

The IFIs and Financial Intermediaries in Europe and Central Asia: Implementation of Environmental and Social Standards

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Over the years, the roles of the international financial institutions (IFIs) have been changing. Once the seat of public sector development activity and controversial conditionality, the banks have increasingly shifted to private investments, particularly in Europe and Central Asia (ECA). The World Bank's private arm, the International Finance Corporation (IFC), along with the European Bank for Reconstruction and Development (EBRD) and Asian Development Bank (ADB), have prioritized private sector development, notably in the areas of finance, energy, and small and medium sized enterprises (SMEs). In August 2008, for example, the IFC announced a targeted focus on microfinance lending in Central Asia.ⁱ In the same month, IFC Executive Vice President and CEO Lars Thunell also emphasized financial sector projects during his visit to Central Asia.ⁱⁱ

For many of the IFIs, recent projects in the ECA region are heavily concentrated in the financial sector. Since 2000, 73% of disclosed EBRD projects in the Kyrgyz Republic have been listed as "lending to banks" or "non-bank financial institutions." The trend is significant in other ECA countries as well: 59% in Azerbaijan, 58% in Georgia, 51% in Kazakhstan, 40% in Mongolia, and 34% in Russia. For the IFC, Azerbaijan and Georgia lead the way with finance and insurance sector projects at 86% and 85% respectively of projects disclosed since 2000. They are followed by Mongolia at 75%, the Kyrgyz Republic at 60%, Kazakhstan at 44%, and Russia at 40%.ⁱⁱⁱ As these statistics reveal, financial sector projects comprise a major area of investment for many countries.

These projects often decentralize lending by filtering IFI assistance through financial intermediaries (FIs), which then distribute funds to various projects, companies, or other banks. Though the borrowing bank itself must commit to respective social and environmental standards, policies surrounding its lending practices are not as clear. The EBRD prohibits FIs from lending to certain types of activities, such as those involving child labor, and requires prior consent for lending to other projects, including those involving nuclear energy or involuntary resettlement.^{iv} Similarly, the ADB requires FIs to verify subprojects' compliance with state environmental requirements and consistency with ADB environmental policies.^v IFC projects in the sector are listed under a special categorization, "FI," unless they fit in the minimal risk category C. For FI

subprojects, the IFC adds certain forestry activities and exploitative labor to its Exclusion List.^{vi} Other projects receiving long-term financing from an IFC-funded FI are supposed to follow national laws where there are limited risks and IFC Performance Standards where risks are more significant. Each FI is also required to create a Social and Environmental Management System to monitor compliance with IFC requirements.^{vii} The creation of strong management systems by FIs that receive IFC financing would clearly be a welcome development.

Although these IFIs provide some guidance to FI lending, they lack adequate policies to deal with the specificities of FI activities. Even where stringent policies exist, it is not generally possible to monitor the use of IFI funds once they have passed through the receiving banks. The Independent Evaluation Group (IEG), the World Bank's independent assessment arm, expressed concern over the IFC's environment-related supervision of FI projects. The IEG noted that, even if a small percentage of subprojects carry risks, the aggregate impacts of these projects may be "significant." The group went on to recommend that the IFC expand its supervision and capacity building activities.^{viii}

Similarly, civil society groups have lobbied the IFIs to include more clear standards for FI projects.^{ix} A 2005 report by the World Resource Institute (WRI) on FI lending made a number of policy recommendations, including assessment of FIs with a transparent environmental and social risk rating tool, provisions that FIs without adequate capacity not fund category A or B subprojects; and requirements for FI disclosures of environmental and social standards applied to each subproject. WRI warned against over-reliance on national regulations, which are often poorly enforced. Instead, the IFIs, given their emphasis on sustainable development, should promote higher standards and provide tailored training to FIs.^x

Civil society groups are concerned the IFIs are sidestepping their oversight obligations, passing responsibility for social and environmental risks to less dependable FIs.^{xi} In recent years, the IFIs have improved their safeguard policies. However, the danger now is the seeming irrelevance of these policies to a large portion of IFI activities. Although not directly, FI subprojects are recipients of IFI assistance and must be held to the same standards as their directly targeted IFI counterparts. Private sector lending presents a valuable opportunity, not only for the expansion of business, but for the spread of environmental and social standards as well.

