mandatory only for projects in which indigenous people are the exclusive or principal direct beneficiaries. For all other projects the Indigenous Peoples Policy provides only the mechanisms of prior consultation, participation, and fair compensation for damage, not a requirement of consent.
- 2.12 **The exclusion lists have created some misunderstandings between IDBG and FIs.** The two exclusion lists of IDB and IIC include some activities that are clearly illegal – such as child labor or the use of internationally prohibited substances – but also other activities that are not illegal but that IDBG does not want to finance, such as the production or trade of tobacco, weapons, and munitions, and gambling or casinos. FIs reported to OVE that the lists often created misunderstandings and confusion, particularly regarding the financing of activities that were not illegal under national and/or international laws.

C. E&S risks of various FI products.

- 2.13 **The various products financed through FI operations differ in their potential E&S risk.** The scope of OVE's evaluation of FI operations covers the following product categories: SMEs (50% of the portfolio), housing (18%), trade finance (13%), green investments (5%), and leasing & factoring (2%).
- 2.14 **Green lending operations have medium to high E&S risks and can, when not properly managed, have significant negative environmental impacts on**



- ecosystems and on local communities.** Green lending operations represent a very wide spectrum of potential projects to be financed: renewable energy, energy efficiency, sustainable tourism, transport, construction, agriculture, biomass, biofuel, water and waste treatment, and eco-certificates and norms. The environmental impacts of renewable energy facilities (hydropower plants, wind farms, and photovoltaic systems) can lead to loss of biodiversity or ecologically valuable habitats. The social risks of infrastructure projects can range widely: local communities may feel disturbed in a negative way by the installed facilities, or they may be affected by resettlements for project implementation.
- 2.15 **Micro, small, and medium-sized enterprises are highly heterogeneous, and their E&S risks can range from low to high.** While some observers feel that SMEs, which are relatively small in comparison to corporates, do not have strong E&S impacts, it is important to point out that together SMEs represent more than 95% of all firms, accounting for 60%-70% of employment and 20%-30% of GDP in the Latin America and Caribbean (LAC) region. SMEs in LAC also have high levels of informality,⁶ and may thus not be captured well by E&S regulations. SMEs operate in low- to high-risk sectors, including extractive industries, chemicals, agribusiness, forestry, general manufacturing, infrastructure, and transport. E&S risks for SMEs depend also on the nearby affected communities or ecosystems, procedures for waste management, potential site contamination, labor regulations, and the safety and occupational health conditions in the company. FIs can assess these factors in a professional manner only if they have an ESMS in place and also apply it to SME operations.
- 2.16 **Trade finance typically consists of short-term transactions, and the activity of importing and exporting per se contains little E&S risk; however, the production of traded commodities can have serious E&S impacts.** The LAC region exports many primary products: soybeans, sugar, palm oil, cattle, and minerals. Producing these export commodities can carry significant E&S risk, and thus trade finance can leverage – or help to reduce – E&S impacts.
- 2.17 **E&S risks for leasing operations are limited and are related to the proper use of leased equipment by licensed facilities.** Leasing operations typically have relatively limited impacts, as long as the equipment has appropriate E&S standards. Many leasing operations involve new equipment, which typically has higher standards than older products. But use of some types of equipment (e.g., heavy construction or mining equipment) can have significant E&S impacts, and such equipment can also be used for illegal purposes or for activities on IDBG's exclusion lists. Thus, it is important to understand the type of equipment that is being leased and to ensure that the borrower has the appropriate licenses.

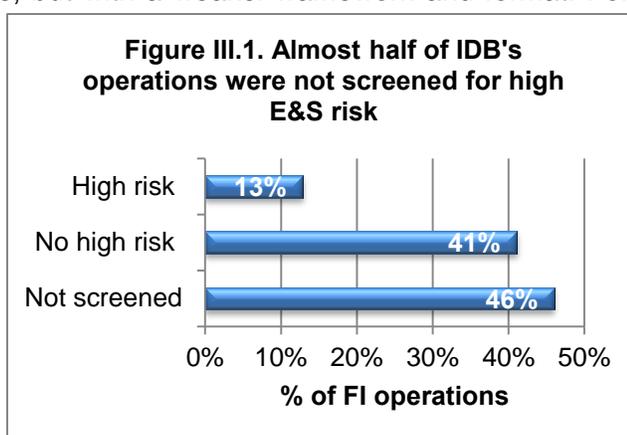
⁶

[“High Growth Small and Medium Enterprises \(HGSMEs\) in Latin America Emerging Economies.” Document prepared by IDB and MIF for the OECD Kansas City Workshop, May 8, 2008.](#)

III. COMPLIANCE OF FI OPERATIONS WITH IDBG'S SAFEGUARD POLICIES

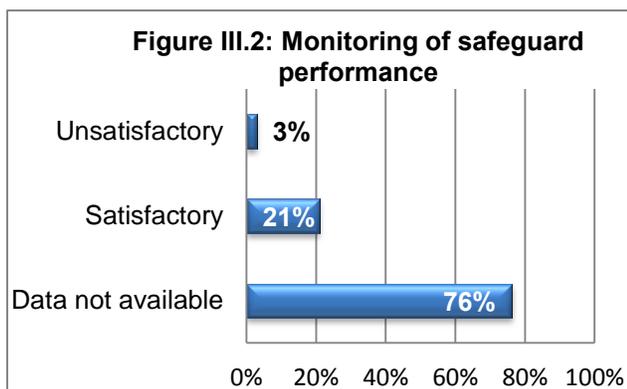
A. IDBG's supervision of compliance processes

