

# RISKY BUSINESS

## INTERMEDIARY LENDING AND DEVELOPMENT FINANCE

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**This issue briefing highlights the increasing use by development finance institutions of financial intermediaries to channel their funding. It identifies features of this lending and the implications for affected communities' access to land and resources. It also provides recommendations for addressing concerns related to these investments.**

### THE RISE OF FINANCIAL INTERMEDIARIES

The last ten years have seen a surge in the use of a new model of lending by institutions that fund development. This model departs from the direct financing of projects or programmes in developing countries. Instead, funds are channelled through financial intermediaries (FIs), such as private equity funds, banks, or credit agencies.

FI lending is becoming common across all sectors, including climate finance, infrastructure development, and even basic services like healthcare and education. For example, the International Finance Corporation (IFC) has invested \$20m equity in the \$100m Asia Water Fund. This has fuelled controversy surrounding the World Bank's support for private sector involvement in water.<sup>1</sup> A recent study of 350 private equity funds backing infrastructure in developing countries found that 125 had received development finance support from FIs.<sup>2</sup>

In 2011, over half of the overall portfolio of the International Finance Corporation (a member of the World Bank Group) was made up of lending to FIs.<sup>3</sup> The European Investment Bank has doubled its use of this model over the last ten years, so that it now accounts for nearly 40 per cent of lending.<sup>4</sup> Development finance institutions (DFIs) promote the role of FIs in helping to reach small businesses.<sup>5</sup> Indeed, in developing economies, there is a gap to be filled: access to financial services and private finance plays a critical role in economic and social development, but is often sorely lacking.

However, questions are being asked about whether this new model of lending is achieving the desired result of environmentally sustainable pro-poor development. FI-funded activities that impact negatively upon the rights of people living in poverty concerning land and resources are of particular concern.

# WHAT IS A DEVELOPMENT FINANCE INSTITUTION?

DFIs, unlike private banks, are guided by both the need to generate profit for their stakeholders and public policy objectives. The IFC, in common with other DFIs, has an explicit poverty reduction mandate. The IFC's Performance Standards, which provide environmental and social safeguards, act as a benchmark for many other DFIs, including the Dutch FMO and the UK's CDC.

Multilateral and regional DFIs are owned by their member states. Bilateral DFIs can be co-owned by national governments and private interests. See *Table 1* for examples of these different types of DFI.

**Table 1: Examples of DFIs**

Bilateral DFIs	Regional DFIs	Multilateral DFIs
<p><b>UK:</b> CDC Group plc</p> <p><b>France:</b> Proparco</p> <p><b>Netherlands:</b> Netherlands Development Finance Company (FMO)</p> <p><b>Germany:</b> Deutsche Investitions- und Entwicklungsgesellschaft mbH (DEG)</p> <p><b>Sweden:</b> Swedfund</p> <p><b>Norway:</b> Norfund</p> <p><b>US:</b> Overseas Private Investment Corporation (OPIC)</p> <p><b>Japan:</b> Japan Bank for International Cooperation (JBIC)</p> <p><b>Canada:</b> Export Development Canada (EDC)</p> <p><b>Spain:</b> Compañía Española de Financiación del Desarrollo (COFIDES)</p>	<p>Asian Development Bank (ADB)</p> <p>Inter-American Development Bank (IDB)</p> <p>African Development Bank (AfDB)</p> <p>European Investment Bank (EIB)</p> <p>European Bank for Reconstruction and Development (EBRD)</p>	<p>International Finance Corporation (IFC)</p> <p>Multilateral Investment Guarantee Agency (MIGA)</p>

## PROBLEMS OF DFI LENDING TO FIs

DFI lending to FIs is handled quite differently from lending directly to a project. Differences in change models, transparency, results sought and achieved, and defining and managing risks are significant. And yet, many activities funded through FIs mirror those funded via DFI direct investment – including extractive industry projects, commercial forestry plantations, dams or power plants and agribusiness. Among these are investments that can significantly impact local communities.

It is striking that the only two complaints relating to IFC FI lending taken to the IFC's redress and compliance mechanism, the Complaints Advisor Ombudsman (CAO), both involve land disputes. One case is that of a tree plantation project in Uganda, to which Oxfam and the Uganda Land Alliance are co-signatories with the affected communities; the other is the GKEL coal mine in India (see Box 1).