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ⁱ [Expanding Microfinance in Central Asia](#) (IFC website)

ⁱⁱ [IFC expands cooperation with Central Asia](#), Comtex, August 22, 2008 (Individual.com website)

ⁱⁱⁱ All statistics for the EBRD and IFC taken for projects disclosed between January 1, 2000 and August 18, 2008.

^{iv} [EBRD Environmental Exclusion and Referral List for FIs](#) (EBRD website, Acrobat pdf)

^v [Environmental Assessment for Financial Intermediation Loans and Equity Investments](#) (ADB website, Acrobat pdf) "The financial intermediaries must verify that subprojects in which they invest meet the environmental

regulations or other requirements of the country (or, as appropriate, state, provincial or local authorities), and are consistent with ADB's environmental policies This essentially means that financial intermediaries must screen projects and ensure that any legally required environmental report has been prepared and approved by the appropriate authorities, before approving any loan or investment. In the absence of such regulations, the financial intermediaries should verify that the environmental assessment meets the ADB's requirements as set out in OM 20." (1).

^{vi} [IFC Exclusion List](#) (IFC website)

"All financial intermediaries (FIs), except those engaged in activities specified below*, must apply the following exclusions, in addition to IFC's Exclusion List:

- Production or activities involving harmful or exploitative forms of forced labor²/harmful child labor.³
- Commercial logging operations for use in primary tropical moist forest.
- Production or trade in wood or other forestry products other than from sustainably managed forests."

^{vii} [Policy on Social and Environmental Sustainability](#), IFC, April 30, 2006 (IFC website, Acrobat pdf)

"28. Through its Environmental and Social Review Procedure, IFC reviews the business of its FI clients to identify activities where the FI could be exposed to social and environmental risk as a result of its investments. IFC's requirements for the FI client will be proportional to the level of potential risk:

§ FIs with business activities that have minimal or no adverse social or environmental risks will be considered Category C projects and need not apply any specific requirements

§ All other FIs will apply the Exclusion List

§ In addition to the Exclusion List, FIs providing long-term corporate finance or project finance will require the recipient of such finance to:

(i) follow national laws where the activity financed presents limited social or environmental risks; and

(ii) apply the Performance Standards where the activity financed presents significant social or environmental risks

29. The FI will be required to establish and maintain a Social and Environmental Management System to ensure that its investments meet IFC's requirements..." (6).

^{viii} [Conclusions: IFC](#), IEG (IFC website)

"The quality of IFC's environmental work at project appraisal has been good overall, but the quality of environment-related supervision of financial intermediary (FI) projects is a concern.

This is explained in part by limited in-house resources to visit FI projects. Even though the percentage of subprojects with environmental or social risks in the FI portfolio appears to be small, the aggregate impacts of a large number of subprojects may be significant, especially when FI clients lack resources to ensure proper mitigation of pollution. IFC has recognized this gap and has increased supervision resources and improved review processes for such operations."

"Improve sustainability of financial intermediary subprojects with environmental and social risks. FIs often do not have legal obligations to the host country to ensure sustainability of their subprojects, lack environmental management capacity, and are unwilling to hire external consultants because of the associated costs in a competitive market situation. There is thus a need for IFC to expand its own environmental supervision resources, nurture consultancies and partnerships to help FIs identify, monitor, and mitigate ESHS risks; and provide adequate capacity building and incentives for FIs and their clients to improve environmental performance."

^{ix} [From bad to worse: IFC safeguards](#), Bretton Woods Project, June 13, 2005 (BWP website)

^x [Multilateral Development Bank Lending through Financial Intermediaries: The Environmental and Social Challenges](#), World Resources Institute, June 2005 (WRI website)

^{xi} [Dubious Development: The World Bank's Foray Into Private Sector Investment](#), by Charlie Cray, The Multinational Monitor, Vol. 22, No. 9, September 2001 (Multinational Monitor website)