'Ulu Foundation - 11.11.11- Coalition of the Flemish North-South Movement - Accountability Counsel - ActionAid International - Article 19 - Asociación Ambiente y Sociedad - Bank Information Center - BankTrack - Bretton Woods Project - CNCD-11.11.11 - Equitable Cambodia - Eurodad - Friends of the Earth Japan - Friends of the Earth US - Fundación Jubileo Bolivia - Fundar - Analysis and Research Center - Global Witness - Inclusive Development International - International Rivers - Latindadd - Oxfam America - Pacific Environment - Programme for Social Action - Re:Common - The Social Justice Committee of Montreal - urgewald

Jin-Yong Cai, Executive Vice President
International Finance Corporation
2121 Pennsylvania Ave, NW
Washington, DC 20433
United States

17 March 2014

RE: IFC investment in the financial sector

Dear Mr Cai,

We are writing to follow-up on your 6 January reply to our November 2013 letter about the International Finance Corporation's lending to the financial sector. While we welcome the constructive dialogue we have had to date, and some of the positive steps taken to try and improve upon the effectiveness of financial market lending, we would like to reiterate that on the whole the IFC's action plan in response to the CAO audit on financial intermediary lending is not yet adequate.

We urge you to:

1. **Immediately revise this action plan to comprehensively address the CAO audit's findings before implementation of the action plan begins**; and
2. **Launch a review to develop a new group-level strategy for investments in the financial sector to fundamentally rethink the nature, purpose, modalities and limits of these investments**.

In your communication to us, you outlined that the IFC "approach to managing the environment and social (E&S) risks of our investments with financial institutions is a management systems approach". We do not accept an approach which is limited to the management systems approach. The IFC staff should be publicly accountable for the real – not theoretical – development outcomes of the IFC's investments, while ensuring that no harm is done to communities and the environment. We fundamentally reject a model in which, by design, the IFC cannot know that its investments contribute to poverty reduction or avoid harm. Even if the IFC's approach is "recognised as market best practice", though the CAO notes evolving practice not implemented by the IFC[1], it does not refute our stance that IFC practice is not good enough. Better practice requires a focus not just on management systems, but also on results for the environment, and social and developmental outcomes.

Implementing the action plan as it stands will mean the IFC has largely ignored the CAO's findings and the most important recommendations from civil society organisations. This is especially pertinent as the World Bank Group looks to greater emphasis of the private sector in enacting the corporate goals of ending extreme poverty and promoting shared prosperity.

[1] For example: "There is an opportunity for IFC to utilize evolving tools developed through multi-stakeholder processes for corporate reporting and verification that could help to further the development of global E&S norms, as well as facilitate more effective utilization of IFC resources by establishing disclosure of E&S impact as a direct responsibility of their clients." *CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries*, p 40.

A number of recommendations to improve the IFC's short-term action plan are included in the attached briefing. However, **we reiterate that these modest measures are only initial first steps towards resolving some of the fundamental problems with the IFC's overall strategy in financial market investment.** We outline our priorities in six key areas, with a focus on FI-1 and FI-2 clients and high risk subclients:

1. *Sequencing of action*: capacity building must come before investment in clients with low capacity;
2. *Risk categorisation*: the IFC must also significantly improve its systems;
3. *Contractual arrangements*: all contracts should be public and include sanctions for E&S breaches;
4. *Transparency*: all FI-1 and FI-2 sub-projects should be disclosed and affected communities informed of IFC involvement;
5. *Supervision*: sites visits for all FI-1 subclient validation must happen annually, include transparent reports on outcomes and engage with communities; and
6. *Third-party verification*: development and E&S outcomes must be independently verified.

Beyond that, proper implementation of the performance standards within FI investment, and better development outcome measurement should not be viewed as a 'cost', but as an indispensable way for the IFC to achieve its mandate, economic development. The vast expansion in financial markets investment has rapidly outstripped the capacity of IFC environmental and social specialists to keep up. Yet the board has recently rejected a request for additional capacity. If IFC does not have the capacity to provide the minimal transparency and supervision as per our recommendations, **we recommend that the IFC undertakes fewer investments in the financial market sector, but does them better**.