*'Isolating the project information from [the] public eye creates more havoc than solution, because there are no strong disclosure and safeguards standards that the company is bound to follow. It then spares the company from accountability.'*<sup>6</sup>

Vijayan MJ of civil society organization Delhi Forum, one of the co-complainants

*'Are these the types of information the IFC does not want to share with us and the greater public because it will jeopardize the interest of its client? Will the World Bank Group remain mum to safeguard its borrower? What about the real dangers we now face?'*<sup>7</sup>

Bhakta Bandhu Behera, a project-affected person from Manibeda village

Box 1: GMR Kamalanga Energy Limited (IFC-backed coal-fired power plant in Odisha, India)

In July 2011, the CAO accepted a complaint from communities affected by the GMR Kamalanga Energy Limited (GKEL) project. This sub-project was financed by the IFC through a 2007 \$100m equity investment in the India Infrastructure Fund (IIF).

GKEL acquired 486 hectares of land. This included irrigated prime agricultural land and 362 hectares of private land that provided food and employment for nearly 1300 families. These people were displaced by the land acquisition for the GKEL project.

The complainants allege that no livelihoods restoration plan was in place. Many families were not properly compensated, and hundreds lost access to land, crops, and property. The complainants also allege that proper consultation procedures for land acquisition were not adhered to, and that violence and intimidation accompanied the project.<sup>8</sup>

The complainants tried for months to find out even the most basic information about the project and its backers. They say that, by protecting FIs from scrutiny and permitting high levels of secrecy, the IFC is having a harmful impact.

The IFC's presence in this deal also appears not to have improved transparency, accountability, safeguards, or benefits for affected communities. Even leaving aside the serious impacts of the GKEL project on the local community and environment, it is difficult to see the economic value of this project.

It is not clear how providing finance for large-scale carbon-intensive power projects in India, where big industrial projects have relatively good access to commercial finance, fulfils the purpose of bringing additional finance to the small and medium-sized enterprises (SMEs) sector, or to projects with particular potential for pro-poor impact. This is especially relevant in Odisha, which has the lowest per capita access to energy of any state in India, and where this kind of project will not address the issues of connectivity and last-mile delivery that could really help the rural poor gain access to energy.

In 2011, the CAO announced a review of the IFC's financial sector investments. This was in response to rising concerns about the institution's use of FIs. The review is due to be published in the summer of 2012. It will focus on whether the IFC's social and environmental standards are being met in FI investments.

The problems associated with DFIs lending to FIs are summarized below.

## Failure of DFIs to leverage positive change

DFIs could do much better at using their financial and reputational influence to ensure better results, as US Attorney John Crutcher explains:

*'A DFI can use its power as an 'anchor investor' to specify the types of activities and measures that would best contribute to positive change and avoid harm. However, DFIs often fail to make the most of this power. Once funds have been disbursed to the FI, the DFI's influence tends to be reduced significantly.'*<sup>9</sup>

This point is especially important because DFIs say their investment attracts other private investors who value their credibility and knowledge.

## Conflicting priorities

DFIs and FIs often have different objectives. FIs make profit-motivated investment decisions. It is difficult to expect them to have a strong motivation to alleviate poverty, or to have an understanding of how to do so.

Yet, it is the FI itself that identifies the projects to be supported and the results to be accomplished. DFIs do not use a screen to determine if a given FI uses a pro-poor lens to guide its investments.

This means that the benefits of strong growth often fail to reach the poorest people.<sup>10</sup> This is compounded if projects fail to protect access to land and other natural resources, which is vital in addressing inequality.

## Reduced transparency

When DFIs directly fund risky activities, extensive amounts of information are provided to the Board of Directors of the DFI and made public. In contrast, the public has virtually no access to information about activities funded by most FI clients of DFIs.

This includes activities posing serious risks to communities and the environment. For example, when the IFC lends through an FI, the public has no access to information about the FI's high-risk activities and activities that pose a risk of 'substantial impact.'<sup>11</sup> See *Table 2* for an overview of transparency requirements at the IFC.