3.1 **Good practice suggests establishing a baseline of the existing ESMS and an action plan to address identified gaps in the FI's management capacity, but this is not being systematically applied.** When IDBG's E&S specialists are involved in a project at the time of origination, they can interact with the FI's operational departments as needed to define an E&S baseline and carry out a gap analysis.⁷ The E&S Management Report (ESMR) for SCF and OMJ operations of the IDB-ESG unit provides an example of how to establish proper baselines and conduct a gap analysis. IIC has also produced some baseline analysis of FIs' ESMS capacities, but with a weaker framework and format. For CMF operations, baseline reports are not applied consistently for all operations. For MIF operations, proper baselines have not been established and gap analysis has not been conducted.



3.2 **IDB uses a screening and monitoring tool (Mr. Blue) to screen FI operations up front and to monitor FIs' safeguards performance.**

"Mr. Blue" is used to flag all of IDB's operations, including those financed through FIs. It screens each operation, triggers the application of specific policy directives, and identifies potential high risks. As a next step, IDB's ESG department assigns an E&S specialist to be responsible for monitoring. As Figure III.1 shows, nearly half of the FI operations have not been screened for high risk.⁸ However, when a potential high risk was identified, in almost all cases (96.5%) an E&S specialist was assigned.



3.3 **IDB's supervision records did not include data on safeguard performance for 76%⁹ of FIs.** (Figure III.2) This may be due in part to FI operations having been

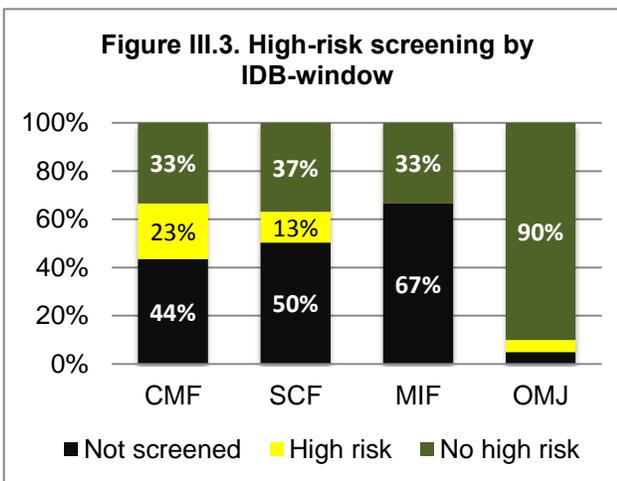
⁷ This information is also crucial for IDBG's internal approval of operations, including also NSG operations, which is subject to disclosure under IDB's *Access to Information Policy*.

⁸ Specifically, there are 202 FI operations for IDB's different windows (SCF, CMF, MIF, and OMJ) in the portfolio of this evaluation, excluding 46 operations which were cancelled, not used, or dropped.

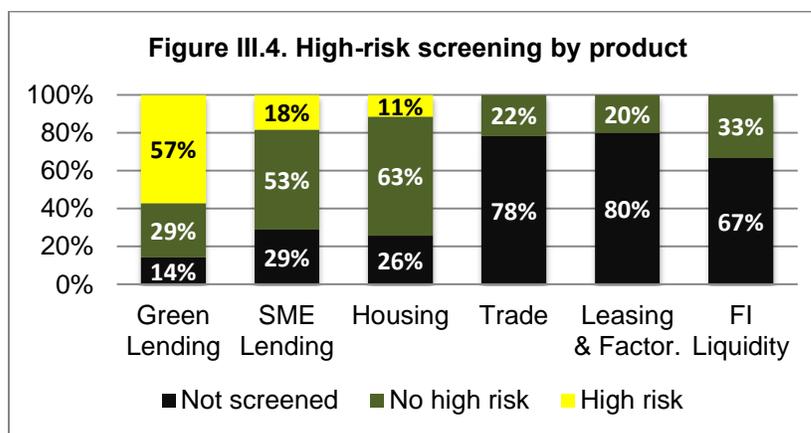
⁹ Data retrieved from IDB's safeguard screening and monitoring tool "Mr. Blue."

considered low risk and ESG prioritizing its supervision on higher-risk activities, and in part to data not having been appropriately entered into the system. Of the 24% that were monitored, 21% were rated by an E&S specialist as satisfactory and 3% as unsatisfactory, though OVE’s assessments differed in some cases from the ratings of E&S specialists.¹⁰

3.4 Screening for potential high risks differs across the different IDB windows, and so do risks. Of MIF operations, 67% had not been screened for potential high risks, compared to just 5% of OMJ’s operations (even though 90% of OMJ operations were considered low risk). CMF and SCF were in the middle, with about half of projects not screened. Of those screened, the highest percentages of operations with potential high risks were in CMF and SCF (Figure III.3).



