RECOURSE SUBMISSION TO THE ADB SAFEGUARD POLICY REVIEW:

Financial Intermediaries

APRIL 2023

Introduction

Recourse welcomes this opportunity to provide input to the Asian Development Bank's (ADB) Safeguard Policy Review. Recourse is a Netherlands-based civil society organisation, working for a world where people and planet are at the heart of development. We campaign to redirect international financial flows away from dirty, harmful investments, towards greener and more inclusive development, working with partners around the world to hold financial institutions accountable.

This briefing is a supplement to the inputs provided by Recourse staff on financial intermediaries (FIs) during the thematic consultation on Safeguards in Different Financing Modalities conducted between 20-24 February 2023. We repeat our call for ADB's updated Safeguard Policy Statement (SPS) to provide effective safeguards for human rights and environmental protection, and support the just transition to sustainable renewable energy.

This input is focused on non-sovereign FI lending and is not comprehensive in terms of its coverage of issues and recommendations. It should also be read in conjunction with other inputs, in particular those of civil society and Indigenous Peoples' organisations in Asia.

From January 2010 until March 2023, FI lending comprised almost a third (30%) of the ADB's non-sovereign operations. Out of the 438 approved non-sovereign projects in the same period, Recourse identified 133 as support to FIs in the form of loans, grants, equity, debt security, guarantees, technical assistance, or a combination of these types of support. The total amount invested in these projects was approximately $10.9 billion.

The ADB classifies FI investments against the 2009 SPS' three safeguard policies individually. There are two types of risk categories for FI investments, according to subproject exposure. Category FI covers category A (high risk) and B (medium risk) subprojects, while FI-C covers low risk subprojects. Out of the 133 FI projects analysed, 98 (74%) were classified FI for the safeguard policy on Environment, 60 (45%) for the policy on Involuntary Resettlement, and 50 (38%) for the policy on Indigenous Peoples. In total, the majority of FI investments (99 projects or 75%) are exposed to high to medium risk, which also means that they are required "to have in place or establish an appropriate environmental and social management system (ESMS)", according to the SPS.

Given the FI lending portfolio's risk profile, it is important that the ADB's revised SPS is adequately robust to be able to protect the environment and the rights of peoples in affected communities. Likewise, strong safeguards are essential for closing loopholes, such as financing for all types of fossil fuels through FIs, which is essential as the ADB sets out to align its operations with the Paris Agreement on climate change and help finance the just transition to renewable energy.

In this submission, Recourse raises several concerns about the ADB's FI lending and provides recommendations for how the revised SPS could address these, including on dangers of risk miscategorisation; lack of transparency, the implementation gap; and climate related issues.

Risk miscategorisation

It is welcome that the ADB applies its SPS to all of its high risk, Category A, sub-investments via FIs. However, this is not enough to ensure risks are mitigated and it also does not eliminate the risk of miscategorising investments.

The Independent Evaluation Department (IED) in its assessment of the effectiveness of the ADB's 2009 SPS found that the "FI safeguard risk-designation does not provide an absolute or relative sense of risk" (p.92).[1] In contrast to the ADB, which merges high and medium risk investments in its categorisation, comparator multilateral development banks (MDBs) typically use further tiers to more precisely identify the risk profile of the FI client. For example, the International Finance Corporation (IFC) uses FI-1, FI-2, and FI-3.

Also in contrast to other MDBs, the ADB's risk categorisation is not integrated, meaning that there are separate categorisations for each of the three safeguard policies on Environment, Involuntary Resettlement and Indigenous Peoples. Failure to apply an integrated approach can lead to a failure in recognising the synergies between the risks in each of the three areas. For example, a project's environmental impact can be labelled with safeguard category FI, while the indigenous peoples safeguards is classified as FI-C. Having this option risks ignoring the tightly interconnected relationships of indigenous peoples with their environment and their ancestral domains.

The lack of sustained monitoring and supervision during project implementation and the assumption of low risk is fertile ground for risk miscategorisation. As research has consistently shown, MDBs have miscategorised subprojects or FIs themselves at a lower risk level (for example, Category B) than is warranted by the project's impacts. For example, the IFC categorised its FI client Hana Bank Indonesia as FI-2 – or medium risk – in 2019, though the bank went on to fund two massive new coal plants in Indonesia in 2020.

Recommendations

To reduce the risk of miscategorising FI investments, the ADB's revised SPS must:

- Include an integrated approach to risk categorisation and management that takes into consideration the risk exposure of the FI clients and the subprojects , and also accounts for the complex interactions between the different risk categories, if rated differently for the different safeguard policies.
- Require sustained monitoring and supervision during the implementation of higher risk FI subprojects to ensure that risk categorisation is accurate in relation to the actual project implementation impacts.

[1] Independent Evaluation Department. (2020). Effectiveness of the 2009 Safeguard Policy Statement. https://www.adb.org/sites/default/files/evaluation-document/448901/files/safeguards-2009-main-report_6.pdf.