We expect that CAO investigations that are already in progress on cases in Honduras and Cambodia will provide further evidence of our concerns and will lead to more negative publicity for the IFC. While we welcome the opportunity to continue to consult with IFC staff on these issues, consultation to date has not been effective because of continued refusal to share information and unwillingness to accept the CAO's findings. Additionally, IFC staff have promised but failed to deliver on dialogue with civil society groups outside North America and Europe.

IFC management's refusal to see that the core of the problem lies with the "management systems approach" itself, has led us to conclude **that the World Bank Group needs a new group-level strategy for investments in the financial sector to fundamentally rethink the nature, purpose, modalities and limits of these investments**. We would be willing to consider working with you to establish a formal external, independent advisory board to develop this new strategy. Such an independent group should be made up of representatives from civil society organisations such as NGOs and trades unions, as well as experts. **We would invite you, and not only staff, to meet directly with us to discuss our proposed short-term revisions of the action plan and our call for a new strategy for these investments**. We look forward to your positive response to this request.

Yours sincerely,

Jesse Griffiths, Director, Eurodad, Belgium
Vijayan MJ, Director, Programme for Social Action, India
Peter Chowla, Coordinator, Bretton Woods Project, United Kingdom
Patrick Alley, Director, Global Witness, United Kingdom
Chad Dobson, Executive Director, Bank Information Center, United States
Ray Offenheiser, President, Oxfam America, on behalf of Oxfam International
Stephanie Fried, Executive Director, 'Ulu Foundation, United States

Antonio Gambini, Centre national de coopération au développement, CNCD-11.11.11, Belgium
Pol Vandevoort, Policy officer, 11.11.11- Coalition of the Flemish North-South Movement, Belgium
Juan Carlos Nuñez, Executive Director, Fundación Jubileo Bolivia, Bolivia
Eang Vuthy, Executive Director, Equitable Cambodia, Cambodia
Derek MacCuish, Executive Director, The Social Justice Committee of Montreal, Canada
Margarita Florez, Executive Director, Asociación Ambiente y Sociedad, Colombia
Korinna Horta, Program Director, urgewald, Germany
Antonio Tricarico, Re:Common, Italy
Hozue Hatae, Public Finance and Environment Program, Friends of the Earth Japan, Japan
Mariana Gonzalez Armijo, Fundar - Analysis and Research Center, Mexico
Johan Frijns, Coordinator, BankTrack, Netherlands
Oriana Suarez, Coordinator, Latindadd, Peru
Soren Ambrose, International Advocacy Manager, ActionAid International, South Africa
David Banisar, Senior Legal Counsel, Article 19, United Kingdom
David Pred, Managing Director, Inclusive Development International, United States
Doug Norlen, Policy Director, Pacific Environment, United States
Jason Rainey, Executive Director, International Rivers, United States
Michelle Chan, Program Director, Friends of the Earth US, United States
Natalie Fields, Executive Director, Accountability Counsel, United States

cc: IFC Executive Directors
James Scriven

Recommendations for immediate changes in the IFC action plan on financial market lending

1. Sequencing of capacity building and investment

The CAO audit report included:

> "The panel concluded that IFC's approach to its clients is based primarily on the nature of their business and their products. This has precluded IFC from creating a systematic approach to identifying potentially challenging clients in terms of E&S performance at the outset of the relationship and deliberately allocating the additional relationship and possibly financial resources needed." (p 30)

While the action plan promises "to engage directly with leading FIs in the various markets to help build their capacity", there is no discussion of the IFC' client choice criteria or the sequencing of capacity building and IFC investment.