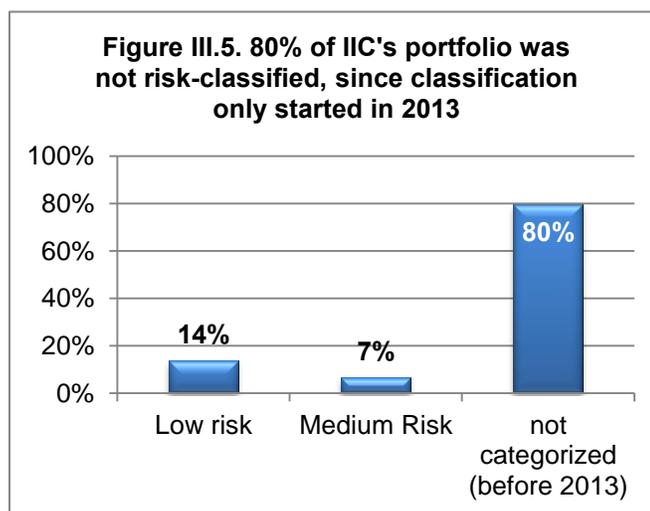
3.5 By product, green lending operations had the highest percentage of projects (86%) that had been screened and the highest percentage (57%) with potential high risk (Figure III.4). In three product groups – FI liquidity, leasing & factoring, and trade – over two-thirds of operations had not been screened. This might be justified for liquidity lines, as most of them had not disbursed, but leasing & factoring and trade operations do face considerable potential risks.



¹⁰ IDB had one green lending and two housing operations with a Peruvian commercial bank. This FI had been rated recently by ESG as satisfactory. However, during OVE’s mission trips the FI’s management could not demonstrate any E&S policy or implementation of an ESMS. In the case of an SG operation, the E&S performance of a Mexican national development bank was rated satisfactory, although there were critical issues regarding the ESMS’s capacity to respond to the high E&S risks of large-scale infrastructure projects.

3.6 **IDB's implementation guidelines require periodic assessments of a representative sample of the FI's subprojects.** However, OVE found little evidence, except for green lending, that this is being systematically carried out. IIC's guidelines do not have such a requirement.

3.7 **IIC could not provide supervision data about the rating of FIs' E&S performance.** Information about IIC's risk classification is available, but only since 2013. IIC's portfolio consists mainly of SME lending and some leasing & factoring. As has been noted, SME operations are in diverse sectors, and their E&S risks can range from low to high. Figure III.5 shows that IIC categorized 14% of operations as low risk, 7% as medium risk, and none as high risk. The very high level (80%) of operations not classified is due to the fact that IIC introduced risk classifications only in 2013.



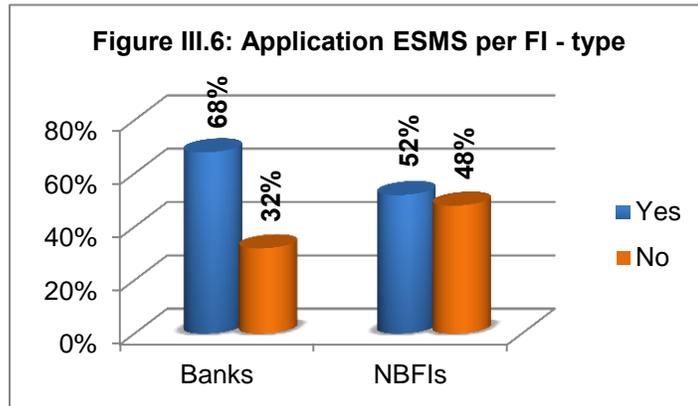
3.8 **IDBG's supervision of FIs' E&S performance is hampered by the weakness in information reporting by FIs.** While both IDB's and IIC's policies require the application of the ESMS just for specific subloans, the reporting format for FIs often lacks basic information on the subloans. For example, in many SME lending operations, the FIs' list of subloans indicated just the name of the individual borrowers and the amounts. Many FIs did not present even the name of the company, the sector, or the use of funds, for either the list of projects or the relevant portfolio. The FIs rarely presented a breakdown of their own risk classification. Where risk classifications were provided, most projects were typically classified as low risk, and neither OVE nor IDBG would be able to verify the appropriateness of the classification. In any event, given the fungibility of money, one would need to review a representative sample of the relevant portfolio – not just the self-selected list of projects – to appropriately judge E&S risks.

3.9 **The quality and specifics of nonfinancial covenants to mitigate E&S risks differ across IDBG windows.** Each of IDBG's windows handles E&S covenants differently. E&S covenants are often the first initial contact with this topic for FIs; therefore, the more clearly and precisely they are formulated, the better the FIs are informed about IDBG's policy. IDB's ESG unit has adopted new nonfinancial covenants for NSG operations financed through FIs. These financial covenants explicitly address all relevant definitions and requirements and provide good initial guidance about the different elements of an ESMS. IIC's covenants are less precise and just set out basic elements for an ESMS. For SG lending, E&S risks are

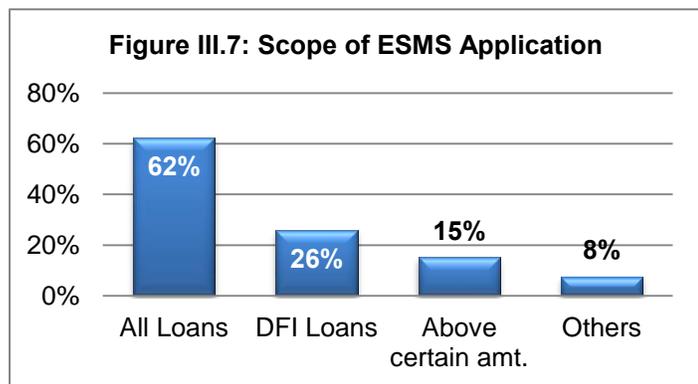
expected to be mitigated through the credit line’s operational manual, but such manuals are often vague and do not emphasize the importance of implementing an ESMS from the beginning. Covenants also do not routinely include references to the specific safeguard policies and the relevant policy directives.

