WRI ISSUE BRIEF

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Multilateral Development Bank Lending through Financial Intermediaries: Environmental and Social Challenges

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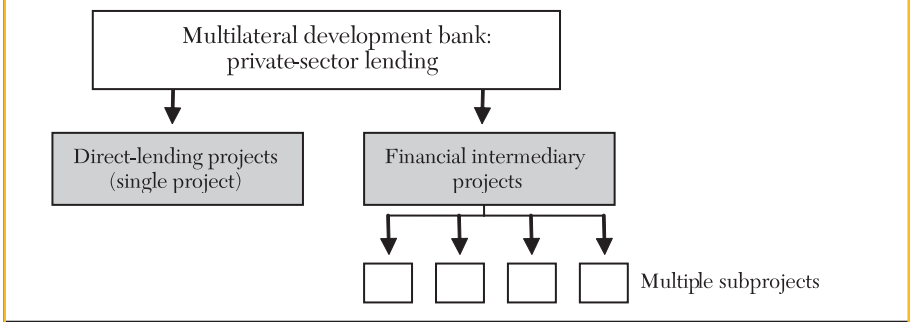
Introduction

This issue brief examines the growing practice of multilateral development bank (MDB) lending through financial intermediaries (FIs), reveals the likely environmental and social implications of this type of lending, and recommends ways in which MDBs can internalize the environmental and social costs of undertaking such operations.[1]

FIGURE 1 Lending Arrangements: Direct-Lending Projects versus Financial Intermediary Projects



Over the last decade, the volume of lending by multilateral development banks to domestic financial intermediaries—institutions that in turn lend to or invest in subprojects—in developing and transition economies has grown considerably. The development and expansion of domestic financial markets and the provision of financing to small, medium-size, and microenterprises are the primary goals of MDB investments in FIs. The MDBs maintain that the delegated nature of FI lending gives the domestic financial institution almost complete responsibility over investments in subprojects. Such decisions extend to identifying, assessing, and mitigating the likely environmental and social impacts of subprojects.

This policy brief is being released while both the International Finance Corporation (IFC) and the Inter-American Development Bank (IDB), two MDBs with large FI portfolios, are revising their overall environmental and social policies.[2] An independent review conducted by the IFC's Compliance Adviser/Ombudsman (CAO) noted that "the rapid growth of the proportion of the [IFC's] portfolio in FIs has outstripped IFC's capacity to conceptualize an effective Safeguard Policy system for FIs" (IFC 2003a, 48). Accordingly, new MDB environmental and social policy systems to govern FI investments and their impacts are needed.

Our analysis is based on the assumption that MDBs—as development institutions with explicit poverty alleviation and sustainability mandates[3]—are accountable for the environmental and social impacts of their financing activities in the traditional financing of projects such as roads and large dams as well as in FI projects. We argue that although the MDBs delegate subproject investment decisions to FIs, they still must hold FI projects to the same standards as those for traditional lending projects. The standards for traditional lending projects include procedural safeguards (for example, IFC's Operational Policy 4.01 on Environmental Assessment), technical standards (such as those specified by the *World Bank Group Pollution Prevention & Abatement Handbook*), and exclusion lists that restrict investment in certain activities. Because they are private financial institutions, FIs do not have the broader development mandates of MDBs. None-

Multilateral development banks are "institutions that provide financial support and professional advice for economic and social development activities in developing countries." This definition "typically refers to the World Bank Group and four Regional Development Banks—the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, and the Inter-American Development Bank Group."

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theless, FIs administer MDB funds and therefore must meet the MDBs' environmental and social standards, as appropriate, in the use of those funds.

By contrasting the differences between traditional and FI lending operations, this brief identifies the limitations of the MDBs and FIs to assess and monitor subproject investments, the need for FI-appropriate environmental and social standards, inadequacies in existing risk management mechanisms that rely almost exclusively on training and developing FI environmental management systems, and the systemwide lack of transparency and information disclosure mechanisms with regard to FI operations at MDBs.

This introduction is followed by a discussion of MDB lending through FIs, including the MDBs' rationale for investing in FIs. We then compare the environmental assessment practices for traditional and FI lending operations. The next section looks at the environmental and social challenges of FI lending. We conclude with recommendations for creating a new environmental and social policy system. Such a system would clarify the application of traditional MDB environmental and social safeguards to FIs and provide ways of developing capacity by targeting training to FI-specific needs and requiring greater transparency and disclosure of information to the public.

Methodology

Our analysis is based partly on information gathered from "not-for-attribution" interviews with 14 staff members at various MDBs, including the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB),[4] and the World Bank's private-sector arm, the International Finance Corporation (IFC). The two other major MDBs, the Asian Development Bank and the African Development Bank, were not included in the analysis as their intermediary finance operations are relatively limited at this stage.[5]

In addition, we surveyed 54 MDB publications produced by the institutions being reviewed. These publications ranged from statistical and analytical reports to policy literature addressing development challenges and opportunities related to financial market investments. We also collected information at nongovernmental organization (NGO) consultation meetings held at the IFC between July 2003 and September 2004, as well as from personal communications with representatives of civil society organizations. Our analysis was improved by the participation of staff from the relevant MDBs during the World Resource Institute's peer review process.

Financial Intermediary Lending at Multilateral Development Banks

Multilateral development banks (MDBs) are mandated to help developing countries improve their economies and reduce poverty. In the initial decades of their operation, MDBs carried out their mandates primarily by financing public-sector infrastructure projects in developing countries through the provision of sovereign loans (also known as direct lending) to governments (Buiter and Fries 2002).

Starting in the 1950s, MDBs began providing finance directly to private corporations as well. For example, in 1956, the World Bank Group established the International Finance Corporation (IFC) to provide credit and equity to private companies doing business in developing countries. Much of the MDBs' private-sector finance has been in the form of direct-lending projects, which are similar to their public-sector operations.

Over the last decade, however, MDBs have redirected a share of their financing away from direct lending to private companies undertaking individual development projects and toward the support of domestic financial institutions in developing and transition economies. For example, between 1998 and 2004 alone, the share of the IFC's support of financial-sector projects rose from 28.3 to 34.4 percent, peaking at 50.2 percent in 2002. Conversely, the share of IFC's total commitments to certain traditional, direct-lending sectors diminished during this period. For example, infrastructure-sector (including transport, warehousing, and utilities) lending fell from 24.0 to 17.5 percent, and oil, gas, mining, and chemical-sector

investment declined from 24.2 to 14.8 percent (IFC, *Annual Reports*, 1998–2004). Box 1 describes the financial-sector operations at the surveyed MDBs.

These operations usually are intermediary financing arrangements, in which the MDB provides loans or equity financing to an entity like a local commercial bank or a private equity fund. The domestic financial institution in turn assumes the authority and responsibility for disbursing the MDB's funds to various private companies and acts as a financial intermediary between the MDB and the beneficiaries of its funds. The entire arrangement is referred to as a financial intermediary (FI) project, and the FI's investments using MDB funds are referred to as subprojects. The MDB's participation in subprojects is, therefore, indirect. Figure 1 (*see page 1*) shows this difference in lending arrangements between direct-lending projects and FI projects.

Types of Financial Intermediary Projects

FI projects can range from the provision of credit lines to commercial banks to equity stakes in leasing companies. Anecdotal evidence suggests that MDB financial sector investments are moving away from credit lines and are increasingly being provided in the form of equity investments in local commercial banks or funds. Such intermediary finance operations, where funds are disbursed directly into FI balance sheets, now apparently comprise approximately half of total IFC FI operations.[6] Box 2 (*see page 4*) describes the various activities that can generally be considered FI projects.