If the IFC continues to choose clients with low capacity in E&S issues and development outcomes, then the IFC should expect nothing more than continued failure to properly implement the performance standards and failure to achieve development impact. **The IFC must choose clients more carefully, and in a standardised, systemic and transparent manner.** The IFC must be explicit and transparent about how it measures proposed client's baseline capacity. Setting up new metrics for client choice should involve consultation with all stakeholders, but at a minimum we recommend that it includes client commitment to World Bank Group goals as determined by the client's structure and governance. Purely profit-oriented corporations aimed at maximising return for shareholders should not be viewed as being align with Bank Group goals. Ratings on new metrics must be provided in standardised formats and published publicly, for example in the E&S review disclosed before a board decision.

Should a client be selected that has low capacity to handle social and environmental risks**, capacity building must come before investment.** This is especially relevant as the World Bank Group looks to invest more in 'frontier' markets, fragile and conflicted states. The CAO sampling shows that many clients receive numerous investments, demonstrating why client selection and upfront work on capacity building are important. This is especially true as formal requirements for compliance with the performance standards are often not included until later investments.[1] Approving an investment without first conducting capacity building, and having proof of self-sustaining cultural change within client organizations, risks the clients using the IFC's resources inappropriately, leading to harm to communities and the environment, as they have not yet developed the appropriate commitment or systems for managing E&S risks.

2. Risk categorisation

The IFC must also significantly improve its systems for risk categorisation, as incorrect risk categorisation exacerbates other problems and potential community harm. This is especially true if risk ratings are used as triggers for greater due diligence and supervision. FI cases brought to the CAO almost always fail in categorisation as one of the initial root causes, especially in that FIs application of standards are applied commensurate of risk.

Arguably the fundamental problem with IFC risk categorisation is that it is ultimately a discretionary process, left to the subjectivity of the staff who make the determination. For example, we have seen projects deemed FI-2 on the presumption of there being lower risk because the projects were micro-

[1] See *CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries*, Appendix H.

finance or trade finance loans, despite there being evidence of an exposure to land issues[2]. Additionally, there is a concerning disconnect between investment teams and E&S teams in making this determination, as they having differing interpretations of the types of risk and engagement in identifying project risks. For example, there is a rigorous and robust assessment of credit risk by the investment staff, and a limited, almost secondary consideration made on E&S risks.

We believe **there needs to be ex-ante involvement of E&S staff at project inception stages**, including the internal due diligence assessments. **The IFC should develop new internal guidance notes for staff** which better standardise the risk categorisation process, including outlining additional thematic areas where a project could have exposure to higher risk areas such land, agribusiness, or based on size of the portfolio of the client.

There is acknowledgement within IFC that FI-2 is too broad of a catch-all, and some have proposed a four tier categorisation scale to better distinguish high and low risk FIs. The EBRD has an indicative list of Category A investments, and the IFC could usefully produce similar lists for FI-1 and FI-2. This could be part of both an interpretation note and/or an internal guidance note. The internal guidance note should also break the strict segregation of credit risk and E&S risk by highlighting the examples of projects where poor E&S outcomes led to poor development results and reduced profitability. The IFC should endeavour to find ways to incentivise staff to improve the robustness of risk categorisation.

The IFC also needs to develop better guidance for IFC financial sector clients to use in their risk categorisation of subclients. Particularly for FI-1 and FI-2 subclients, **the IFC should ensure that the client E&S management system includes an effective classification of subprojects that is equivalent to the IFC in all key respects** (definition of significant impacts, exclusion list, independence review and clearance at concept stage of the project cycle, and public signalling of categorisation decision to affected people). IFC must verify that this component of the ESMS is functioning by taking a random sample (minimum of 10 per major business line) of client subprojects to validate adequacy of risk classification at appraisal. Risk categorisation for a smaller random sample of subprojects (minimum of 5 per major sector) should be validated during each supervision visit (see below).