FIs are required to disclose information only to local communities for higher-risk projects.<sup>12</sup> However, the IFC provides relatively little oversight of this disclosure.<sup>13</sup> (See *Box 2*.)

Cases such as the GKEL coal-mine project in India show that information and consultation are often poor or absent. It can be extremely difficult to investigate and achieve redress after the fact. Early disclosure of information is vital for deals involving acquisition of land and other natural resources.

A contributing factor to this reduced transparency is the sheer number of investments by FIs. This can create challenges for providing information to the public. Additionally, DFIs indicate that they are constrained by national investor regulations providing some restrictions on public disclosure of information related to FI investments.

Box 2: El Tejar (IFC-backed agribusiness in Mato Grosso, Brazil)

London-based hedge fund Altima Partners created Altima One World Agriculture Fund (AOWAF) to invest in farmland in South America, emerging markets, and sub-Saharan Africa. The IFC made its biggest ever agribusiness equity investment (up to \$75m) in AOWAF in 2009.

The IFC invested in AOWAF via a 'special vehicle'. Using this separate company means the IFC's investment remains separate from the main fund, permitting the main fund still to invest in projects that may be excluded from IFC funding.<sup>14</sup> Altima says the fund aims to create the 'first Exxon Mobil of the farming sector'.<sup>15</sup>

Altima Partners is one of the leading backers (40 per cent equity) of the Argentine company El Tejar. El Tejar aims to plant 400,000 hectares of soybeans and corn in Mato Grosso, Brazil, and a further 1.1m hectares across South America. This would make it the largest farm company in the world.<sup>16</sup>

Failure to protect indigenous peoples and resolve land rights disputes is a recognized problem in Mato Grosso. IFC itself notes that in Mato Grosso "[soy] expansion is contributing to the destruction of large areas of natural vegetation annually".<sup>17</sup>

Altima discloses no detailed information about its activities and policies, and admits it does not adhere to the UK Financial Reporting Council's Stewardship Code (which aims to improve transparency and the exercise of investors' governance responsibilities). Given this lack of transparency, it is impossible to know exactly what El Tejar is doing with IFC money in Mato Grosso, or whether Altima is fulfilling its responsibilities as an IFC-backed investor to ensure that environmental and social safeguards are implemented and rights protected.

**Table 2: Comparison of transparency requirements for direct and indirect lending at the IFC**

	<b>Direct investments</b>	<b>Financial intermediary lending</b>
<i>Risk identification and management</i>	IFC staff identify and manage risk. IFC categorization system used to characterize project as Category A, B, or C.	IFC shifts responsibility to FI to identify and manage risks. Capacities among FIs to do this vary widely. Each FI uses its own system to characterize risk, creating potential for inconsistent risk characterization.
	<b>Highest-risk projects (Category A)</b>	<b>Highest-risk sub-projects (Category A)</b>
<i>Information to public</i>	At least 60 days before IFC decision to lend.	Once a year and only for private equity projects after financing by IFC.
<i>What</i>	Name, location, sector impact assessment information, etc.	Name, location, sector. (No impact assessment information is disclosed.)
	<b>Category B</b>	<b>Category B</b>
<i>Information to public</i>	At least 30 days before IFC decision to lend.	Information never available.

### Development outcomes not properly specified or tracked

Scrutiny of what DFI funds accomplish in terms of social and environmental standards largely ends once funds are provided to an FI. DFIs do not ask for an assessment of development outcomes achieved by a given sub-project.

Instead, performance measures relate largely to whether the capacity of the FI has been enhanced, and whether the FI has increased the number of SMEs funded. They fail to comprehensively capture the development impact on the ground, e.g. the impact upon local food production, access to credit, local livelihoods, small-holder farmers, women's livelihoods and empowerment, biodiversity, and ecosystems.

### Inadequate safeguards

DFIs' assessment of risks largely focuses on FIs' financial health, and the risk of poor financial returns from investment. The responsibility to manage environmental and social risks to poor people is usually shifted to the FIs. Many DFIs require FIs to ensure that some or all of their environmental and social standards are applied to higher-risk activities. However, even DFIs struggle to implement safeguards and standards well.<sup>18</sup>

FIs generally have much less experience than DFIs with safeguards such as community consultation requirements. This means they are less likely to be able to ensure that their clients conduct adequate community consultation.