Subprojects also vary in size and operation, from investments in small and medium-size enterprises (SMEs) in sectors such as manufacturing, textiles, and construction, to finance for larger companies in industrial sectors, including energy and infrastructure.[7]

Because of this diversity, the financing of subprojects through FIs can lead to a variety of environmental and social impacts associated with their operations. For example, lending to a highly polluting SME, such as a tannery, may result in the contamination of a local stream. Financing a wood-processing industry may contribute to local deforestation if the wood is not harvested in a sustainable fashion. FI investments in fossil fuel–based energy development or large hydropower infrastructure projects can lead to a significant increase in greenhouse gas emissions or the displacement of local communities. Likewise, trade finance facilities that finance oil shipments can indirectly cre-

BOX 1 Financial-Sector Operations of the Surveyed Multilateral Development Banks

European Bank for Reconstruction and Development (EBRD)

Established in 1991, the EBRD's mandate is to advance private-sector development and political transition by financing projects in Eastern Europe and Central Asia. In 2002, the EBRD established the Financial Institutions Group as part of its organizational restructuring, reflecting the growing importance of financial market operations to its long-term investment strategy. Between 1991 and 2000, nearly 30 percent of all these commitments targeted the financial sector through individual projects or investment vehicles. Examples of FI operations are the EU/EBRD Small- and Medium-Size Enterprise (SME) Facility, which provided 36 credit lines totaling nearly $400 million to 25 banks (resulting in more than 12,000 loans worth nearly $300 million to SMEs) and the Russian Small Business Fund, which issued to small businesses more than 138,000 loans totaling more than US$1.16 billion.

Inter-American Development Bank (IDB)

The IDB is composed of the Inter-American Development Bank (IDB), the Inter-American Investment Corporation (IIC), and the Multilateral Investment Fund (MIF). All parts have separate FI operations. Between 1990 and 2002, financial-sector and related financing accounted for approximately US$18 billion, or 20 percent, of the IDB's financing. Multisector and global credit programs targeting SMEs are the IDB's main form of FI lending. As part of 26 separate programs, the IDB's lending to FIs totaled $6.2 billion during this period. The IDB often relies on an apex structure for its intermediary financing, in which it grants loans to a "second-tier" institution which channels resources to a "first-tier" FI which in turn provides loans to SMEs. The main departments that engage in intermediary financing to support private-sector development are the IDB's Private-Sector Department (known as PRI), the IIC, and the MIF. The PRI prioritizes lending to infrastructure and capital markets; the IIC focuses on SMEs needing medium- and long-term capital; and the MIF directs grants and investments to small and microenterprises.

International Finance Corporation (IFC)

As the private-sector lending arm of the World Bank Group, the IFC is the largest direct provider of equity and debt to private-sector companies in emerging markets. In 2003, its investments in finance, insurance, and funds accounted for 50.2 percent of its total commitments, or roughly $2.5 billion. Intermediary financing is provided principally through two departments or groups, the Global Financial Markets Group and the Private Equity and Investment Funds Department. By 2003, approximately 35 percent of the IFC's total cumulative commitments, or $5.89 billion, were investments in finance, insurance, or collective investment vehicles.

Sources: EBRD 2003b; IDB 2003b; IDB 2002; IFC 2003c.

BOX 2 Types of Financial Intermediary Projects

Bank Loan (Credit Line): A loan, often referred to as a *credit line*, extended to a commercial bank operating in a local financial market for the purpose of providing medium- and long-term debt financing to subprojects and for expanding subprojects' access to capital. *Example:* The Inter-American Investment Corporation (IIC)'s issuance of a $1 million line of credit to Bolivia's Fondo Financiero Privado Prodem S.A. to extend financing to several microsize and small Bolivian companies for working capital or to finance capital assets, machinery, or other fixed-asset purchases (BO 3178A-01, November 2004).

Trade Finance Facility: A loan extended to a commercial bank to support subprojects that enable or encourage local exports and imports or trade-related activities. *Example:* The IDB's extension of loans amounting to $110 million to Brazil's Banco Bradesco to finance international trade transactions (principally exports) by Brazilian companies or their subsidiaries (IDB/PRI-BR0407, March 2003).

Equity Investment in a Private Equity Fund: The purchase of minority shares in a new or existing private equity fund (PEF). The purpose of the MDB's participation in such a fund is to stimulate additional investment from private-sector cofinanciers and to encourage the PEF to make equity purchases in medium- or large-size companies. Funds often have a regional, country, or sector-specific focus. *Example:* The IFC's purchase of a $35 million equity stake in the $350-million South Africa Private Equity Fund, managed by a private institutional investor and established to invest in growth companies, management buyouts, and corporate expansions (IFC-9153, June 1998).

Equity Investment in a Local Bank: The purchase of a minority stake in a commercial or newly privatized bank. Such investments are made for the purpose of strengthening domestic financial institutions and are often undertaken in partnership with other strategic investors, including other MDBs. The stake allows the MDB, through active participation on supervisory boards, to undertake corporate restructuring that streamlines operations and increases the efficiency and profitability of the domestic bank's operations. *Example:* The EBRD's €789,000-stake in the Armenian bank Armeconombank, to which it offered technical assistance and institution-building support (EBRD-27309, June 2004).

Donor-Supported Investment Facility: A stand-alone fund or vehicle, managed by or established with the help of an MDB, that pools grant and nongrant resources from various public and private development institutions. This vehicle typically operates under a specific organizational mandate and is often used to supplement debt or equity financing to subprojects. *Example:* The EU/EBRD SME Investment Facility, which to date has directed €716 million from the EBRD and €130 million in grants from the EU to accession countries. The facility provides debt and equity financing to FIs, which in turn provide debt and leasing services to SME subprojects. The EU grant supports the recruitment and training of staff, improvements to information systems, and strengthening of management capabilities for participating FIs (EBRD/EU, established April 1999).

Leasing Facility: A vehicle to facilitate the availability of debt financing or the purchase of equity stakes in leasing facilities, leasing companies, or commercial banks. Leasing permits small companies, newly established businesses, or organizations with weak credit standing to acquire costly capital equipment, which in turn allows them to expand their production or operations. *Example:* The EBRD's provision of $13.3 million in financing for the $40 million Caterpillar Financial Leasing Facility, established to lease Caterpillar equipment to Russian small- and medium-size construction and mining companies (EBRD-30353, February 2003).

Sources: Product descriptions are from IFC 1998a and the EBRD Financial Institution Group's web site. Project descriptions are from project databases on MDB websites.

ate incentives to explore and produce more oil by facilitating the connection between producers and suppliers. Furthermore, even though the use of resources or emissions of individual subprojects in a particular sector within a country or region may be negligible and comply with local environmental standards, the cumulative impacts on common resources such as local waterways, waste management sites, and agricultural land by several similar subprojects may be substantial (IFC 2003a).

Rationale for Financial Intermediary Operations at Multilateral Development Banks

Over the last five years, FI operations have averaged between 18 and 40 percent of MDBs' total annual commitments to private-sector clients.[8] MDBs cite two reasons for their strategy of directing a large portion of their investments through FIs: their own institutional capacity constraints and financial market capacity constraints (see IFC 2004a).