3. Contractual arrangements

The audit found:

> "a number of examples where failure to comply with E&S covenants in legal agreements did not cause IFC to refuse additional IFC financing, although IFC staff advised that it was not accepted practice to do this. Several portfolio managers voiced the opinion that exiting a facility based exclusively on a default on the legal provisions related to the E&S requirement could be challenging, based on the formulations used in the legal agreement." (p. 31)

It is simply unacceptable that this significant problem has been left unaddressed by the IFC action plan. The recent case related to Corporacion Dinant is illustrative of the IFC's lack of enforcement of existing E&S requirements.[3] Dinant was in clear violation of the performance standards, according to the IFC's own site visit reports, but a second disbursement to Dinant was only held up because of civil society organisations' complaints about the project. This indicates the need for stronger enforcement of whatever existing contractual arrangements there are, and for stronger contractual arrangements to be developed. The IFC's subsequent 2011 investment in FICOHSA, despite non-

[2] See http://effectius.com/yahoo_site_admin/assets/docs/LetiziaDellAsin_Newsletter11.5424106.pdf
[3] See http://www.cao-ombudsman.org/cases/case_detail.aspx?id=188

compliance on the direct loan to Dinant is also problematic, given that Dinant is the third largest client of FICOHSA.[4]

Similarly in the case of rubber plantations in Cambodia and Laos, the Vietnamese subclient made material disclosures to financial regulatory bodies in Europe about potential violation of domestic laws. This should have been a red flag for both the IFC and its client Dragon Capital, and triggered immediate action. However the IFC and its clients may have had little leverage given the contractual limitations.

All new IFC contracts should include language requiring suspension of IFC support and immediate refunding of investment, without prejudice or fee, and the imposition of sanctions (including financial), in the event of breach of environmental and social requirements[5]. IFC financial sector clients should also be contractually required to include IFC's Performance Standards on Environmental and Social Sustainability in their contracts with all sub-clients. The IFC must include enforceable provisions with clear time-bound triggers open to public scrutiny. We also believe **the IFC should publish all of its contracts**, with appropriate redactions to handle commercial sensitivity, as a confidence building measure.

Finally, **contract revision needs to be done retroactively, so that the IFC renegotiates existing contracts or writes new legally enforceable side-letters that include these provisions into its entire portfolio.** The IFC should make clear to clients that failure to agree to these terms would make them ineligible for further IFC funding.

4. Transparency

Another key finding of the CAO audit[6] is that:

> "the constraints posed on disclosure effectively mean there is no information publicly available about the end use of IFC's funds. IFC discloses information about the primary activity it funds. In the case of intermediary financing, this is the IFC client (the financial intermediary). In the CAO's sample, depending on the type of client and investment, there were parts of the sample portfolio where IFC itself did not have the information on the end use of funds available, other than on an aggregated level collected by the client, and mainly based on the size of the loan provided to subclients" (p. 25)

Accountability is a fundamental requirement for multilateral finance provided by a public institution, and essential if the World Bank Group wants to credibly achieve its corporate goals. However accountability is impossible if there is no information about the ultimate destination of funds. Affected communities already have difficulty accessing appropriate information in a timely fashion for IFC direct investment projects. The challenges are far greater for the use of funds by subclients of the IFC's financial sector clients. If the IFC is not even aware of the use of its funds, it will be impossible for affected communities to be able to seek redress for any harm done. There is also inadequate consideration of language and information access constraints of affected people, precluding access to remedy for harm done.

Cases in Honduras are emblematic of the problem. Communities, which had complained about the IFC's direct investment in Dinant, had no knowledge or information about the IFC's subsequent FI investment in the commercial banking partner of Dinant. This would have remained a problem irrespective of the 2012 performance standards being applied. While the CAO is still investigating

[4] See http://www.cao-ombudsman.org/cases/case_detail.aspx?id=209

[5] Note that civil society groups also feel that the existing performance standards are not strong enough, particularly around human rights due diligence, lack of independent verification, and insufficient attention to implementation issues.