Some DFIs have 'exclusion lists' that specify activities that cannot be funded by a DFI. However, such exclusion lists fail to account for the significant differences between DFI lending directly and via FIs. They do not rule out investments via FIs that significantly affect communities' access to land and resources.

## RECOMMENDATIONS

### *Focus on development impact*

- The selection of FIs should be prioritized towards institutions that have substantial local ownership and are equipped to make investments that are in line with the DFI's development objectives and approach.
- DFIs should establish a public registry of all FIs for which a record of sufficient development expertise, capacity, and pro-poor lending exists. There should be public disclosure of the specific criteria used to evaluate eligibility and the DFI's justification for each FI's eligibility status.
- Investments which involve the wholesale transfer of land away from affected communities should be excluded, unless there is demonstrable application of social and environmental standards, including Free Prior and Informed Consent, proper compensation, and full transparency.
- FI lending must be directed much more to low-income countries, specifically where private sector finance is most lacking. Lending to FIs must be reformed to demonstrably reach those most in need, including more enterprises and businesses at the smaller end of the SME spectrum.

### *Increase transparency*

- Information disclosure should be increased for FI sub-projects, especially those affecting communities' access to land and other natural resources. Information provided to local communities, such as impact assessments, should also be made available on DFIs' websites.<sup>19</sup>

### *Greater due diligence*

- Due diligence and monitoring requirements focused on development impact, and not exclusively financial performance, must be included in contracts between DFIs and FIs, and between FIs and their clients.
- DFIs should apply performance standards to all high- and moderate-risk sub-projects, and to all projects that adversely impact the land and natural resources on which people living in poverty rely for their livelihoods.

### *Increase accountability*

- DFIs should ensure that contracts include conditions permitting them to withhold and, if need be, withdraw funding from FI clients if violations against either the exclusion list or performance standards are found. These conditions should be backed by appropriate monitoring arrangements.
- All DFIs must ensure that suitable redress mechanisms are made available and communicated at the onset of a project to all affected communities when FI clients are used.

Other ways of reaching local SMEs directly should also be considered. Oxfam

is piloting two initiatives to help reach agriculture-related SMEs, which find it difficult to access commercial finance. These initiatives focus on making a positive impact and filling the financing gaps that FI lending does not reach. They aim to empower small-holder farmers to build enterprises and help ensure food security for poor and vulnerable communities. See *Box 3* for an overview of the initiatives.

#### Box 3: Filling the finance gap for SME agriculture

##### ***Enterprise Development Programme (EDP)***

The EDP targets rural enterprises with \$10,000–\$200,000 turnover and requiring \$50–\$100,000 investment for equipment or working capital.

Most of these enterprises operate in very remote areas of countries such as Ethiopia, Tanzania, and Nepal, are farmer-owned, and have one to three paid staff.

Investment is channelled through local banks or microfinance organizations. However, it is managed directly rather than via intermediaries. EDP started in 2008 and currently has 15 enterprises in its portfolio.

##### ***Small Enterprise Impact Investment Fund (SEIIF)***

SEIIF is an impact fund offering investors the opportunity to achieve positive social change and modest returns through investing, via Small Enterprise Financing Intermediaries (SEFIs), in SMEs in developing economies.

Oxfam's role is to advise on the development focus of the fund's activities and to ensure that it is reported as fully and accurately as possible. Through its due diligence processes and monitoring (as well as technical support through an Impact Support Facility), SEIIF will contribute to a new impact investing industry standard. Importantly, this includes both ensuring that intermediaries and investee sub-projects meet the IFC's Performance Standards and monitoring fulfilment of development impact throughout the life of the investments.