The MDBs' first reason for increasing their FI investments is that it is a more efficient and effective way for them to channel funds, especially to SMEs. FIs do not face the same institutional constraints that MDBs do in servicing this sector. MDBs argue that they do not have the resources and manpower necessary to service SMEs directly—because the individual loan amounts are too small and the number of SMEs or subprojects is too large—and that by leveraging their established relationships with their clients and their knowledge of local financial markets, the FIs can expand the SMEs' access to medium- and long-term capital. FI financing for SMEs accounts for most of the EBRD's commitments (78 percent) and a significant share of the IDB's (52 per-

cent) and the IFC's (37 percent) FI operations.[9] According to MDBs, FIs are better situated to work systematically with SMEs than are the larger multilateral banks.

The MDBs' second reason for greater FI investment is that it can help develop the capacity of financial markets in developing countries. At the client country level, MDBs provide intermediary finance to enhance FIs' access to longer-term credit and capital and to strengthen the intermediaries' financial security during periods of financial market instability.[10] The MDBs' participation in intermediary finance creates a demonstration effect and attracts additional financing from domestic participants.[11] At the financial institution level, MDBs often provide intermediary finance as part of a larger corporate restructuring program aimed at building the domestic FI project sponsor's capacity and enhancing competitiveness through staff training and advisory services.[12]

BOX 3 Project Categorization

As part of the screening process, MDBs such as the EBRD and the IFC assign to each project an environmental screening category—A, B, C, or FI—which describes the nature of the project, and indicates the expected level of risk associated with its likely environmental and social impacts.

Category A is generally assigned to direct-lending projects likely to have significant adverse environmental impacts; category B to direct-lending projects predicted to have less severe environmental impacts (those that are site specific, reversible, and more easily mitigated); and category C to direct-lending projects with minimal or no adverse environmental impacts. Category FI is assigned to financial-sector projects.

Whereas the EBRD assigns all financial-sector projects to the FI category, the IFC assigns the FI category to only those projects whose operations the IFC deems may result in adverse environmental or social impacts. IFC projects involving entities deemed likely to have no potential adverse impacts or likely to finance subprojects with minimal environmental impacts are assigned to category C.

Within the FI category, the IFC distinguishes among three types of FI projects, each triggering different environmental management and due diligence requirements:

- Type 1 requirements apply when the IFC funds are not targeted to specific subprojects but the financial institution conducts operations that may have adverse environmental and/or social impacts, for example, corporate loans and equity investments.
- Type 2 requirements apply when the IFC funds are targeted through the financial intermediary to specific subprojects that may have adverse environmental and/or social impacts, for example, credit lines or private equity funds.
- Type 3 requirements apply to circumstances in which the IFC remains the lender of record on subproject loans but relies on the financial institution to identify and administer financing proposals.

In turn, FIs may categorize subprojects as category A, B, and C. Subproject monitoring is generally delegated entirely to the FI.[1.]

Sources: IFC1998a; EBRD 2003a.
Notes:
1. The IFC reserves the right to review and approve category A subprojects of type 2 FIs and to subject these to detailed environmental due diligence. Similarly, the EBRD's policy follows the practice in which most high-risk or category A type subprojects require prior approval. The IDB has no similar stated policy at present. (The IDB's draft Environmental Policy provides for the categorization of projects as A, B, and C, but it does not categorize financial intermediaries as FIs.)

Environmental Assessment: A Comparison of Direct-Lending and Financial Intermediary Projects

With some variation, MDBs typically screen all prospective projects for environmental and social impacts. This screening is part of a framework that commonly also categorizes the project according to type or level of risk posed (see Box 3) and applies specific standards for assessment, review, and monitoring over the life of the project.

The environmental assessments of direct-lending and FI projects differ because of differences in the operational structure of the lending arrangement, applicable environmental and social standards, risk management mechanisms, and transparency and information disclosure mechanisms. In general, FI projects have many more "known unknowns" than do direct-lending projects.

Operational Structure

The transfer of decision-making authority from MDBs to FIs greatly affects the way in which environmental and social impacts are handled. That is, this transfer of authority does not allow MDBs to make as straightforward an environmental assessment of FI projects as they can for direct-lending projects.

In a direct-lending project, the clients provide detailed information about the projects for which they are seeking financing. This information becomes the basis for weighing concerns about the project before the decision to proceed is

made, thereby allowing the MDB to compare the proposed activities against an exclusion list of prohibited activities and to identify and determine their likely adverse impacts. MDBs require that direct-lending projects follow the host country's requirements, comply with the MDBs' environmental and social standards, and abide by procedures and guidelines for environmental mitigation, prevention, monitoring, and reporting.[13] Requirements for consultations with local communities that will be affected are routine in MDBs' traditional financing.

MDBs lend to FIs using a different structure and arrangement. In this case, the actual beneficiaries of the MDB funds or the subprojects are usually not identified when the FI project is appraised, meaning that MDBs cannot conduct as detailed an assessment of FI operations as they can with direct-lending projects. For FI projects, an environmental assessment is more a calculation of the FI project sponsor's *capacity* to manage the environmental and social risks associated with future subprojects than a calculation of the actual environmental and social risks associated with that particular undertaking. As a result, the environmental assessment is normally limited to a determination of the FI's capacity to conduct environmental assessments of future subprojects and a review of the FI's existing portfolio and environmental management procedures. The environmental assessment does not extend to an assessment of individual subprojects because they usually have not been selected by the FI at the time of the environmental assessment.

Intermediary finance delegates the authority to make investment decisions concerning subprojects to the FI, which assumes responsibility for determining the environmental and social risks. In the case of the IFC, for example, policy 4.01 (paragraphs 9 and 10) and annex F to its environmental and social review procedure state that it is the FI's responsibility to undertake the environmental and social assessment of subprojects.

MDBs hold that even if it were possible to review all subprojects in the same way that they do for direct-lending projects, it would defeat the purpose of channeling MDB funds through FIs: subproject delegation is part of a broader effort to build the FI's capacity to work with SMEs and to develop local financial markets. If the MDBs conducted the environmental assessments of individual subprojects, it would constitute "hand-holding" and thus impede the development of domestic FI capacity. For instance, the EBRD's environment policy states, "EBRD needs to ensure the proper implementation of its environmental mandate in its FI projects while respecting the principle of delegated responsibility which characterizes such projects" (EBRD 2003a, 7). As a result, MDBs have historically focused on determining the FI's capacity and commitment to address environmental and social impacts of subproject operations, even when those impacts are not known at the time of the MDB's assessment.

Applicable Environmental and Social Standards

All direct-lending projects are subject to specified MDB environmental and social standards. Different MDBs have different FI project requirements. Environmental and social standards include operational safeguards, technical standards, and exclusion lists that restrict investment in certain activities. As a minimum standard, MDBs require FIs' subprojects to comply with the host country's laws. Some MDBs require FIs to apply MDB standards while screening subprojects. For instance, at the IFC, type 2 and type 3 FIs must apply IFC safeguards to their subprojects, but type 1 FIs do not need to do so. Furthermore, the IFC's general exclusion list applies to only its types 2 and 3 FIs.[14] The EBRD requires all its FIs to comply with its environmental exclusion and referral lists.

The IFC and the EBRD have similar restrictions on FIs.[16] FIs cannot finance subprojects that involve, among other things:

- Activities prohibited by the host country's legislation or international conventions.
- The production of, trade in, or use of unbonded asbestos fibers or asbestos-containing products.
- The production of or trade in products containing PCBs (polychlorinated biphenyls).
- The production of or trade in hazardous substances subject to international phaseouts or bans.
- The production of or trade in ozone-depleting substances subject to international phaseout.
- Trade in wildlife or wildlife products regulated under the CITES (Convention on International Trade in Endangered Species of Wild Fauna and Flora).
- Drift net fishing in the marine environment using nets greater than 2.5 km in length.[17]

In addition to its environmental exclusion list, the EBRD uses a referral list of economic activities that typically entail a high degree of environmental risk. FIs may finance such activities only af-

ter receiving the written approval of the EBRD. Activities subject to prior review and approval by the EBRD include projects likely to involve the construction or major extension of large dams and reservoirs, mining and oil and gas production and processing, and projects that affect indigenous peoples, cultural property, or ecologically sensitive areas.

