NGO Forum on ADB

Via electronic mail

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Copied to:
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Members of the Board of Directors of the AIIB

Re: The AIIB's investments in financial intermediaries: CSOs call for disclosure and accountability

Dear President Jin,

We write to you as representatives of civil society organizations to draw your attention to concerns associated with the AIIB's investments via financial intermediaries (FIs), including infrastructure funds.

We note that the AIIB has, in 2017 invested in three FIs - the Indonesia Regional Infrastructure Development Fund, the India Infrastructure Fund, and the Emerging Asia Fund - and that further FIs are on the proposed projects list, including the India National Investment Infrastructure Fund. In addition, we have learned that the AIIB is in the process of developing a strategy for investment in equity and funds. This is an opportune moment for the AIIB to consider the lessons learned from other development finance institutions to avoid the pitfalls and reputational risks associated with FI lending.

While investing in FIs can help mobilize funds and attract private capital for economic development, this form of third-party or 'hands-off' lending also comes with significant risks - in particular around clients' adherence to environmental and social (E&S) safeguards. In recent years, the International Finance Corporation (IFC) - over half of whose investment portfolio is channeled via FIs - has come to acknowledge these risks, and has taken some steps to address them. Following critical findings from both the IFC's own accountability mechanism, the Compliance Advisor Ombudsman (CAO) and from civil society, the IFC's CEO, Philippe Le Houérou, has committed to reduce high-risk lending through FIs, saying "we will reduce IFC's own exposure to higher risk FI activity and apply greater selectivity to these type of investments, including equity investments."[1]

In March 2017, the CAO released its third monitoring report on the IFC's financial sector portfolio.[2] The report examined actions taken by IFC to address the findings of the CAO's 2012 *Audit of a Sample of IFC Investments in Third Party Financial Intermediaries*, in which the CAO found, among other things, that the "result of [IFC's] lack of systematic measurement tools is that IFC knows very little about potential environmental or social impacts of its F[inancial] M[arkets] lending."[3] In this year's update, it is of particular concern that the CAO found that the "IFC does not, in general, have a basis to assess FI clients' compliance with its E&S requirements." As the CAO states, this is highly problematic in relation to FI clients that are supporting high-risk projects, and "where IFC does not have assurance that the development of a client's ESMS [Environmental and Social Management System] is leading to implementation of the Performance Standards at the sub-project level."[4]

Independent research carried out over the last year has supported these findings. Inclusive Development International (IDI) conducted a financial investigation to track IFC's investments in financial intermediaries to their end use. This research only examined the business of a tiny segment of the 700 financial institutions and 220 private equity funds in the IFC's FI portfolio; however, IDI found more than 130 projects and companies funded by two dozens IFC intermediaries that are causing or are likely to cause serious environmental harms and human rights violations. The projects are located in 24 countries and come from a range of high-risk sectors, including energy, industrial agriculture, mining, transportation, infrastructure, and even private military contracting. In each of these cases it is apparent that IFC's environmental and social Performance Standards are not being applied. IDI has detailed these findings, in collaboration with Bank Information Center, Urgewald, 11.11.11, Ulu Foundation and Accountability Counsel, in a four-part investigative series, entitled *Outsourcing Development: Lifting the Veil on the World Bank Group's Lending through Financial Intermediaries*.

Responding to these problems, the IFC's CEO recently announced that the IFC has cut its high-risk lending from 18 to just 5 investments[5], and has committed to increase the number of FI investments ring-fenced for such ends as climate mitigation and women-owned SMEs[6]. In addition, the IFC has also begun "tracking FI clients' exposure to coal, and plans to incorporate a reporting requirement on coal exposures in legal documents with all new FI clients".[7]

In this context, we urge the AIIB to learn from the IFC's problematic experience with its financial intermediary portfolio and act to avoid the associated social, environmental and reputational damage. The AIIB can do so by putting in place robust policies and systems around financial intermediary investments to ensure transparency, accountability and efficient channels of communication with all stakeholders. These requirements, in AIIB's policies, investment decision-making and contracts with FI clients should be mandatory and include:

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[1] https://medium.com/@IFC_org/re-examining-our-work-with-financial-institutions-208c4161d9e3
[2] http://www.cao-ombudsman.org/newsroom/documents/documents/CAOMonitoringReport_FIAudit_March2017.pdf
[3] http://www.cao-ombudsman.org/newsroom/documents/Audit_Report_C-I-R9-Y10-135.pdf
[4] http://www.cao-ombudsman.org/documents/CAOMonitoringReport_FIAudit_March2017.pdf
[5] https://www.devex.com/news/opinion-here-s-how-the-ifc-is-working-with-financial-institutions-91223
[6] https://medium.com/@IFC_org/re-examining-our-work-with-financial-institutions-208c4161d9e3
[7] IFC 2017 Improving IFC's Approach to Environmental and Social Risk Management: Listening, Learning, and Adapting (updated April 2017). See: https://www.ifc.org/wps/wcm/connect/77c11449-261e-484b-a885-f9d77b087386/Improving-IFCs-+Approach-to-ES-Risk-Management-Updated-April-2017.pdf?MOD=AJPERES

- Scrutinising the existing project portfolio and pipeline of proposed FI clients to ensure that all projects are in line with the bank's policies and strategies;
- Ensuring that the proposed FI client has in place a robust environmental and social management system before the investment is approved;
- Reviewing the track record of the FI client in applying the environmental and social framework and making this assessment public;
- Ensuring that FI clients require sub-projects to be compliant to all AIIB policies specially the Environmental and Social Framework (ESF), Complaints Handling Mechanism (CHM), Public Information Policy, and all relevant sectoral strategies and guidelines. This should enable FI sub-projects to remain accountable to AIIB oversight and due diligence at all levels of the project cycle;
- Monitoring the proposed client's social and environmental due diligence and supervision of its investment; and
- Ensuring FI sub-project affected communities have access to redress, including through the AIIB's accountability mechanism.

In addition, it is crucial that the AIIB contractually require the FI client to disclose publicly all of its investments and permit the AIIB to disclose the information on its website. This will help ensure that affected communities and other stakeholders are aware that the sub-projects must comply with environmental and social standards and can alert the client, the AIIB, and its Board at *early stages* if those standards are not being met. A provision requiring this disclosure of FI sub-projects should be included in the AIIB's forthcoming Public Information Policy. In this regard, as a first step, the AIIB could follow the ADB's policy requiring 120-day public disclosure of draft environmental and social assessments "where the subprojects financed by the FI … through either credit-line, other loans, equity, guarantee, or other financing instruments, have potential for significant environmental or social impacts."[8]

In any case, funds routinely disclose a range of information. For example, PT. Indonesia Infrastructure Finance, a financial intermediary with equity held by the ADB, the IFC, and PT. SMI where the AIIB's Regional Infrastructure Development Fund will be housed, discloses all subprojects and discloses environmental and social impact assessments.[9] Other funds, routinely disclose a range of information.[10]

In addition, DJ Pandian told NGOs in Jeju during the AIIB AGM that he can see no obstacle to disclosing publicly high risk AIIB sub-projects supported by private equity funds. Such information would enable the Board, bank management, civil society and potentially affected communities to monitor whether the AIIB's standards are appropriately applied to these investments, greatly increasing transparency and facilitating and incentivising better management of environment, social, and governance issues across AIIB's financial sector portfolio.

We look forward to your response to these concerns and your commitment to ensuring that the AIIB takes on the lessons learned at IFC to reduce high risk FI lending.

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[8] ADB Safeguard Policy Statement, 2009. SAFEGUARD REQUIREMENTS 4: SPECIAL REQUIREMENTS FOR DIFFERENT FINANCE MODALITIES

[9] http://iif.co.id/en/social-environment-principles/project-summary?text=&category=0&option=com_qflarticlesfilter&view=articles&Itemid=238&qfl-search=1&modulename=

[10] In addition to PT Indonesia Infrastructure Finance see, for example, the India Infrastructure Fund (IDFC) http://www.idfc.com/alternatives/infra-equity/portfolio_companies.htm.

Yours sincerely,

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