## NOTES

- <sup>1</sup> Another example is the IFC's support for Kaizen Private Equity LLC, an \$80m single sector private equity fund dedicated to investments in the education sector in India.
- <sup>2</sup> N. Hildyard (2012 forthcoming) 'More than Bricks and Mortar: Private Equity Infrastructure Funds', The Cornerhouse.
- <sup>3</sup> Author's own calculations based on the figures provided by the IFC in its annual report for the financial year 2011.
- <sup>4</sup> A. Tricarico (2011) 'EIB lending through financial intermediaries in Africa: a call for action', <http://ictsd.org/i/news/tni/108593/> (last accessed April 2012)
- <sup>5</sup> See Table 1 for examples of DFIs.
- <sup>6</sup> Bank Information Center (2011) 'Ombudsman accepts complaint against GMR project in Odisha', Bank Information Center, 13 May 2011, <http://www.bicusa.org/en/Article.12436.aspx> (last accessed April 2012)
- <sup>7</sup> Ibid.
- <sup>8</sup> Odisha Chas Parivesh Sureksha Parishad and the Delhi Forum (2011) Letter of complaint to the Compliance Advisor/Ombudsman, [http://www.cao-ombudsman.org/cases/document-links/documents/IndiaIFcomplaint\\_April152011\\_web.pdf](http://www.cao-ombudsman.org/cases/document-links/documents/IndiaIFcomplaint_April152011_web.pdf) (last accessed April 2012)
- Bank Information Center (2011) 'Ombudsman accepts complaint against GMR project in Odisha', Bank Information Center, 13 May 2011, <http://www.bicusa.org/en/Article.12436.aspx> (last accessed April 2012)
- <sup>9</sup> John Crutcher (2012) Personal communication with CIEL.
- <sup>10</sup> Oxfam International (2012) 'Left behind by the G20? How inequality and environmental degradation threaten to exclude poor people from the benefits of economic growth', <http://policy-practice.oxfam.org.uk/publications/left-behind-by-the-g20-how-inequality-and-environmental-degradation-threaten-to-203569> (last accessed April 2012)
- <sup>11</sup> Although the Access to Information Policy has a presumption of disclosure, in Section 8(b), for 'project level information regarding investments and advisory services supported by IFC', IFC management indicates that 'project level information' relates only to information about IFC's direct investment in an FI. The presumption does not follow funds provided by the FI to subprojects.
- <sup>12</sup> 'Higher risk' is not defined in the Access to Information Policy, but the non-binding Interpretation Notes suggest that higher risk includes Category A and Category B projects.
- <sup>13</sup> Access to Information Policy, Section 9.
- <sup>14</sup> International Finance Corporation (2008) 'Summary of proposed investment', <http://www.ifc.org/ifcext/spiwebsite1.nsf/f451ebbe34a9a8ca85256a550073ff10/dd0aeac40d774535852576ba000e2c74?OpenDocument> (last accessed April 2012)
- <sup>15</sup> Joseph Carvin, Altima Partners' One World Agriculture Fund (2009) cited in GRAIN (2010) 'The new farm owners: corporate investors lead the rush for control over overseas farmland', <http://www.grain.org/article/entries/4389-the-new-farm-owners-corporate-investors-lead-the-rush-for-control-over-overseas-farmland> (last accessed April 2012)
- <sup>16</sup> K. Gartland (2010) 'Brazil outback lures Argentine farm giant', <http://www.farmlandgrab.org/post/view/14579> (last accessed April 2012)
- <sup>17</sup> Biodiversity and Agricultural Commodities Program (BACP), Notice of Anticipated Grant Award (2010), [http://www1.ifc.org/wps/wcm/connect/78ce3700488553fab0fc26a6515bb18/ICV\\_PublicPostingSummary.pdf?MOD=AJPERES](http://www1.ifc.org/wps/wcm/connect/78ce3700488553fab0fc26a6515bb18/ICV_PublicPostingSummary.pdf?MOD=AJPERES) (last accessed April 2012)
- <sup>18</sup> Compliance Advisor/Ombudsman (2010) 'Review of IFC's Policy and Performance Standards on Social and Environmental Sustainability and Policy on Disclosure of Information', [http://www.cao-ombudsman.org/documents/CAOAdvisoryNoteforIFCPolicyReview\\_May2010.pdf](http://www.cao-ombudsman.org/documents/CAOAdvisoryNoteforIFCPolicyReview_May2010.pdf) (last accessed April 2012)
- <sup>19</sup> Greater transparency for at least the higher-risk projects is possible. OPIC requires that information for high-risk activities funded through FIs be disclosed publicly prior to OPIC Board approval of the FI portfolio.

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