Risk Management Mechanisms

An environmental management plan (EMP) contains specific mitigation, management, monitoring, and institutional measures for direct-lending projects that the project sponsor should follow during the implementation and operation of the direct-lending project, in order to minimize or avoid adverse environmental and social impacts.

Following their assessment, MDBs generally rely on two main mechanisms to manage the risks associated with the operations of an FI project and potential subprojects. First, if an FI lacks the needed capacity, staff members must be given environmental training. Second, an FI must agree to develop or operate an environmental management system (EMS) that conforms to certain standards in order to screen subprojects for environmental and social risks.

An EMS typically formulates an environmental policy and a set of procedures that integrate environmental screening, monitoring, supervision, and review into the intermediary's existing investment operations and organizational structure.[17] The MDB may supervise the development and implementation of an EMS by interacting with its FI clients and reviewing their annual performance reports.

Some of the FI staff are selected to learn the basics of EMS implementation in regional training workshops usually financed with donor funds and conducted by either the MDB staff or external consultants. These FI staff must then oversee the FI's implementation of its EMS as a condition of the disbursement of funds.

The EMS is required in order to incorporate the main components of the MDB's environmental policies and procedures into the FI. The EMS is usually part of an operational policy covering sustainable development, information disclosure, and transparency commitments and describing subproject selection, review, and approval procedures, as well as monitoring and reporting provisions for individual investments. Although the EMS may be based on a generic template provided by the MDB, the FI generally tailors the EMS subject to the MDB's approval. As part of the EMS's implementation, FIs are encouraged to adopt the MDB's system of categorization for subproject assessments.

Transparency and Information Disclosure

Before the board's approval, most MDBs release, through project summary documents, information about the projects being considered for financing. Over the course of a direct-lending project, the MDB's staff monitor the project, require its sponsors to submit monitoring reports for review, and, depending on the project's environmental and social complexity, supervise missions and project-site visits.

In contrast, with the exception of the MDB's monitoring of certain category A subprojects, an annual report from the FI project sponsor to the MDB is often the only check with regard to the subprojects' compliance with the MDB's environmental and social standards over the life of an FI project. This annual report on the FI's subproject investments covers the EMS's performance and includes notification of instances when subprojects' did not comply with the host country's environmental laws and regulations.[18] Although a subproject's noncompliance with MDB requirements may trigger a site visit to the subproject by the MDB staff, the MDB's oversight of FI projects usually is minimal. Furthermore, apart from the environmental assessment requirements for certain category A subprojects, MDBs often do not require subproject environmental assessment or monitoring reports from FIs.

In summary, the environmental assessment of FI projects currently relies on a determination of the FI project sponsor's capacity to manage the environmental and social issues associated with future subprojects. Each MDB has different environmental and social standards for different FI projects. The FI projects' risks are managed mainly through staff training programs and the requirement that FIs adhere to an EMS. Finally, public information about FI projects by MDBs is limited to a one-time disclosure provided in project summary documents disclosed before the board's approval.

Environmental and Social Challenges of Financial Intermediary Lending

The delegation of environmental and social assessment and monitoring of FI subprojects leaves open the possibility

that these subprojects may evade standards that apply to MDB direct-lending projects. The environmental assessment process for FI projects is often ad hoc and not transparent. The particular challenges are the following:

- The limited capacity of FIs to manage environmental and social risks.
- Environmental and social standards that are not tailored to the needs of FI projects.
- Difficulties with training and EMS implementation.
- The lack of transparency in decision making and the absence of an institutionalized process of disclosing information about FI projects to the public on an ongoing basis.

Capacity Concerns Related to Multilateral Development Banks' Delegation to Financial Intermediaries

The limited information available to MDBs about subprojects and the delegation of FI investment decision making requires assurances that the FIs do have the capacity to effectively manage the environmental and social impacts of subprojects. All the MDBs that we surveyed acknowledged that the successful execution of a project and its positive development outcome hinge largely on the organizational capacity and commitment of the FI project sponsor to implement a well-functioning EMS. For example, the EBRD acknowledges that "developing environmental due diligence procedures appropriate to a [private equity] Fund's needs can prove challenging where availability of environmental information and expertise may be limited and where time available for investigation may be limited by the need to make rapid decisions" (EBRD n.d., 1).

In short, when a FI project sponsor lacks capacity, it is unlikely that it can adequately identify and mitigate the environmental and social risks in subprojects. Ensuring that FI project sponsors have adequate capacity to assess and monitor the environmental and social risks associated with the subprojects they choose to finance is thus crucial to the subprojects' stakeholders. Currently, however, there is no formal, publicly disclosed tool, like an environmental impact assessment (EIA) for direct-lending projects, to gauge this capacity. Although both the IFC[19] and the EBRD[20] rate the risks of their FI projects from an environmental and social perspective, neither reveals this rating to the public in the same way that they disclose the EIAs for direct-lending projects.

Lack of Financial Intermediary-Specific Environmental and Social Safeguards

An MDB's environmental and social standards are written primarily for direct-lending projects, and so these existing standards cannot be easily applied to FI operations. For example, a discussion note from the World Bank observed that safeguard policies were not designed to address the kinds of impacts typically associated with FI projects (World Bank 2002). Specifically, the note stated that the existing safeguards were sometimes unclear and might require more skilled judgment and interpretation than is usually available to the FI project sponsor. Therefore the FI staff, and thus intermediary financing projects, would benefit from greater clarity and coherence in environmental policies and procedures.

The MDBs also argue that the nature of FI projects often precludes the application of safeguard policies. For instance, the EBRD maintains that it is beyond a local FI's capabilities to ensure the compliance of thousands of SME customers with anything other than local laws. As a result, subprojects are required to meet only national health, safety, environment, and labor standards, rather than the EBRD's more stringent direct-lending regulations. Because 78 percent of the EBRD's FI portfolio focuses on SMEs, most FI projects are therefore not required to apply the EBRD's safeguard policies.[21]

The MDBs' baseline performance standard is that FI subprojects must follow the host country's regulations, despite the risk of overrelying on these regulations in regard to implementation and enforcement. The effectiveness of this policy for on-the-ground protection depends on the FI project sponsor's capacity and commitment to monitor subprojects for compliance and, more important, on the scope and comprehensiveness of relevant environmental regulations and whether they are adequately enforced in the host country. According to the MDBs, FIs often operate in regulatory environments characterized by poor enforcement, inadequate sharing and gathering of information about existing environmental problems, and sometimes weak legal frameworks (IDB 2003a). As a result, it is unlikely that this requirement alone will achieve protections in line with international standards. The challenge, therefore, is to incorporate a clearer and more coherent system into the FI's safeguard policy framework.

Risk Management Mechanisms: Difficulties with Training and Environmental Management System Implementation

Rather than using resources to monitor FI projects, MDBs have chosen to train the FI staff as a way of building capacity and teaching them to use an environmental management system (EMS). But how well these training programs can incorporate EMSs into FIs depends on the quality and content of instruction, the duration of the workshop, how effectively the information is conveyed, and the participants' authority and commitment to act on this knowledge at their home institution. If they are successful, FIs can develop a valuable long-term internal capacity to screen subprojects for environmental and social risks, propose mitigation strategies, and monitor and report on their performance.