B. FIs’ compliance with IDBG’s safeguard policies

3.1 **OVE conducted a survey for this evaluation asking FIs with IDBG operations if they apply an ESMS in their credit decisions.** Overall, 57% of banks and NBFIs indicated that they apply an ESMS in their credit cycle. Results of the survey show that banks (incl. 2TFIs) are more advanced than NBFIs in the application of an ESMS (Figure III.6): 68% of IDBG’s client banks apply an ESMS to their credit decisions, compared to just 52% of NBFIs. Results of two surveys on E&S issues conducted in 2012 by IDB’s beyondBanking initiative¹¹ and by the financial initiative of the United Nations Environment Program (UNEP FI)¹² also found that about 70% of banks applied an ESMS to their credit decisions. Among FIs indicating that green lending or the environment is a strategic priority, 82% apply an ESMS to their operations. A 2014 CMF study¹³ surveyed 17 national development banks in 9 LAC countries and found that just 41% of them had implemented a full-fledged ESMS. This shows that public national development banks are lagging far behind commercial banks and NBFIs.



3.2 **More than half of FIs applies their ESMS to all loans** (Figure III.7¹⁴). As mentioned above, 57% of FIs integrate an ESMS into their credit cycle: of those 62% of FIs applied an ESMS to all of their loans, and 26% apply their ESMS just to loans financed by DFIs and 15% to



¹¹ [IDB: Sostenibilidad ambiental, social y de gobierno corporativo en los intermediarios financieros de América Latina y el Caribe – segunda encuesta regional – \(2012\)](#)

¹² [UNEP – FI: Integración de la sostenibilidad en las instituciones financieras Latinoamericanas – encuesta regional \(2012\)](#)

¹³ [IDB: Managing Environmental and Social Risks: A Roadmap for National Development Banks in Latin America and the Caribbean \(2014\)](#)

¹⁴ Multiple answers were possible.

loans over a certain amount. Those FIs have implemented an ESMS but apply it only to loans over \$5 million or even more. Subloans to SMEs are often by definition below this limit.

- 3.3 **The development of E&S policies and implementation of an adequate ESMS are more likely when E&S risks for credit decisions receive attention and support from FIs' higher management levels.** Implementing an effective ESMS affects the way FIs do their business. FIs reported to OVE that the most important factor for the implementation of an ESMS was the support and commitment of high-level management inside the FI. Without this support no fundamental changes were triggered. Often E&S departments inside FIs are neglected and encounter strong internal resistance. Direct support by DFIs for the FIs' E&S departments can help to facilitate effective E&S performance by improving awareness and raising the priority given to E&S issues internally.
- 3.4 **The categorization of both FI operations and subprojects was not always appropriate.** FIs have generally classified microfinance, services, and trade finance as low risk, but this automatic classification can be inappropriate, given that trade transactions sometimes finance large companies and transactions in high-risk sectors, resulting in serious environmental and social issues (Box III.1). With their automatic low-risk classification, trade transactions¹⁵ are not screened and monitored by the ESG department. Although it is difficult to apply an elaborated ESMS to trade transactions, given their short-term nature, simple and quick online background checks may result in excluding companies or certain commodities in high-risk sectors. Such measures can be effective in mitigating E&S risks, and they are being applied by other DFIs.¹⁶

Box 3.4. Trade finance and pig iron in Brazil – E&S implementation issues

Using trade finance provided by IDB, a large Brazilian bank – known in the marketplace for its commitment to sustainability – financed a pig iron producer in Brazil through one of their Caribbean branches, with 47 transactions in 2013 and 2014 for a total amount of \$26.7 million. Before receiving the trade finance, the pig iron producer had already been convicted in 2011 of illegally purchasing charcoal and thus contributing to deforestation of over 9 million acres of Amazonian rainforest. The company was obliged to recover the deforested area or pay a fine of \$31.6 million. The membership of this pig iron company in the National Pact against Slavery had also been suspended since 2012, when the Ministry of Labor found 150 workers held in slavery-like conditions in a charcoal production site linked to its supply chain. The company was required to agree to a change in conduct. In 2015, the Brazilian Ministry of Environment announced an embargo against the company for violation of that agreement. Overall, this reflects the challenges of E&S safeguard implementation. In fact, IDB had properly structured legal covenants, including giving it the right to reject non-compliant projects and demand the application of national E&S law.

- 3.5 **OVE found evidence of cases in which the FI's risk classification and mitigation mechanism clearly indicated that the FI's ESMS was not able to**

¹⁵ For the evaluation period the list includes more than 5000 transactions and hundreds of different importers and exporters. It often involved operations in high-risk sectors like mining and production of chemicals, palm oil, and soybean. Thus there may well be cases among the trade transactions that are as serious as the ones uncovered during the evaluation.

¹⁶ For example, IFC checks the trade transactions it finances against a risk database that addresses E&S and other risks (e.g. KYC/AML and politically exposed persons risks). See info.risk.thomsonreuters.com or [IFC's Global Map of Environmental and Social Risks in Agro-Commodity Production \(GMAP\) Pilot](#)

respond independently and appropriately to IDB's safeguard policy (Box III.2). Particularly when FI operations finance large infrastructure projects (e.g., in green lending), it is important to have an effective ESMS in place before the FI starts to provide financing.

