
Evaluating the Promotion of Environmental and Social Standards in DEG's Investments in Financial Intermediaries:

Evaluation Report

Prepared for
DEG

January 2017

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Executive Summary

Introduction

DEG, as a Development Finance Institution (DFI), promotes economic success and sustainable business practices through the provision of finance to private sector clients in developing and emerging economies. DEG understands that managing environmental and social issues, related to the activities of DEG's clients, is an essential part of good business practice.

DEG's investments extend to countries and sectors with different levels of Environmental and Social (E&S) regulations and standards as well as different degrees of enforcement. As a result, DEG requires its clients to implement a structured E&S risk management process adapted to each client's activities and specific business context.

Monitoring compliance with E&S standards and promoting the opportunities for E&S improvement is challenging for DEG when providing finance indirectly via financial intermediaries – namely, Private Equity Funds (PEFs) and financial institutions (FIs). In particular, this is the case for commercial banks, which may have thousands of clients with diverse E&S risks.

The Evaluation

In order to better understand the challenges facing the financial intermediary portfolio, DEG commissioned Citrus Partners LLP to undertake an extensive evaluation of environmental and social risk management by financial intermediaries, with a particular focus on the implementation of Environmental and Social Management Systems (ESMS).

Financial intermediaries represent more than 40% of DEG's client portfolio and, hence, are a significant part of DEG's global operations:

- Within its EUR 7.2 billion portfolio, there are 238 intermediary financial clients (comprising 138 banks ('FIs') and 100 Private Equity Funds ('PEFs')) with a combined commitment volume of EUR 3.2 billion (~44% of DEG's portfolio)¹;
- The financial intermediary portfolio is regionally diverse with the largest shares, by value, in Asia and Latin America;
- The majority of committed finance of the overall portfolio comprises medium E&S risk clients (Category B, 53%), while a third are higher risk clients (Category A, 33%). The remainder comprises low E&S risk clients (Category C, 14%).

Managing E&S Risks: The focus of the evaluation is on the management of E&S risks through the adoption and integration of ESMS processes and procedures.

From DEG's perspective, the starting point is the inclusion of standard E&S requirements in contracts for all DEG financial intermediary clients. DEG requires its clients to structure these requirements into a formalised Environmental and Social Management System (ESMS). The objective is to identify, manage and monitor environmental and social risks adequately to ensure that DEG's standards of environmental and social performance are maintained.

An ESMS includes the use of a specific Exclusion List (for prohibited business activities) in the screening process, categorization of E&S risks, the appointment of a dedicated E&S Officer, and the provision of an annual report on E&S performance. The planning and implementation of ESMS at the financial intermediary level is central to the achievement of DEG's E&S requirements.

¹ Portfolio data from 31.12.2015. Data is slightly different to official DEG data as this analysis includes i) all Commercial Banks and Private Equity Fund clients in DEG's clusters "financial institutions" and "funds" ii) with cash exposure >0. The final list has been screened manually to further exclude clients belonging to the cluster due to their financing structure e.g. clients involved in leasing etc.

DEG also monitors and supports its clients with trained investment personnel and a dedicated sustainability department. In addition, DEG offers a Technical Assistance (TA) programme to support and enhance the development and uptake of ESMS through its Business Support Services (BSS).

Objectives of the Evaluation: The evaluation centred on the following three core objectives:

- Objective 1: Evaluate the implementation and practical use of ESMS by DEG's clients;
- Objective 2: Evaluate the effectiveness and impact of the ESMS at the level of i) DEG's clients and ii) clients of the FIs and PEFs;
- Objective 3: Evaluate (i) the Functioning of DEG, and (ii) the Value-Added of DEG (in particular in the TA framework on ESMS)

Methodology Used: The evaluation involved four key stages. Each stage served to inform the next through an increased understanding of the portfolio and E&S risks. The four stages comprised:

- A **desk-based Portfolio Analysis**, which was used to gain a broad understanding of the global portfolio, to select clients for the Control Group for the Web Survey and to cluster the portfolio to enhance the analysis going forwards;
- A **Web Survey** of 108 clients based on a clustered sample of DEG's portfolio, representing different operating regions and levels of E&S enforcement, E&S risk categories, clients with SME activity etc. The clustering and the high response rate (57%) allowed feedback from a representative group of financial sector clients;
- A follow up **Telephone Survey** of 19 clients, which allowed deeper insights into specific issues raised in the Web Survey and to increase client representation in regions which had a lower response rate;
- **Evaluation Visits** to 8 Case Study clients across all regions of DEG's portfolio: Africa (Mozambique, Namibia, South Africa), Asia (Cambodia, Vietnam), Latin America (Panama, El Salvador), and Europe (Georgia). The Case Studies are available online with this report and provide in-depth examples of ESMS implementation both in practice and on the ground.

General Findings

The following general findings can be drawn from the assignment:

Objective 1: Evaluate the degree of implementation and practical use of ESMS by DEG's clients.

- All PEFs have most elements of an ESMS in place and so do most Category A FIs (>80% of web-survey respondent for each element);
- For PEFs, this is mainly because an ESMS is a contractual requirement prior to first disbursement of DEG's investments and because its implementation is strongly supported by fund managers, who consider ESMS to be a core element of their business;
- Medium risk FIs (Category B) tend to face more challenges. The Web Survey suggests that up to a third of DEG's Category B FI clients do not have an effective ESMS in place. For these Category B FIs, particularly in low income and low E&S enforcement environments and those with many SME clients, some aspects of ESMS implementation are proving challenging.

Objective 2: Evaluate the effectiveness and impact of the ESMS at the level of i) DEG's clients and ii) clients of the FIs and PEFs.

- The study showed clearly that there are many direct business benefits from the effective use of an ESMS, including:
 - reducing portfolio risks, increasing returns on investments or attracting finance particularly from other development finance institutions;

- enhancing reputation and business brand and improving relationships with local communities.
- Highly relevant for business success, ESMS is also important for staff motivation and helps to attract and retain good loan officers and analysts;
- In some cases, where ESMS implementation has been completed and trained staff have been motivated to go “beyond compliance”, FIs are starting to target direct ‘green’ investments in sectors such as renewable energy, energy savings, recycling and reuse of waste and water etc. This next step is an important transition from compliance to enhancement and has been seen to have multiple benefits for the businesses involved, however, there is still a significant way to go before large numbers of FIs progress beyond compliance;
- For sub-projects of DEG’s clients, benefits are likely, however the specific impact of ESMS is harder to attribute. DEG clients indicate that application of the ESMS, and in particular due diligence and site visits by E&S Officers, is having a positive effect on sub-projects. Where Environmental and Social Action Plans (ESAPs) at the sub-project level have been produced, the ESMS process is driving improved E&S performance. Several sub-project clients also reported improvements in health, safety and working conditions directly as a result of ESMS implementation.

Objective 3: Evaluate (i) the Functioning of DEG, and (ii) the Value-Added of DEG (in particular in the TA framework on ESMS)

- The evaluation showed clearly that DEG’s clients value the relationship with DEG highly. There were very few negatives other than a few FIs which have not received comments on their E&S reporting submissions, have requested further training, are unclear about E&S risk categorisation and do not know where to go to get help – a guiding document on ESMS produced as part of the evaluation should help significantly with this issue;
- The Web-Survey highlights that clients see DEG as the DFI most committed to E&S performance and with the highest influence;
- DEG’s Technical Assistance covers a vast range of countries and is generally working well. Clients have emphasised the benefits of developing the ESMS together with an experienced consultant; the TA programme has been very well received – in some cases, however, the TA was provided several years ago and DEG’s clients would like refresher training or further access to tools and guidance and to good practice; a few clients have experienced difficulties with TA either due to the length of the process or the challenges faced by business interruption which has necessitated a more flexible approach and lends itself to more front-end consultation;
- Overall Findings: DEG has had a positive role in actively supporting structural change.
 - DEG’s E&S standards have been widely-adopted by its financial intermediary portfolio; moreover, implementation of an integrated ESMS is increasingly seen by DEG’s clients as integral to business rather than a separate requirement; through this process, DEG’s clients have been able to become market sustainability leaders or are actively contributing to banking round tables and other resource-sharing platforms in some cases and are able to avoid or remove projects which carry unacceptable risks from their portfolios;
 - The representative survey results show that a large majority of FIs and PEFs (>70%) in DEG’s portfolio of financial intermediaries have introduced an ESMS for the first time or improved their ESMS since DEG’s investment;
 - 25% of FIs and 39% of the PEFs in the Web Survey were actively supported by DEG’s TA programme in developing or improving the ESMS.