As noted, FIs are a diverse set of organizations, operating in different regions, providing a variety of financial products, and serving a multitude of sectors. Collective training workshops for numerous FIs, consistent with the IFC's current practice, are less able to address individual concerns and needs than are more specific programs. A review conducted by the IFC's CAO found "enormous frustrations among financial intermediaries that there was not more support tailored to their needs" (IFC 2003a, 48).

Institutionalizing an EMS often depends entirely on the capacity, resources, and efforts of a few FI staff members who have been trained to manage the screening process during the FI project's implementation. If the operational environment is not conducive to implementing an EMS because of inadequate interest or limited resources allocated by management, the FI project sponsor is unlikely to be able to effectively manage the environmental and social issues associated with the subprojects. The sponsor is even less likely to be able to offer environmental management advice or otherwise add value to its subproject clients.

Transparency and Information Disclosure Concerns

According to MDBs, the disclosure of information by publicly owned institutions working in the private sector reduces risk, improves the development impact of investments, builds stakeholder trust, ensures the consistency and efficiency of investments, and broadens the public's appreciation of their business performance (IFC 2004b). Nonetheless, concerns about MDBs' own information disclosure practices persist.

MDBs assert that it is their practice to appraise environmental capacity and risk before investing in the FI. For instance, the IFC noted that based on a review conducted by its environment division, the IFC management and board of directors considers the EMS and capacity-training requirements at the time that it approves the FI and that they are reflected in the legal agreement with the FI (IFC 2005). There are, however, no established policies articulating the specifics of this appraisal process to the public. Although the IFC provides a generic evaluation template to the public, neither the substance nor the final outcomes of these appraisals of any single FI investment decision by an MDB are made public.

In most cases, the MDB's disclosure of project information is limited to the project summary document disclosed at the time that the MDB considers investment in the FI project. Apart from the limited information presented in the project summary document, no other project-specific information is usually released to the public during the life of the FI project.

For the most part, project summary documents provide only cursory information about the project under consideration and are not released for public comment. They rarely contain details about the types of subprojects that the FI project may finance in the future, nor is there any mechanism for providing the public with updated project summary documents as information on subprojects becomes available. We reviewed some project summary documents describing FI projects under consideration and confirmed that it is difficult to infer from such summaries the likely environmental and social impacts associated with individual FI projects.[22] As a consequence, an opportunity to engage the public in an informal regulation of subprojects in situations in which "formal regulation leaves a gap between actual and locally preferred environmental quality" has been lost.[23]

Interviews with MDB staff revealed that they rely heavily on informal personal relationships with FI staff to influence the FI's decisions and to ascertain whether subprojects are complying with environmental and social requirements. While this strategy may work sometimes, obtaining such information should be neither optional nor irregular. A formal documentation and disclosure process would provide a more reliable structure for MDB–FI accountability. Without such a process, FI operations at MDBs may be particularly vulnerable to staff turnover and organizational changes.

BOX 4

Financial Intermediary Operations and Transparency: An Example from Trade Finance

One element of the recent surge in FI lending operations is trade finance. Trade finance is the issuing of credit or guarantees by MDBs to qualifying commercial banks. The commercial banks then facilitate the financing of trade-related business, such as the working capital needed to export or import goods and services. MDBs frequently organize trade finance through large facilities, for example, the EBRD's Trade Facilitation Program, the IDB's $1-billion International Trade Finance Reactivation Program, and the IFC's $500-million Global Trade Finance Facility.

Because the facilitation of trade may encourage export-oriented economic activities in environmentally sensitive industries, it cannot be assumed that the provision of trade finance is environmentally or socially benign. As the EBRD noted in its *Environmental Risk Management Manual for Financial Institutions*, "There may still be environmental risks associated with trade finance activities, associated with the nature of the goods that are being traded and the activity carried out by the client" (EBRD 2001a). There is a notable absence of publicly disclosed information during the project preparation stage with regard to targeted industrial sectors or economic activities, and even less information available about the environmental and social impacts of subprojects that receive FI financing.

In May 2003, the IFC approved a five-year, $100-million intermediary loan to the Moscow Narodny Bank (MNB), a trade finance bank and a subsidiary of the Central Bank of Russia. At the time, it was the biggest loan the IFC had extended to a Russian company or financial institution. Both the summary of project information (SPI) document (the IFC's project summary document) released by the IFC during its review of the FI project and the subsequent press release announcing the completed deal (the only public sources of information about the project issued by the IFC at the time)[1] stated that the MNB would use the IFC's funds to "extend medium-term, trade related credit facilities to privately-owned and creditworthy Russian exporters." In accordance with IFC policy, the SPI document also stated that the environmental screening category assigned to this FI project was type 1. This exempted the MNB from providing the IFC with an annual report summarizing the subproject's environmental and social performance and from complying with the IFC's exclusion list (even though MNB voluntarily chose to adopt the exclusion list; see Moscow Narodny Bank 2003), its environmental and social policies, its guidelines for category A subprojects, and its category A requirements for subproject investments.

An independent news report covering the signing ceremony stated that IFC funds would be used primarily for medium-term financing to "the export operations of Russian companies active in the oil and gas, metallurgy, chemistry and services sectors."[2]

Dialogue with the IFC staff while preparing this policy brief indicated that the MNB intended to use the IFC's funds solely to finance shipments of oil from Russian producers to buyers elsewhere and that the money would not finance the exploration and production activities of Russian producers (personal communications, IFC staff, January and February 2005). It also emerged that the IFC's financing agreement required the MNB to follow the marine safety guidelines of the International Maritime Organization and "other appropriate measures."

Thus while measures appear to be in place in this case, MDB policy on trade finance and other FI operations would be enhanced by requiring the routine public release of specific environmental and social information concerning the subprojects that demonstrates compliance with applicable safeguards and laws.

Notes

1. IFC Summary of Project Information (SPI), Project 20169: IFC press release June 9, 2003.
2. Statement made by MNB Chairman and Group Chief Executive Igor Suvorov to *Moscow News*, http://english.mn.ru/english/issue.php?2003-23-10.

The absence of an institutionalized information disclosure mechanism for FI operations means that stakeholders cannot determine whether MDBs are following up on their delegation of financing and environmental and social assessment and monitoring responsibilities to the FI with appropriate accountability and oversight (see Box 4).

In summary, a number of policies and practices are in place in MDBs to deal with environmental and social challenges. But these policies and practices often differ from one MDB to the other and also sometimes differ within an individual MDB, depending on the type of FI at issue and the organization from which the funding originates. The overall result is a number of emerging practices but no consistent and transparent policy system to ensure the efficient and universal protection of the environment. Interviews with MDB staff and NGOs, coupled with reports such as the independent review by the IFC's CAO, underscore the need for a clear, objective policy system that will make sure that FI projects and the impacts of their lending to subprojects are managed more effectively.