[6] http://www.cao-ombudsman.org/documents/Audit_Report_C-I-R9-Y10-135.pdf

the FICOHSA investment, on the face of it, it lays bare the problems with transparency around subclients of IFC financial market clients. Had there been no CAO investigation of the direct investment, information about the financial links through FICOHSA would likely never have come to light. In any similar situations, where the IFC does not have a direct investment, harm to the communities would occur without accountability or possibility for redress. Complaints also surfaced about IFC involvement, through financial intermediaries, in the Agua Zarca dam, which has been rejected by indigenous people[7]. Indigenous groups had no reliable information about which, if any, IFC-funded financial sector clients were financing the hydropower project, initially believing that FICOHSA had a stake. Ultimately this was denied by FICOHSA and the IFC, though the IFC failed to tell the affected communities that another IFC client, CAMIF, was considering an investment in the project.[8]

The IFC action plan only proposes: “PE funds disclose all projects starting on a best efforts basis to establish feasibility and client implications, before formalizing.” This is insufficient, as it neither covers all FI-1 rated clients nor the vast majority of IFC financial market lending which is classified as FI-2. As a case in point, the FICOHSA investment would not have been covered by this provision, as FICOHSA is a commercial bank and not a PE fund. **We believe the IFC and its FI client should take responsibility to ensure that all FI-1 and FI-2 sub-projects should be disclosed, in a manner and language accessible to affected communities, as a mandatory part of IFC investment**.[9] We understand that the IFC believes banking regulations in some markets would preclude these disclosures for commercial banking clients. However commercial banks already have exceptions to the duty of confidentiality related to public interest.[10] Further exceptions can be made with customer consent, emphasising the importance of new IFC requirements for contractual provisions between clients and subcients. In loan documentation client-subclient contracts can include express consent for the IFC client to disclose the existence of the financial relationship, while still maintaining confidentiality over the entire scope of the relationship, its commercial terms, and some of the subclient’s private information. The IFC can phase in these requirements over time, with a clear timetable to help build capacity and make any necessary legal changes.

The action plan proposes that FIs disclose “means to access their public communication mechanism in their annual reports”. This is an impractical response that does not solve the problem of communities being unaware of the FIs involvement, let alone the IFC’s involvement, in investments which affect their lives and livelihoods. To ensure accountability, **the IFC needs to require FI clients to demonstrate that communities who will be affected by the activities of FI sub-projects are informed of IFC’s involvement and the IFC’s performance standards**, **and aware of the availability of the CAO in the event they experience harm**.

5. Supervision

A key finding of the CAO audit[11] is that:

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[7] See http://www.brettonwoodsproject.org/2013/12/ifc-financed-private-equity-fund-implicated-honduras-dam/.

[8] Similar transparency problems bedevilled communities in Odisha who have complained about a thermal power plant being developed by an IFC subclient (http://www.cao-ombudsman.org/cases/case_detail.aspx?id=165) and communities in Cambodia who have complained about rubber plantations being developed by an IFC subclient (http://www.inclusivedevelopment.net/world-bank-group-implicated-in-illegal-seizures-of-indigenous-land-in-cambodia-and-laos-communities-call-for-banks-help-to-get-their-land-back/).

[9] Guidance to FI clients about the scope and adequacy of the subclient information disclosed should be modelled on the IFC’s own disclosure policy, meaning more information than simply subclient name, title of investment and investment amount.

[10] Cranston Ross, *Principles of Banking Law* (Second Edition, Oxford University Press 2002), p 174-5.

[11] http://www.cao-ombudsman.org/documents/Audit_Report_C-I-R9-Y10-135.pdf

> "IFC does not have the tools to measure E&S performance at the subclient level to confirm that there has been no harm" (p. 36).

As we have pointed out in previous communications with you, IFC's inability to ensure its projects and their clients do no harm is the most worrying aspect of FI lending – as is demonstrated by new cases continuing to emerge since the CAO audit of harm resulting from IFC's FI investments[12]. In fact in the system agreed with FI client Dragon Capital, the IFC's supervision was so weak that neither IFC or Dragon Capital noticed that when subclient HAGL listed on the London AIM Stock exchange, it admitted in public documentation that it knew its plantation holdings in Cambodia and Laos did not have the correct legal permits and licenses.[13]