Box III.2. Wind farms in Mexico financed through a national development bank

Through an NDB IDB financed several wind farms in Mexico for over \$150 million. These wind farms had negative environmental impacts on migratory birds and were constructed in a sensitive area affecting indigenous populations. However, in a disbursement request to IDBG, the NDB categorized a wind farm as a low-risk operation. IDB also directly financed that same wind farm and classified it as a high-risk (category A) operation. The NDB indicated in the disbursement request that indigenous people were not affected by the project implementation, even though there was evidence of protests by indigenous people. This raises concerns about the effectiveness of the NDB's ESMS, particularly with respect to such high-risk operations. For other wind farms financed exclusively through the NDB, IDB had to rely on the ESMS capacity of the NDB. There are indications that the NDB's ESMS was based only on the application of local laws, and not on IDB's E&S policies. IDB's ESG unit tried to follow project implementation closely and made use of its right to object because of the insufficient information and weak mitigation measures provided by the NDB. However, the ESG unit was involved only at a very late stage, when the project had already been licensed by the Mexican authorities, and thus it could not confirm whether required public consultation with indigenous people (Directive B.6) had been conducted before project approval. Particularly for projects with high E&S risks, delegating the responsibility to a NDB with a weak ESMS is likely to result in poor E&S outcomes and create a reputational risk for IDB.

Photo: A committee of resistance to one of the wind farms that represented the major part of the total disbursed amount (\$128M) and was financed solely through the NDB.



- 3.6 **It was difficult to assess how IDBG's Independent Compliance and Investigation Mechanism should be applied to FI operations.** Grievance mechanisms are a vital instrument to ensure that affected communities can bring their complaints against operations financed by IDBG. OVE found little evidence that grievance mechanisms were an integral part of the organizational structure around FI operations. Usually neither loan recipients nor local communities were aware of IDBG's involvement.¹⁷
- 3.7 **E&S safeguards have been used mainly to mitigate E&S risks, but typically have not been seen as part of an integrated system to also achieve E&S benefits.** Both IDB's and IIC's policies contain a developmental mandate to not only mitigate risks, but also create E&S benefits for IDBG's operations. OVE

¹⁷ For a wind farm other than those discussed in Box III.2, with double financing (direct and through an FI), a complaint with respect to IDB's direct lending regarding land conflict issues affecting indigenous communities was submitted in 2011 to IDB's Independent Consultation and Investigation Mechanism. This was only possible because IDB was visible as direct lender, but it is difficult to see how communities could seek recourse for projects that are financed solely through FIs.



found little evidence, except in some green lending and an identified good practice in the housing sector (Box III.3), that E&S development benefits had been formulated as specific objectives or expected results of FI operations. An ESMS typically tracked the mitigation of negative impacts and did not include identification or tracking of positive effects.

Box III.3. Sustainable building eligibility criteria

In addition to applying E&S requirements, an incentive scheme was included in a SCF-financed securitization operation with a Brazilian securitization company. The structure offered more attractive financial terms for mortgages with sustainable building certifications or for those that met specific sustainable building criteria: efficient lighting and water usage, efficient use of construction materials, appliances that promote energy efficiency, recycling, and low carbon emissions. This nonfinancial environmental additionality, added to the E&S requirements, is a good example of how to promote the adoption of environmentally responsible practices among developers, lenders, and other participants in the Brazilian real estate financing market.



IV. IDBG ADDITIONALITY IN E&S SAFEGUARDS

- 4.1 **In consultation with Management and IDB's and IIC's ESG departments, OVE identified several cases in which additionalities to achieve compliance can be clearly attributed to IDBG.** These cases include training sessions and regional knowledge-sharing mechanisms, technical cooperation (TC) in which IDB offered customized support to FIs, and general guidance for FIs in their efforts to comply with IDBG's safeguard policies.
- 4.2 **FIs are often exposed to the topic of E&S for the first time through the operations they implement with DFIs.** Numerous FIs told OVE that DFIs had been the driving force for their establishing E&S procedures. If IDBG was the driving force, it was typically because it was the first DFI that engaged with that FI.
- 4.3 **FIs need guidance on developing E&S procedures, especially at the beginning of cooperation with DFIs.** When starting cooperation with IDBG, FIs often did not have E&S expertise and lacked even basic knowledge or contacts with E&S consultants. TCs were sometimes used to strengthen the FI's capacity, but usually only when FIs struggled to respond to IDB's safeguard standards, not proactively from the beginning of the operation. IIC has a different approach: it provided E&S training sessions and opportunities for knowledge sharing among different FIs throughout the region (Box IV.1). In one Brazilian commercial bank, IDB provided the staff a tailored seminar on the application of the ESMS.
- 4.4 **In some green lending operations, IDB provided well-appreciated additionality to develop E&S policies and implement an ESMS.** When FIs prioritize green lending, they are often already aware of the importance of environmental benefits. Though green lending can help mitigate the effects of climate change, it can involve infrastructure projects that carry high E&S risks. OVE identified three cases in which IDBG TCs, combined with green lending operations, helped FIs implement or refine the application of an ESMS (Box IV.2).