Transparency, accountability, and stakeholder engagement

Lack of transparency is a significant problem in FI investing. Too often there is little to no information about where the money ends up. We welcome the ADB's recognition of the "[n]eed for greater clarity on disclosure requirements".[2] This recognition should pave the way for improving the ADB's transparency practice.

The ADB's requirement that high-risk projects are disclosed 120 days ahead of Board discussion is a leading commitment among MDBs. The ADB is, however, poor at disclosing information on FIs. According to research conducted by Publish What You Fund (PWYF) on the transparency practices of development finance institutions, ADB scored 1.25 out of 10 in disclosing information on sub-investments through FIs (non-sovereign).[3] Research by Recourse confirms PWYF's findings. An overwhelming 98% or 130 of the 133 FI projects that were approved since 2010 did not have their subprojects disclosed on the ADB's website.[4] The three projects that did were two equity investments in Creador: Creador III (49274-001) and Creador IV (52067-001), and an equity investment in OrbiMed Asia Partners IV (54042-001). Of the 99 category FI projects that are required to have an ESMS, only 18 (18%) have this published on the ADB website. More than half (60 or 61%) do not have their ESMS on the website, while 21 (21%) were withheld.

This lack of transparency increases risks that the ADB's FI investments may ultimately finance projects that result in harm. For example, in 2020 the ADB made a $95 million equity investment in Clifford Capital Pte. Limited (CCPL) through the project Asian Sustainable Infrastructure Mobilization Project (53397-001). [5] However, CCPL is involved in environmentally risky projects, such as gold and copper mining, oil drilling, oil shuttle tankers, gas power plants, liquified natural gas and oil-power plants. In 2015, the ADB entered into its first co-financing deal with CCPL with support to Myanmar's Myingyan Natural Gas Power Project, which failed to adequately consider project alternatives such as wind and solar.[6] The Myingyan project was also shrouded in secrecy as the financial supporters, including the ADB, refused to disclose the terms of the power purchase agreement to the public. Without this disclosure, it is impossible to assess whether the project is of public benefit, fulfils its development impact aims, or represents good value for money.

Enhanced transparency can shine a light on such risks and thus reduce them, ensuring the ADB upholds its commitments. Stakeholder engagement is an important component of transparency in order to fully determine the risks involved in an FI's portfolio. Likewise, transparency about FIs and their subprojects is important for stakeholder engagement to ensure that affected peoples or communities' rights are safeguarded, especially for high-risk projects. Transparency and stakeholder engagement enable project-affected communities to hold the ADB and its FI clients accountable to their commitments and seek redress for harms suffered. Only through being aware that a subproject is linked to ADB funding through FIs, will affected communities know that they can approach the ADB's accountability mechanism to access redress for any wrongdoing related to the FI and its subprojects. It is further concerning that the ADB's current SPS does not require FIs to develop

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[2] ADB. (2023). ADB Safeguard Policy Review and Update: Safeguards in Different Financing Modalities [Presentation during regional consultations].

[3] Publish What You Fund. (2023). DFI transparency index 2023. https://www.publishwhatyoufund.org/app/uploads/dlm_uploads/2023/02/DFI-Transparency-Index-Report-January-2023.pdf

[4] ADB's SPS 2009 became operational in January 2010.

[5] https://www.cliffordcap.sg/projects

[6]https://www.re-course.org/news/in-the-dark-secrecy-and-the-myingyan-public-private-partnership-gas-power-plant/

stakeholder engagement plans. This is another fault in the ADB's already poor performance on disclosure in FI investing.

On a positive note, the ADB has demonstrated that such disclosure is possible: Its investment in Creador private equity fund in 2018 is a model of good practice, disclosing not only the names of the sub-investments on ADB's website, but also a summary of the investment purpose and risk categorisation.

Recommendations

To improve its transparency and accountability in relation to FI investments, the ADB's revised SPS must:

- At the minimum, require the disclosure of the name, sector and location of high and medium risk subprojects funded via FIs.
- Require FI clients to include meaningful stakeholder engagement plans in their ESMS and in sub-projects, throughout the project lifecycle.
- Require information about the ADB's involvement in a FI subproject to be disclosed at project sites, in a manner and form accessible to local communities, as well as information about the ADB's accountability mechanism. This can help to ensure local communities are aware of the ADB's safeguard requirements and their right to redress if they suffer harms.
- Maintain the ADB's commitment to transparency for high risk project disclosure, at 120 days ahead of Board discussion.

Implementation gap

We are concerned about the implementation gap in the ADB's FI lending. The IED reported that between 2010-2018 "projects implemented through financial intermediaries were the **weakest performers on safeguards**, for both sovereign and [nonsovereign operations]" (p.46, emphasis added).

Strong safeguards for FI lending are particularly important given the risks inherent in the longer investment chain, where environmental and social protections risk being diluted. Since FI investments are often approved before subprojects have been identified, it is vital to ensure continuous monitoring and supervision of safeguards implementation once subprojects commence. However, ultimately the safeguards are only as strong as their application during the implementation stage of a project's life cycle.