Supervision – one of the concerns highlighted by CODE in its April meeting[14] – can provide an opportunity for IFC to monitor and address the impacts of its investments. However, IFC's proposals in its action plan in regards to supervision fall far short of any commitment to assess adequately the outcomes of projects it invests in. IFC currently carries out an insufficient number of supervision visits to clients at approximately 150 annually.[15] The action plan proposes to increase the visits to FI clients by 30 – which would still represent only 20% of clients, despite 40% of clients being classified by IFC as high or medium risk.[16]

The picture for sub-clients is worse: the IFC claims to have visited 150 sub-clients since 2006.[17] The action plan gives no clear target for this to increase, only that from now on all FI-1 and high-risk FI-2 sub-clients will be subject to 'validation'. Crucially this 'validation' need not include a site visit, but can comprise "loan file reviews or a combination of loan file reviews and field visits to sub-client sites". Additionally, there are conflicts of interest in allowing IFC investment staff to determine the necessity for site visits. We believe **all FI-1 subclient validation must include at least one site visit annually. The IFC should also apply it's at least once every three year FI client site visit requirement to all subclients above a certain threshold in size.**

As the CAO points out[18], even supervision visits to clients or sub-clients may be ineffective however, unless accompanied by tools and procedures for measuring impact:

> "While IFC does visit some subprojects during its supervision process, the absence of any systematic measurement of impacts or outcomes at the subclient level means that IFC is unable to measure the actual effectiveness of the SEMS requirement." (p. 29)
>
> "During its supervision activity, IFC also selectively visits sub-projects to validate implementation of the SEMS. As is discussed below, however, none of these approaches systematically tracks or measures E&S impact at the subclient level. They also do not

[12] Including the displacement of forest communities in Laos and Cambodia (http://www.globalwitness.org/rubberbarons/), the allegations of human rights abuses in Honduras (link to CAO complaint) or coal project-affected people in India (http://www.cao-ombudsman.org/cases/documentlinks/documents/CAO_Appraisal_IndiaInfrastructureFund_June262013.pdf)

[13] See *Rubber Barons*, Global Witness, April 2013, page 35, Box 4.

[14] IFC claims that CODE "emphasised the need for a sampling of subclients, with a balanced evaluative approach." IFC action plan: *E&S Risk Management of Financial Institutions at the IFC: Presentation to the Committee on Development Effectiveness September 4th 2013*

[15] The IFC action plan on page 8 shows 145, 163 and 140 FI client visits in each of the last three years.

[16] The IFC claims 900 clients of which 180 (existing 150 plus proposed 30) to receive supervision visits. See Graph page 4 of the action plan for breakdown of client risk profile.

[17] In its letter to civil society of April 2013, IFC writes "We have conducted over 150 sub-client field visits for sub-projects since the 2006 Policy framework to validate the work of our FIs, following a risk-based approach." IFC letter to civil society 18 April 2013.

[18] http://www.cao-ombudsman.org/documents/Audit_Report_C-I-R9-Y10-135.pdf

> measure the expanded objectives of the 2012 Sustainability Framework, which are to move beyond doing no harm to having a positive development outcome." (p. 25)
>
> "There is an opportunity for IFC to utilize evolving tools developed through multi-stakeholder processes for corporate reporting and verification that could help to further the development of global E&S norms, as well as facilitate more effective utilization of IFC resources by establishing disclosure of E&S impact as a direct responsibility of their clients." (p 40)

We conclude that IFC's current proposals for its supervision of clients and sub-clients will not enable it to address the CAO's core criticism: that the IFC has no means to ensure its investment through FIs do no harm. **The IFC needs to significantly increase subclient supervision in a way that looks at the development, environmental and social impact**, with clearer implication of these visits on the ESRR and DOTS ratings of the project. This will imply higher intensity of engagement on site visits. We **insist on disclosure of the results of supervision visits** to both clients and subclients, otherwise they do not increase public accountability. The IFC should also provide annual data on FI risk in the active portfolio, E&S staff capacity, and aggregate information on client and subclient visits.

This supervision would also give the IFC an opportunity to address concerns about project transparency, **as community engagement should be made an essential part of all subclient visits**, not least to ensure that communities who are affected by the activities of FI sub-projects are informed of IFC's involvement, its performance standards and aware of the availability of the CAO. Community engagement must be publicly documented. Such an increase in sub-client supervision will also additionally serve to help build capacity of clients and subclients in implementation of the E&S best practices.