Box IV.1. Learning from each other – IIC's Sustainability Week

The annual IIC Sustainability Week is an example of how to promote organizational changes toward more sustainable business practices in FIs. Sustainability Week includes training sessions focused on environmental risk management, sustainable business opportunities, and corporate governance. All FIs with IIC funding are contractually required to participate in E&S training sessions to ensure compliance with IIC's safeguard policy. IIC started training courses in 1999, and since then around 1,700 people have been trained. This has also provided a mechanism for regional experience sharing. The main goal of the training is to support FIs in their implementation of the required ESMS. FIs reported that IIC's training was often a strong incentive to raise the importance of sustainability, which eventually led to the implementation of an ESMS. In some cases E&S training sessions helped FIs implement or improve application of their ESMS, and no further support was required. IIC's training sessions normally aim at training two or three key E&S experts in the FI. In a Mexican bank with two IIC operations, the FI's participation in training sessions helped it implement an effective ESMS covering all credit decisions.

Box IV.2. Green lending and ESMS

A private bank domiciled in Panama offering universal banking services to individuals and corporations in Panama and Costa Rica; also with offices in Mexico and Colombia has grown into the largest private bank in Panama. Since 2008 this bank has worked through 2 loans with IIC in the housing sector and 4 loans with SCF (1 trade, 1 green lending, and 2 housing operations), with a total approved amount of \$240 million. Because of its long-term relationship with SCF and IIC, the FI made many changes in its portfolio management systems. In 2008, after attending the IIC's Workshop on Environmental and Social Management and after the approval of the first IIC loan, the FI developed and implemented its ESMS. In 2009 IDB approved a green lending operation for \$20 million with the aim of establishing a green lending portfolio four times bigger than the size of the loan. Through the planetBanking initiative and with finance from the Sustainable Energy and Climate Change Initiative, TC had been provided to the FI. This TC helped the FI's management revise the eligibility criteria for green lending as required by the legal agreement and to implement procedures for the identification of operations for the green lending portfolio. The green lending operation had an excellent performance, reaching the expected result of establishing a green portfolio. Before the TC, the FI's ESMS applied only to corporate loans, but now, thanks to the TC, all credit risk decisions consider E&S risk factors, including a special procedure that takes into account the nature of mortgage loans and green lending. The green lending combined with the TC helped the FI sharpen its profile in contrast to its peers and position itself as a market leader in the sustainable green business sector in Central America.

- 4.5 **In 2014, CMF published guidance on why and how NDBs should manage E&S risks.**¹⁸ NDBs face different challenges than commercial banks when it comes to implementing an ESMS. For these public institutions the implementation of an ESMS typically takes longer than for commercial banks. The CMF publication gives good guidance for the different types of NDBs when acting either as first-tier financial intermediaries (1TFIs) (providing direct lending) or as second-tier financial intermediaries (2TFIs) (working through other FIs). For 2TFIs, it is even more challenging to implement an effective ESMS, as they have the same challenge as DFIs, having to rely on 1TFIs. However, 2TFIs also have the potential to affect E&S risk mitigation mechanisms in a large number of 1TFIs, and CMF promoted the use of this leverage. As has been mentioned, CMF surveyed NDBs in LAC for this publication. Because of the complexity of integrating E&S procedures for 2TFIs, only 14% of them – compared to 50% of NDBs acting as 1TFIs – had a full-fledged ESMS in place. Two case studies show differences between NDBs, one acting as a 1TFI and the other as a 2TFI (Box IV.3).

¹⁸ IDB: Managing Environmental and Social Risks: A Roadmap for National Development Banks in Latin America and the Caribbean (2014).

Box IV.3. National development banks and ESMS

Colombian 2TFI implementing a full-fledged ESMS with IDB's support

IDBG began working with the Colombian 2TFI in 2005, approving a total of 6 SME and 1 green lending operation (4 by IDB; 3 by IIC). In 2010 IDB provided a TC to the 2TFI to implement an ESMS aimed especially at supporting the efficient and effective management of E&S risks and opportunities arising from its second-tier operations. Implementing this ESMS was a long process; it took around 3 years to find consensual solutions for all involved actors and internal departments. The main challenge for the 2TFI was to delegate the responsibility and costs of E&S risk mitigation to 1TFIs. The 2TFI decided to create an incentive structure by providing in-house training sessions for the 1TFIs. The final arrangement of the ESMS is a shared responsibility: the 2TFI hired an E&S expert who is in charge of applying the ESMS for second-tier operations. The 1TFIs have to apply basic E&S procedures and are supported by the E&S expert. For cost-efficiency reasons, the ESMS is now applied to subloans over \$5 million; the amount limit and the shared responsibility may change in future. The Colombian green protocol, a voluntary E&S regulation for the financial sector, motivates more 1TFIs to implement their own ESMS. This will further help the 2TFI expand E&S risk mitigation measures to all of its second-tier operations.

IDB's support to elaborate an ESMS for the Uruguayan NDB

With IDB's support, the Uruguayan NDB, acting as a 1TFI, implemented an ESMS for its energy, infrastructure, civil engineering, and agriculture projects. The TC was part of the first and until now the only IDB operation, approved in 2014. By the end of 2014, the TC delivered first results by elaborating an ESMS offering the necessary tools and sector background information. The ESMS is a multi-factor approach used to assess potential E&S risks by taking into account size, type, context, and the loan amount of projects. The ESMS has clear and detailed procedures, stages, and requirements. The final version of the ESMS has been presented to high-level management for approval. This case shows that, especially where IDB has single operations with the FI, it is important to include, from the beginning of the operation, support for the elaboration of an ESMS.