Conclusions and Recommendations

MDBs need to enhance their environmental and social policies to keep pace with the increasing investments in FIs. Even though FI operations entail a significant delegation of responsibilities to intermediaries, MDBs have an opportunity to improve their oversight of and influence over subproject financing. If the MDBs' environmental and social policy frameworks are tailored to the diversity of FI projects, they will bal-

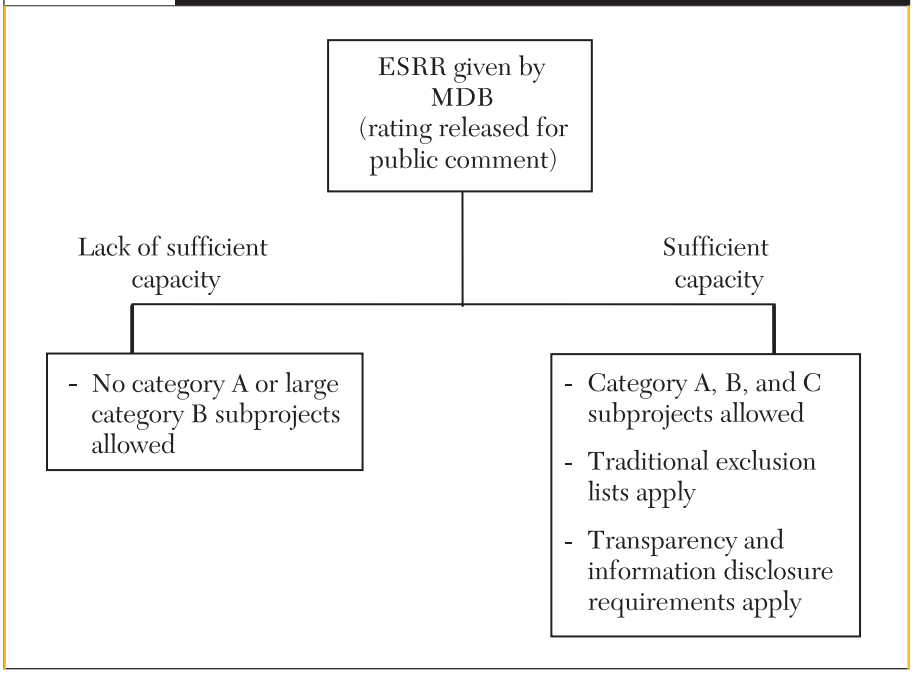
ance the need for policies that work for FIs with the MDBs' broader poverty alleviation and sustainability mandates.

A policy system directed to FIs should include the following:

- A transparent environmental and social risk rating (ESRR) tool and process, similar to the EIA process for MDBs' direct-lending policies. An ESRR tool would describe the capacity, categorization, and action plans for each FI.
- The MDBs' presumption that all FIs will apply the same environmental and social standards to their subprojects as are applied to MDB direct-lending projects.
- If the ESRR determines a lack of FI capacity, a provision that category A and large category B subprojects would be categorically excluded from FI investment (see Figure 2).
- A new set of disclosure requirements for FIs, resulting in the release to the public of the environmental and social standards applied to each subproject investment. Greater public transparency can be expected to result in informal regulation by affected stakeholders to supplement the MDB's delegation of responsibility.

The following subsections offer additional suggestions for tools to help implement these new environmental and social policy systems for FIs.

FIGURE 2 Proposed Financial Intermediary Project Capacity Assessment



Enhanced Oversight and Disclosure Regarding Financial Intermediary Capacity

Limited capacity may constrain the effective management of environmental and social risks associated with FI operations. These constraints include both the MDB's capacity to assess, train, and monitor FI project sponsors and the FI project sponsor's capacity to assess and monitor subprojects and report back to the MDB.

The current FI assessment process assumes that once limited training has been provided, the intermediary institutions are likely to meet their environmental management obligations, with little oversight by the MDB. This assumption is made despite the lack of a transparent, formalized process that documents the FI's environmental capacity and commitment and a lack of information about the specific subprojects to be financed.

MDBs should improve their assessments of the FI project sponsor's capacity by using a transparent FI ESRR tool, to be applied by the MDB before it approves the FI project proposal. The ESRR should be created in accordance with public consultation. Before investing in an FI, the ESRR for that FI should be open to public notice and comment, as are the EIA procedures used by MDBs when considering a project for direct lending.

By incorporating transparent governance and management criteria relevant to the FI—such as the extent of MDB training received by the FI project sponsor, the FI's own relevant staffing and experience, staff turnover, past performance, monitoring capabilities, targeted sectors and subproject partners, and the size of the FI project sponsor—the ESRR will allow the MDB to rate each proposed FI project in accordance with the FI project sponsor's institutional capacity to address the subprojects' environmental and social risks.

The MDB staff we interviewed were somewhat resistant to making the ESRR for each FI transparent and subject to public comment. Although some agreed on the utility of transparency, they cited the institutional argument that the FI assessments are specific to the MDB's internal decision-making processes (personal communications, EBRD staff, January and February 2005). Our report suggests that while MDBs should indeed retain ultimate responsibility for the decisions made as a result of their ESRR findings—just as they are accountable for their EIA decisions—as with traditional EIA processes, the ESRR process would be improved by stakeholders' comments with a view to achieving sustainability goals.

Using the ESRR score as a decision-making tool would enable MDBs to classify FI projects into two categories, based on the FI project sponsor's capacity and its lending and investment portfolio. If the ESRR reflects insufficient capacity, when the FI project sponsor chooses a subproject, it should be required to apply a categorical exclusion that clearly defines those subprojects not eligible for investment. FI project sponsors lacking sufficient capacity to fulfill the MDB's environmental and social requirements independently should not be allowed to use MDB funds to support category A or large category B subprojects. This exclusion requirement should be included in all financing agreements with the FI project sponsor, including loans to support trade finance, short-term investments, and general equity investments, as well as subproject credit lines. Conversely, if the ESRR shows that the FI project sponsor has sufficient capacity, it should be permitted to make subproject investment decisions that include investment in category A and large category B subprojects.

A number of practices are emerging that could form the basis for better MDB oversight and disclosure regarding FI capacity. The IFC, for instance, calculates an environmental and social risk rating (ESRR) for all its portfolio projects as a part of its *post*approval project due diligence. The IFC's ESRR uses a four-point scale, with a score of 1 indicating very low risk and a score of 4 signaling very high risk. The risk rating is updated annually. This rating allows for a concise, up-to-date assessment of the client's environmental and social risk throughout the life of the project and permits the IFC to allocate staff and resources for environmental and social supervision (IFC 2003b). The scores for individual FI projects are not, however, released to the public.

We propose instead that the ESRR be carried out *before* a decision is made to invest in the FI and that the ESRR be updated regularly and be disclosed to the public throughout the life of the project. By revising the ESRR periodically over the life of the FI project, the MDB could ensure that the FI project sponsor maintains adequate commitment and capacity to assess, manage, monitor, and report on subproject impacts and risks.

Environmental and Social Standards for Financial Intermediaries

While FI projects do not demand a new set of environmental and social standards, they should adhere to those already established for direct-lending investments. At the same time, MDBs need to tailor the current standards to better encompass FI and subproject investment operations: they should revise their policies to avoid overrelying on the host country's standards and to be able to incorporate the MDB's standards and best practices into the operational structure of the type of FI at issue. When FIs are investing in a large quantity of SMEs or microprojects, MDB standards could be accompanied by new portfolio management systems that allow FIs to monitor the cumulative impact of multiple subproject investments.

The host country's standards are a valuable tool, but experience demonstrates that the government's implementation and enforcement of such regulations are often significantly constrained by the lack of capacity. Without a requirement to move toward higher standards, it is not clear what value MDBs are adding by participating in FI projects, especially with regard to advancing their mandate of sustainable development in developing countries.