6. Third party verification

A key finding of the CAO audit[19] is that:

> "In the investments in the sample, IFC had not explored the evolving industry practice of requiring the client to engage third-party verification of end use of funds. The CAO panel recognizes the significant challenge that any enhanced disclosure would constitute. However, the fact that the end use of such a significant proportion of IFC funding remains opaque is a matter of some concern." (p. 26)

We believe that the incentives in the IFC's current systems can generate conflicts of interest and are not well geared towards finding and minimising risk, let alone promoting positive development outcome.[20] DOTS indicators and project reviews are completed by IFC investment teams, who have a stake in the project's success and an incentive to cover up or remain ignorant of breaches of the performance standards.[21] Clients likewise have an incentive to report that they satisfactorily meet the performance standards, regardless of whether that is the case. The IFC action plan makes no effort to remedy these problems.

[19] http://www.cao-ombudsman.org/documents/Audit_Report_C-I-R9-Y10-135.pdf

[20] For example the CAO audit of investment in Wilmar Corp noted several instances of disagreement between environmental & social teams and investment teams, and found that the investment department's opinion always prevailed. See CAO audit C-I-R6-Y08-F096, 19 June 2009, pp 22-3.

[21] DOTS ratings are given by investment teams themselves, though the lead environmental and social specialists produce the E&S ratings for the DOTS. However, "The Portfolio Officer is responsible for ensuring that the client obligations including Social and Environmental Performance Report (SEPR) reporting are fulfilled." IFC-CESI Environmental and Social Review Procedures Manual, version 8, 31 May 2012. The CAO report on the Dinant case shows the internal incentive problems clearly, including highlighting that "When a more 'compliance based' approach to the supervision of the Dinant investment was thus raised, CAO finds that this elicited push back from the IFC portfolio manager as a result of which the lead environmental specialist working on the project was replaced." (p 54)

Financial auditing is a foundational part of business practice to counter malpractice and to ensure integrity and accuracy of financial reports. The IFC no doubt makes ample use of financial audits of clients which must be carried out by independent third party auditors. As the IFC claims to have a dual purpose of generating profit as well as development outcomes, it makes little sense that the IFC pursues independent verification of results on only the profit-oriented half of this mandate while not on the development outcome side. **Development outcomes, including environmental and social risk management and community engagement, must also be independently verified.**

Independent, third-party verification of appropriate handling of environmental and social risks would operate much like a financial audit with firms of auditors contracted by the IFC's clients to independently ascertain the impacts of subclient investments and projects. This could help ensure that communities do not bear the cost if performance standards are inadequately implemented. It would also provide assurance that provisions related to the performance standards, community engagement requirements discussed in point 4 above and the IFC exclusion lists are being implemented. Finally, independent verification of claimed development outcomes at both the client and subclient level would bolster IFC's ability to set targets and correct course in investments to reach development goals.

Just as IFC clients pay for their own financial audits, as a cost of doing business with the IFC they would have to bear the cost of an E&S and development outcome verification of subclients. Ultimately, **we believe annual third party verification should be applied for all high risk sub-projects in FI-1 and FI-2**, in addition to a random sampling of lower risk subprojects in FI-2 clients. The IFC should also require third-party verification of the environmental and social risks and development outcomes of certain FI-3 trade finance sub-projects, selected because of the size of the investment or the exposure in high risk sectors. As third-party verification is phased in, it would complement the increased supervision discussed in point 5 above.

In dialogue with us, IFC staff have said that capacity does not exist in the private sector for these verification processes. We find it incredulous that existing private sector players, including the four big international accountancy firms, would not respond to increased demand signals from IFC clients as the IFC phases in a third-party verification requirement. The IFC also has sufficient capital head room to develop the capacity of the private sector to undertake these audits by directly investing in auditing firms based regionally and/or in developing countries with the express intent of enhancing their E&S and development outcome auditing capacities.