4.6 Long-term relationships and repeat operations often improved the FI's E&S performance.

In nearly all cases IDBG had more success in influencing the FI when IDBG had more than one operation with it. Complying with IDB's safeguard policies and implementing an effective ESMS can require fundamental internal changes for FI management. Organizational

change typically requires time and persistence, and a relationship of trust and open communication between IDBG and the FI can be helpful (Box IV.4).

Box IV.4. ESMS long-term partnerships

IIC began working with a Chilean commercial bank in 2006 with a general SME lending operation. As a requirement for the IIC loan, staff of the FI participated in E&S training sessions provided by IIC. The FI had in total 3 operations with IIC, until 2011 when SCF started to work with the FI on a green lending operation. After building up a long-term and trustful relationship, the FI implemented an ESMS, especially intended to mitigate E&S risk associated with its (relatively higher risk) green lending portfolio.

4.7 IDBG treats implementation of an ESMS as a condition, but does not offer incentives for effective implementation of the ESMS.

IDBG bases interest rates on the risk of operations, but usually considers only financial risks. Although E&S risks also affect the performance and reputation of both the FI and IDB, they are not considered in determining interest rates. Some other DFIs (e.g., FMO) provide such incentives, lowering rates once the FI can prove effective implementation of the ESMS.

V. EXTERNAL FACTORS INFLUENCING E&S COMPLIANCE

- 5.1 **External factors often affected FIs' handling of E&S matters more than IDBG engagements.** Although in some cases improved E&S performance can be clearly attributed to IDBG, in others four external factors influenced that performance: (i) general E&S industry trends; (ii) E&S policies of the FI's own headquarters; (iii) engagement with other DFIs; and (iv) E&S banking regulations and self-regulation initiatives.
- 5.2 **Various international and multilateral organizations sponsor global initiatives to help the banking industry integrate sustainable and responsible principles into finance.** The United Nations Environment Program Finance Initiative (UNEP FI), launched in 1992 during the Earth Summit in Rio, is a platform of over 200 members from public and private FIs from the developed and developing world. The UNEP FI has strengthened the link between the financial sector and ESG challenges by offering a networking mechanism, training, E&S guidelines, and risk assessment tools. The Equator Principles,¹⁹ launched in 2003, are another important industry trend: 10 FIs in the LAC region have signed the principles. However, commitments to apply the Equator Principles cannot be taken as a confirmation that FIs are in compliance with IDBG's safeguard policies, because they apply just to investments over \$10 million and there are no independent checks on whether they are effectively implemented.
- 5.3 **IDB often worked with an FI that also received investments from other DFIs with stricter E&S requirements (e.g., IFC or European bilaterals), and these other DFIs had a stronger impact on the FI's E&S performance than IDBG.** According to the results of the benchmarking with other DFIs conducted for this evaluation, the trend among DFIs is to apply E&S requirements to the whole FI (Box V.1) rather than just to specific subloans, as IDB does.
- | Box V.1. Scope of application of E&S requirements by other DFIs |
|--|
| The scope of the E&S requirements of other DFIs varies: some apply exclusively to the portfolio financed, and some to the asset class or to the entire FI. The consensus among European DFIs (DEG, FMO and PROPARCO) is to apply E&S requirements to the entire FI, in some cases with a strong view that others should follow the same practice. CABEI and OPIC also follow a "whole FI" approach. FIs with an equity stake from IFC usually had a very strong E&S performance and well-resourced internal E&S departments. |
- 5.4 **In several LAC countries E&S topics have received increased attention through sector initiatives, self-regulation, and E&S banking regulations.** Banking regulations have imposed requirements in two countries, Brazil in 2014 and Peru in 2015 (Box V.2). Voluntary E&S initiatives among industry peers exist in three countries: green protocols in Brazil (1995) and Colombia (2013), and

¹⁹ The Equator Principles are based on IFC's E&S safeguard policies.

sustainable roundtables for the financial sector in Paraguay.²⁰ These sector initiatives create peer pressure among FIs and, combined with national political support, are a highly effective way to convey the importance of E&S risk mitigation to other FIs.

5.5 **In some cases IDBG worked with market pioneers to promote sustainable business practices, though it has not worked systematically with sector groups, banking associations, or regulators to promote E&S agreements or regulations.** Ensuring compliance with IDBG's safeguard policy for each single FI operation takes a lot of effort and time. Also, the more stringent IDBG's own requirements become by comparison with the market, the higher the risk that FIs will seek alternative forms of financing. A more efficient and effective approach may be to pursue sectorwide initiatives with the aim of developing a common E&S framework. Box V.3 describes how IDB worked with a single FI that later became a driving force for sustainable business practice in Colombia. Involving banking associations, regulators, and ministries can also be an effective way to convey the importance of E&S regulations.

5.6 **FIs perceive E&S procedures as not only a burden, but also a profitable business opportunity.** Sustainability, green, and social investments are not just buzzwords, but rather represent a growing market in the financial industry. More and more FIs acknowledge the potential of this market segment. In addition, pursuing sustainable business practices by promoting green investments and including E&S risk mitigation in credit decisions has reputational effects and can attract new investors and open doors to new markets.

Box V.2. E&S regulations and compliance

Though it is a positive development that countries adopt their own E&S banking regulations, it is important that IDBG ensure that gaps between local regulations and IDBG's safeguard policies do not lead to noncompliance. Two areas are particularly important in analyzing gaps between country regulations and IDBGs safeguard policies: reporting requirements and lending amount limits for applicability. For example, the new Peruvian E&S banking regulation requires the application of an ESMS just for project finance over \$10 million. And the Brazilian E&S regulation does not set out clear reporting requirements and supervision mechanisms to ensure compliance.