Challenges, Solutions and Success Factors of ESMS Implementation

- Additional information on challenges, solutions and key success factors for successful E&S management were identified through the Web Survey, Telephone Interviews and Case Studies, and are summarised below:
 - **Challenges remain**, particularly in countries where E&S legislation and enforcement is at an early stage: Common challenges faced include finding and retaining adequately-qualified E&S staff, the application of appropriate risk categorization, and on-the-ground risk identification;
 - **Tailored solutions**: The study found that solutions to challenges always had to be adapted to the specific FI or PEF context and were developed in a collaborative effort by management and staff. The report shows how some of DEG's clients addressed the different challenges and what others may learn from it; in some cases, innovative solutions have been developed;

Keys to Success

- Despite the need for tailored solutions, some general keys to success when implementing an ESMS could be identified: i) senior level commitment and strategic vision for ESMS, ii) supportive market conditions, iii) an appropriately-targeted ESMS tailored to the existing portfolio, iv) quick procedures for small loans with low E&S risk, v) experienced or fully-trained E&S Officer/Manager (vi) a flexible approach to ESMS implementation for new FIs or those operating in jurisdictions where more buy-in is needed for Senior Management to get started;

Supporting Documents

- Case Studies: The eight Case Studies complemented the quantitative survey results and provided the opportunity to learn about the specific experiences clients have had with ESMS. This allowed the evaluators to identify both innovative uses of ESMS – for example in the identification of 'green' investment opportunities in El Salvador – and areas where further action might be necessary – e.g. a bank in Mozambique exemplified the need for DEG to focus more on medium risk banks with large portfolios and systematic follow-ups on ESMS implementation;
- Guide for clients: Building on the information and insights gained through the evaluation, relevant content for an ESMS Guide was developed. This Guide highlights the benefits resulting from sound E&S risk management, explains DEG E&S requirements, and describes solutions to specific challenges as well as recommendations for the implementation and operation of a successful ESMS.

Recommendations for Continuous Improvement:

- The evaluation identified five principal areas where improvements could be made:
 - tailoring the ESMS TA offering to different clients depending on the country and client context;
 - providing feedback on E&S Reporting with increased emphasis on Category B clients;
 - providing accessible, central resources through the ESMS Guide on where to go for help and online E&S risk management tools;
 - improving data and information management to help FIs and PEFs to benchmark performance and overcome challenges;
 - helping existing clients to transition to the next ESMS stage through the identification of 'green' investment opportunities;
 - providing tailored training in E&S risk management and, in particular, E&S issues associated with different sectors.
- Specific emphasis is needed on medium risk banks – particularly those with large portfolios and/or those with SMEs. One of the common challenges faced by medium risk banks is the

correct categorisation of E&S risk and allocation of appropriate resources. More guidance is needed to provide these clients with a proportionate approach so that limited staff resources may have the greatest impact.

Overall Conclusion

- *Overall, it is clear that DEG has a strong, positive E&S influence on its financial intermediary clients. DEG has made significant progress in the implementation of ESMS across the global intermediary portfolio. ESMS implementation is high and the business benefits are clear. There are challenges associated with the FI element of the portfolio and particularly those with medium risks and large portfolios;*
- *The evaluation has resulted in a number of clear recommendations for improvement which are documented in the Evaluation Report. Evidence to support the conclusions is provided in the Case Study Reports and other supporting documentation. Further development of the TA programme will help the portfolio clients to drive the transition from compliance to on-the-ground improvement, to become market leaders in E&S and to identify opportunities for green or social improvement investments.*