Follow through to ensure the safeguards are also applied to the FI's subprojects is another area where the ADB's performance is lacking. According to the IED report, although the pre-implementation due diligence process was adequate, the ADB's "oversight and monitoring of FI projects was below average for the sovereign and non-sovereign portfolios. Supervision of social safeguards and information disclosure during implementation were particularly weak" (p. 46). Despite the risks being greater where investment chains are longer, the ADB provided the lowest level of supervision for FIs compared to other funding modalities.

The gap in the application of safeguards during the due diligence and project implementation stages resulted in FIs having the lowest scores for the pollution prevention and abatement indicator (56%) in IED's evaluation. This underperformance is worrying because of possible impacts on communities and further strengthens the case for sustained monitoring and supervision of FIs and their subprojects during project implementation. The IFC for example has a detailed Interpretation Note on Financial Intermediaries which clarifies how the IFC's safeguards on FIs work in practice and the responsibilities of the FIs in the application of these safeguards.[7]

Another potential implementation gap issue arises from the lack of explicit requirements in subproject contracts. A recent investigation by the Compliance Advisor Ombudsman (CAO) into the IFC's FI support to RCBC bank in the Philippines found that the IFC had failed to ensure its Performance Standards were implemented at the project level in the construction of 10 coal power plants. A reason CAO identified for this was that RCBC had failed to ensure the IFC's Performance Standards requirements were included in subcontracts with the coal plant developers.

Recommendations

To close the implementation gap and ensure that safeguards are applied, the ADB's revised SPS must:

- Include clear guidelines on FIs' responsibilities in applying safeguards to subprojects.
- Require safeguards requirements to be included in subproject contracts.
- Require sustained monitoring and supervision during the implementation of the FI subprojects to ensure that safeguards are applied, including site visits.

Climate change and energy access

The ADB calls itself "Asia and the Pacific's Climate Bank",, referring to achievements such as being the first MDB, in 2015, to set climate investment targets for 2030 and for launching a Climate Change Operational Framework in 2017. The ADB has joined other MDBs in committing to align operations with the goals of the Paris Agreement on climate change with a first deadline of 1 July 2023. The ADB also finally committed to stop financing coal power projects in its revised Energy Policy In addition to reviewing the SPS, including a new proposed safeguard on climate change, it is also currently working on a Climate Change Action Plan and a Paris Alignment Guidance Note.

Despite these promising moves, significant loopholes mean that the ADB cannot yet be termed a "Climate Bank". The ADB's new Energy Policy did not exclude financing for all fossil fuels; significantly the bank continues to promote fossil gas with only few limitations. There are also questions on how 'Paris alignment' will be interpreted in practice. It is important that the SPS addresses these weaknesses.

The 2009 version of the SPS only mentions climate change three times. It has since been complemented by climate risk assessments, but the IED's 2021 assessment of ADB's support for action on climate change found the implementation and quality of these "variable". The assessment further concluded that the SPS lacks "strategic guidance, focus and capacity with regard to climate change", concurring with a 2020 analysis of the SPS, also by IED, which recommended that the new SPS should include a dedicated focus on climate change.

As described above, the ADB's FI investing lacks transparency, which makes it impossible for civil society to track and monitor the implementation of any of the ADB's climate commitments. The concern is that money invested through FIs could end up supporting fossil fuels by the back door. Without transparency reforms, there is no way for the general public to know whether FI money is going to coal and other fossil fuels.

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[7] IFC. (2018). Interpretation Note on Financial Intermediaries. https://www.ifc.org/wps/wcm/connect/a6de7f69-89c8-4d4a-8cac-1a24ee0df1a3/FI%2BInterpretation%2BNote.pdf?MOD=AJPERES&CVID=n27ywSg

A positive use of FI lending can be the bundling and promotion of smaller, hard to finance projects; so it is encouraging to see the ADB's focus on this progressive use of intermediated finance in its recent Energy Policy: "ADB will use financial intermediation as an approach to supporting dispersed subprojects. Financial intermediation loans can be used for rural electrification, clean cooking, island energy supply, demand-side energy efficiency programs, and other programs that are not amenable to project loans or other investment modalities. ADB will apply the financial intermediation modality partnering with national banks and specialized financial institutions." The SPS should further support this direction, ensuring that the ADB chooses the right financial partners, with experience in meeting the needs and priorities of vulnerable and marginalised communities, and who comply with ADB's development mandate.

Recommendations:

To ensure the ADB's FI investments do good, by closing fossil fuel loopholes and supporting energy access for all, the ADB's revised SPS must:

- Exclude direct and indirect financing for all fossil fuels including coal, oil and gas, as well as for associated facilities and infrastructure, such as transmission lines, roads, and ports. As the ADB emphasises increasing support for the private sector, the risks from FI investments leaking to fossil fuels will only grow, so action is needed to address this in the revised SPS.
- Require the ADB to publish the name, sector and location of all high and medium risk projects it supports through FIs, including any fossil fuel exposure, to enable public tracking and assessment of ADB's fossil fuel commitments. Without transparency reforms, there is no way for the general public to know if FI money, which is ultimately public funds, is going to coal and other fossil fuels.
- Include incentives for the ADB to prioritise FIs that have substantial local ownership and are equipped to make investments that are in line with ADB's development objectives and approach.