Box V.3. Colombia's sustainable market forces

In 2011 SCF supported one of the biggest Colombian commercial banks with a loan of \$30 million for green investments. This Colombian commercial bank was a pioneer in the Colombian green market, creating a demonstration effect on green investments with other banks. This FI also was one of the driving forces behind setting up the green protocol for the Colombian financial sector in 2012. The green protocol is managed by the Colombian Banking Association (ASOBANCARIA). The protocol also has high-level political support from the President of Colombia, a signing party to the protocol. This creates peer pressure for other banks to join the green protocol.

²⁰

In Paraguay, with the leading support of FMO, sustainable roundtables for the financial sector were established to elaborate sector guidelines for sustainable business practices. IDBG supported this initiative in a secondary role. In an interview, FMO described its support for establishing these roundtables as their most relevant success overall for their FI operations in recent years.



VI. GOING FORWARD

- 6.1 **The analysis in the paper points to the progress made in the IDBG and in LAC countries in designing and applying E&S safeguards, but also indicates that there is still a long way to go to reach the objectives that have motivated this work.** On the basis of the evaluation's findings, OVE has identified five areas where further efforts are warranted.
- 6.2 **First, IDBG should review and adopt safeguard policies for FI operations that take into account the fungibility of money and provide clearer internal guidance and procedures for the implementation of those policies.** This includes guidance on conducting coherent risk classification and gap analysis and formulating action plans. While in 2013 IIC adopted E&S guidelines covering FI operations, IDB lacks such clear guidelines. IIC considers the relevant portfolio for risk classification, but not always for the scope of application of ESMS, while IDB focuses solely on the use of proceeds. Given the fungibility of money, considering the characteristics of the relevant portfolio (class-of-assets approach) is more appropriate than relying only on a list of projects self-selected by the FI. At least for subordinated loans and equity stakes, IDB and MIF should consider applying requirements to the whole FI portfolio, as IIC already does. As mentioned in the recommendations of the overall evaluation, the measurement of the results of FI operations needs to be based on the overall relevant portfolio. This applies also to the E&S compliance of FI operations.
- 6.3 **Second, IDBG should consider using incentive structures by offering better financial terms when FIs have implemented an ESMS meeting certain conditions and also when additional E&S benefits are achieved.** Favorable financial terms are normally derived from lower risks. IDBG could thus consider structuring FI operations in such a way that interest rates are lowered once FIs can demonstrate that they have effectively mitigated E&S risk, or offering better terms once environmental benefits are achieved, as IDB has already done in the case of the sustainable building securitization in Brazil.
- 6.4 **Third, IDBG could improve levels of compliance of FI operations with IDBG safeguards policies by improving guidance on how to implement an ESMS and focusing on closing compliance gaps.** IDBG could from the beginning provide FIs with stronger guidance on how to implement an ESMS based on their portfolio characteristics (e.g., sector, size, type and nature of investments). Compliance gaps with respect to different product profiles could be assessed and then closed. FIs often lack E&S expertise for their operations and for the sectors they operate in. In addition to training, IDBG could provide guidance documents for different product profiles, including description of associated E&S risks, for processes of risk classification and for mechanisms of supervision. It will be important that requirements be tailored to the size and risk of the subloans. For green lending – especially when large infrastructure projects are involved – establishment of a functional and effective ESMS could be a precondition for disbursement. For trade finance, the automatic low-risk classification could be

changed to an approach that takes into account sector risk, perhaps with basic checks on the client companies receiving financing.

- 6.5 **Fourth, IDBG could improve its own supervision by improving reporting on the ESMS and on a representative sample of the relevant portfolio, instead of a self-selected list of subprojects.** A standard template could be used for FIs to assess the efficacy of the ESMS, with a particular focus on the gaps identified at appraisal. Periodic reviews of a representative sample of the relevant portfolio, already required by IDB's (but not IIC's) safeguard policies, could be done by using local consultants and running periodic background checks on companies operating in high-risk sectors.²¹ The effort could be significantly strengthened without extra effort by making lists of subprojects representative (not self-selected) and by including basic information, including names of companies,²² type and nature of subloans in the relevant portfolio, and breakdowns of E&S risk classifications. It would be beneficial to consistently document the supervision of the FI's safeguard performance in IDBG's internal databases.
- 6.6 **Fifth, IDBG could promote common national E&S risk mitigation frameworks and build on its initiatives for the financial sector.** In addition to project-level E&S risk mitigation, IDBG could pursue a systemic approach of promoting the implementation of common national E&S risk mitigation frameworks. IDBG could elaborate status-quo analysis and strategies for interested countries on how to promote common national E&S risk mitigation frameworks for the financial sector, and could identify and work with change agents or market pioneers with the aim of establishing initiatives, agreements, or regulations involving public and private FIs, banking associations, regulators, and national authorities. IDBG could also further build on its regional role, providing training and platforms for knowledge sharing among FIs, such as the Sustainability Week and beyondBanking.

²¹ This may include the elaboration of "hot lists" of temporary exclusions of companies, sectors, or commodities that are known to face serious E&S issues in each country.

²² When the relevant portfolio contains only a small number of companies, a sectoral breakdown could be provided instead.