The EBRD's current practice is to require FIs to follow detailed environmental risk management procedures in their assessment, monitoring, and reporting of subprojects. These environmental procedures are explained to the FIs and are based on the nature of the transactions, which can involve corporate loans, lending to SMEs and microfinance operations, equity investment, leasing, trade finance, broking and advisory services, franchising, and insurance and pension funds (EBRD 2001a; EBRD 2003b, 7/8). The IDB sometimes integrates local government institutions and various public or private technical support agencies into its microfinancing advisory and monitoring activities in order to increase its FIs' capacity and to improve the subproject borrowers' compliance with environmental protection laws (IDB 1997).

The MDBs should expand this practice and coordinate it with their public-sector arms and use the opportunity to address environmental and social concerns that affect FI operations. For example, the ongoing IFC–World Bank collaboration on evaluating and improving investment climates in the countries where they operate focuses exclusively on reducing the legal, political, and financial restrictions on free enterprise and does not address regulations and institutions that protect the environment.[24] The broader mandate of the World Bank and the IFC suggests that their partnership should also ensure that environmental and social regulations expand along with the private sector. In the context of intermediary financing, this collaboration could facilitate the inclusion of a technical assistance component that would assess and address the capacity of local environmental agencies to enforce environmental regulations before the IFC makes investments.

More Targeted Training

MDBs should use the ESRR rating tool to allocate their resources for training that is less general and more tailored to the needs of individual FIs. Training and building capacity to address the decision-making context and capacity of individual FI project sponsors, as opposed to the current norm of the same training for all FIs, would improve the subprojects' development outcomes.

The public ESRR process should result in a transparent training action plan tailored to the particular FI's capacity needs. The EBRD has made available its environmental procedures as an online manual, ready to use with a reasonable adaptation to each FI's credit appraisal process. Resources could be pooled both within and across MDBs to train a subset of FIs whose ESRR results indicate they face similar capacity constraints. The EBRD provides training specific to each FI, free of charge. Occasionally it organizes workshops for several FIs from the same country that offer similar financial services. This enhanced capacity training must be coupled with a greater allocation of resources for training. For instance, the continuation of the EBRD's approach of targeted training for FIs is in jeopardy owing to the phasing out of its funding source, the European Union Phare program.

Current capacity-building exercises suffer from significant funding constraints and generic approaches, which are not, however, the fault of these MDBs' environmental staff. To its credit, the IFC has put in place initiatives to develop FIs' capacity by broadening the capacity of its "training partners" that offer IFC workshops and attract participants besides IFC clients. An example is the partnership that the IFC forged with the Union of Arab Banks to create environmental and social principles addressing nonproject finance, such as SME lending, trade finance, and finance to small corporations. Such initiatives to establish environmentally and socially responsible financial institutions now have an annual budget of $3 million to $5 million in donor-funded, IFC-managed assistance. These initiatives were set up to address criticism of the IFC in the independent review conducted by the CAO (IFC 2003a, 48). But the IFC still customarily offers three days of training for a wide variety of FIs grouped together. This approach should be revised.

These capacity-building efforts are on the margins of the MDBs' routine policy and resource priorities. They could allocate their resources more efficiently and provide value-added services by using the ESRR results to identify and address FIs' specific constraints and subproject concerns. Clearly, an immediate increase in donor country support for FI capacity building is also needed.

Enhanced Transparency Mechanisms for Compliance and Enforcement

MDBs need to acknowledge that the shift toward intermediary financing has significantly reduced publicly available information about the development impact of MDB funds and has lessened the MDBs' ability to monitor on-the-ground impacts. Therefore they must devise a means of being more forthcoming about their FI operations and conveying to external stakeholders any trade-offs with regard to environmental and social considerations in their FI operations. Furthermore, in the course of MDB-financed projects, MDBs should make it mandatory for FI projects to notify persons affected by subprojects of their rights.[25]

To address the MDBs' concerns about their ability to oversee a vast number of FIs and their subprojects, they should use the ESRR tool to monitor and supervise those FI project sponsors with a weaker capacity and lower ESRR scores. The ESRR tool should be the vehicle for determining how many site monitoring visits the MDB will require. Results of the ESRR can be posted in the project summary document that MDBs already use to make project information available to the public.

The project summary documents should become evolving compliance documents for the MDBs' oversight of FI operations, to be updated for the public over the life of the FI project. Com-

pliance information also should be updated and disclosed annually to the public. As a matter of policy, a formal report by the FI on the environmental and social impacts of subprojects should be required at least once a year.

In order to increase transparency and monitoring, MDBs should require the same consultation expectations of FI subprojects as are required for direct-lending projects, including the release to the public of EIAs of subprojects and the independent auditing of category A subprojects. A greater disclosure of information would also create opportunities to engage the public in "informal regulation," especially when the host country's enforcement of environmental regulations is weak.

Some good practices regarding monitoring requirements are emerging at the different MDBs. The IDB requires FIs to submit both biannual project supervisory reports with environmental compliance information and annual environmental reports evaluating the environmental and social performance of subprojects for the previous year (IDB 2004b). The IFC applies its CAO provisions to FI operations. The EBRD requires that all projects, including FIs, provide at least annual updates of environmental information to be included in their project summary documents. Yet comprehensive policies for ground truthing the results of compliance reports, ensuring that communities are aware of their rights, and ensuring the transparency of the subprojects' adherence to standards remain ripe for improvement.

The issues cited in this report underscore the challenges posed by the growth in increasingly complex multilateral financing schemes involving a range of financiers, financial products, cofinancing, intermediation, and multiple beneficiaries across industrial sectors. The main question is where to draw the lines of responsibility and accountability at a time when development finance to the private sector is moving away from direct-lending projects.

The delegation of authority to FIs should not mean the MDBs' abdication of accountability. The MDBs must not lose sight of their development mandates and commitments to their shareholders to promote environmentally and socially sustainable development. As development institutions, MDBs are faced with many trade-offs regarding FIs. They correctly are trying to develop and expand local financial markets. At the same time, however, commitments to transparency and managing environmental and social risks are necessary, along with the other benefits to the markets being opened. In order to meet their mission of poverty alleviation in the broadest sense, MDBs should acknowledge it if they are having to make trade-offs with FI investments, and accordingly they should enhance their systems to find the right balance.

Our analysis here has identified the gaps between commitments to and mandates regarding environmental and social issues and current intermediary financing practice, as well as ways to bridge these gaps. Adopting these recommendations will enable MDBs to align their private-sector lending priorities with their development mandates by ensuring that their FI investments in developing countries strengthen the domestic financial markets and, at the same time, increase domestic capacity to account for and mitigate environmental and social risks.

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NOTES

1. When characterizing current practices, we have had to simplify some of the differences in policies across and even within MDBs. This report tries to portray accurately the general state of MDB lending through financial intermediaries without detailing the many exceptions to the prevalent norms.
2. The IFC is developing a set of "Performance Standards" that will be supplemented by Guidance Notes. The performance standards are currently scheduled to come into effect on January 1, 2006. The IDB's Environment Policy is the bank's first update of its environment policy since 1979.
3. For instance, the IDB's main goals are "to promote poverty reduction and social equity as well as environmentally sustainable growth." Similarly, IFC's mission is to "promote sustainable private sector investment in developing countries, helping to reduce poverty and improve people's lives."
4. The IDB is made up of the Inter-American Development Bank (IDB), the Inter-American Investment Corporation (IIC), and the Multilateral Investment Fund (MIF). The main departments within the IDB that engage in intermediary financing to support private-sector development are the IDB's Private-Sector Department (PRI), the IIC, and the MIF.
5. For instance, only 2 percent of the Asian Development Bank's portfolio is channeled through FIs.
6. Not-for-attribution interview, MDB staff, 6 October 2004.
7. The definition of a "small and medium-size enterprise" (SME) varies across MDBs. For example, the IFC defines an SME as an enterprise that employs between ten and 300 people, with assets and annual sales between $100,000 and $15 million (IFC 2004a).
8. Figures reflect the financial-sector operations of the IFC, the EBRD, and the IDB. Because each MDB defines financial-sector investment differently, data collected from annual reports do not allow for accurate comparisons across MDBs, only within MDBs from year to year. Data on financial-sector investment before 1999 are not included because they either are not available for all MDBs or the MDBs use different reporting methodologies that do not allow a comparison of pre- and post-1999 figures within MDBs. IFC figures include finance, insurance, and investment vehicles, as reported in its annual reports between 1999 and 2003. These figures do not include SME lending, as SMEs are incorporated into several industry sectors and therefore are not explicitly reported in sectoral breakdowns of annual financing commitments. The EBRD figures include Financial Institutions Group–sector data in these annual reports, and the IDB figures include "Financial Market Operations" as defined in IDB 2003a.
9. EBRD: 78 percent of financial market operations (http://www.ebrd.com/pubs/factsh/themes/ar.pdf). IDB: the totals are derived from summing the SME activities of the MIF ($70 million) and the IIC ($193 million), which total $263 million, roughly 52 percent of financial market operations ($505 million) (http://www.iadb.org/pri/english/dbase/results.cfm). IFC: 37 percent of financial market operations (http://www2.ifc.org/sme/support_for_smbusiness.pdf) and http://www1.ifc.org/ar2003/highlights/financials.htm, "commitments by strategy" graph.
10. For a theoretical overview of the historical determinants of financial market growth, see Beck, Demirgüç-Kunt, and Levine 2001; Caprio and Demirgüç-Kunt 1997; and Rother 1999.
11. The major international rating agencies (Duff & Phelps, Moody's, Standard & Poor's) have given MDBs preferred creditor status, which often exempts their projects from certain banking regulations and enhances borrowers' access to foreign exchange. These favorable creditor conditions make loan syndication and cofinancing arrangements with MDBs particularly attractive to private commercial banks, especially in countries with volatile financial markets. See the IFC's web site under "Syndications and Resource Mobilization—The Treatment of Participants," http://www.ifc.org/ifcext/treasury.nsf/Content/TreatmentofParticipants.
12. According to a senior MDB official, building FI capacity by assisting financial institutions with portfolio management has become an important goal of MDBs' intermediary financing operations. Not-for-attribution interview, MDB staff, September 15, 2003. Also see IDB 2003a, 10.
13. For an overview of the environmental policies and procedures commonly used in multilateral financing to the private sector, see IFC 1998a; EBRD 2003a; and IDB 2004a.
14. Type 1 FIs that support microfinance at the IFC are an exception to this general rule, as they are subject to a microfinance exclusion list.
    The IFC's general exclusion list prohibits "commercial logging operations or the purchase of logging equipment for use in primary tropical moist forest (prohibited by the Forestry policy)," and the microfinance exclusion list prohibits the

"production or trade in wood or other forestry products from unmanaged forests." The microfinance exclusion list has the following restrictions in addition to the general exclusion list: the production, trade, storage, or transport of significant volumes of hazardous chemicals; the commercial-scale usage of hazardous chemicals; and production or activities that impinge on the lands owned or claimed under adjudication by indigenous peoples, without full documented consent of such peoples.

15. The EBRD's exclusion list in addition prohibits the "shipment of oil or other hazardous substances in tankers without valid IMO certificates." The IFC's exclusion list also prohibits the "production or trade in radioactive materials." This is contained in EBRD's referral list.
16. http://www.ebrd.org/enviro/index.htm; http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/aa_exclusionlist/$FILE/AnA_exclusionlist.pdf.
17. The ISO 14001 Standard. See http://www.iso.org/iso/en/iso9000-14000/iso14000/iso14000index.html
18. Environmental information specific to subprojects that the FI is expected to report is typically limited to material incidents, such as accidental pollution discharges or other operational emergencies that may be in violation of the host country's laws and regulations and have adverse impacts on the environment.
19. The IFC uses an environmental and social questionnaire to assess an FI project sponsor's capacity at the time of appraisal. Capacity over the life of a project is determined by assigning an environmental and social risk rating.
20. The EBRD's risk rating usually takes into account the nature of the FI's portfolio, its existing environmental policies, if any, and the nature of the EBRD's investment and how much control it will exert over the FI's operations. The calculation of the rating is not a transparent process, and no formalized tool is apparent.
21. EBRD: 78 percent of financial market operations (http://www.ebrd.com/pubs/factsh/themes/ar.pdf).
22. Documents from the IFC, EBRD, and IDB were included in this survey. IFC: *Summary of Project Information* documents of projects with environmental screening category FI disclosed between March 5, 2004, and July 2, 2004 (25 projects); EBRD: *Project Summary Documents* of projects assigned environmental screening category FI or involving a framework facility, disclosed between November 25, 2003, and July 2, 2004 (20 projects); IDB: *Project Documents*, and attached documentation, of all intermediary financing projects conducted between January 1, 2003, and July 2, 2004 by the Private-Sector Department (4 projects); and the International Investment Corporation (IIC) (15 projects).
23. For more on the subject of informal regulation by the public, see Pargal and Wheeler 1995; and Pargal et al. 1997.
24. The World Bank, "Doing Business—Benchmarking Business Regulations," at http://rru.worldbank.org/DoingBusiness/default.aspx.
25. For instance, recourse to the Compliance Adviser/Ombudsman for the IFC, the Independent Recourse Mechanism for the EBRD, and the Independent Investigation Mechanism for the IDB.

THE INTERNATIONAL FINANCIAL FLOWS AND THE ENVIRONMENT PROJECT

WRI's International Financial Flows and the Environment (IFFE) project works to align public and private investment with sustainable development that results in positive outcomes on the ground.

IFFE influences upstream decision- making in order to enable change downstream at the project and community levels. The project concentrates on both public and private finance.

Our research, analysis, and engagement strategies target a subset of international financial institutions including Export Credit and Guarantee Agencies (ECAs), Multilateral Development Banks (MDBs), and private Equator Principle Banks that have agreed to apply social and environmental safeguards to project finance.

We focus our efforts on banks that shape international environmental and social policies and norms for finance, trade, and investment because these institutions set the conditions for private sector investment.

THE INSTITUTIONS AND GOVERNANCE PROGRAM

Established more than five years ago, the Institutions and Governance Program at World Resources Institute was one of the first policy research centers to focus explicitly on issues of environmental governance.

The Program partners with governments, international institutions, and public interest groups to foster inclusive and accountable decision-making processes that result in more socially just and environmentally sound decisions.

By asking the right questions, designing practical solutions, and facilitating change, the Institutions and Governance Program builds bridges between those who make decisions and those who are most affected by them.

About WRI

World Resources Institute is an environmental research and policy organization that creates solutions to protect the Earth and improve people's lives.

Our work is concentrated on achieving progress toward four key goals:

- protect Earth's living systems
- increase access to information
- create sustainable enterprise and opportunity
- reverse global warming.

Our strength is our ability to catalyze permanent change through partnerships that implement innovative, incentive-based solutions that are founded upon hard, objective data. We know that harnessing the power of markets will ensure real, not cosmetic, change.

We are an independent and non-partisan organization. Yet, we work closely with governments, the private sector, and civil society groups around the world, because that guarantees ownership of solutions and yields far greater impact than any other way of operating.

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