BIC EUROPE

Via electronic mail

President Jin Liqun
Asian Infrastructure Investment Bank
B9 Financial Street
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People's Republic of China

13th September 2019

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Members of the Board of Directors of the AIIB

Re: The AIIB's investments in financial intermediaries: Urgent reforms needed

Dear President Jin Liqun,

We write to you as representatives of civil society organisations to draw your attention to concerns associated with the AIIB's investments via financial intermediaries (FIs), and to request that the AIIB institute urgent reforms to manage the heightened social and environmental risks associated with this hands-off form of investing. This letter follows from our initial letter to you of 18 January 2018[1] on this issue.

To date, around 10 per cent of the overall AIIB investment portfolio is supporting FIs - a figure which has risen dramatically in the last two years. The AIIB's equity strategy makes clear that FI lending will become an increasingly significant part of the AIIB's aim to mobilise funding from the private sector and institutional investors. At the same time as the AIIB's FI portfolio is growing, there is an important opportunity to ensure the standards governing its implementation are fit for purpose: the forthcoming review of the AIIB's Environmental and Social Framework (ESF) provides the chance to make sure that

[1] See: https://bic-europe.org/news/aiib-urged-to-take-on-lessons-learned-in-risky-lending/

the AIIB is following best practice and is taking on board lessons from other peer institutions on FI lending.

While investing in FIs can help mobilise 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 50 per cent of whose investment portfolio is to FIs - has been forced to acknowledge these risks and has taken some steps to address them. Following critical findings from both the IFC's Compliance Advisor Ombudsman (CAO) and from civil society groups, the IFC's CEO, Philippe Le Houérou, has committed to reduce high-risk lending through FIs, including reducing investments linked to coal. The IFC is currently consulting with clients, shareholders and civil society on a new 'Green Equity Approach' to help to transform not only its own lending but that of its FI clients, shifting away from fossil fuels and towards greener investment.

These are important developments and we urge the AIIB to learn from the IFC's problematic experience with its FI portfolio and its efforts towards reform. At the same time, other institutions, such as the Green Climate Fund – which lends 100 per cent through FIs – have developed robust policies, for example around information disclosure, that the AIIB could emulate.

Apart from these developments among the AIIB's peers, we also wish to draw to your attention experiences to date with the AIIB's own FI investments. Civil society groups have been working with local communities to monitor certain AIIB FI investments, including the IFC Emerging Asia Fund[2], the India Infrastructure Fund (now renamed North Haven)[3] and the National Investment and Infrastructure Fund[4]. A number of common concerns arise from analysis of these projects:

- **Lack of information disclosure:** The AIIB does not include information about sub-projects funded through any client FIs on its website. No information at all is publicly available on the sub-projects supported by the two Indian FIs, for example. This leaves potentially affected communities in the dark about their rights to know both who is behind the project affecting them, and that the AIIB's E&S standards should be applied. Though the AIIB has committed to release information 'within 12 months' of such projects' approval, this is too late to help third parties and potentially affected people to identify and raise concerns up front, and lags behind best practice at other institutions.
- **Exposure to fossil fuels:** though the AIIB aims to be a 'green' bank, there is a significant risk of FI investments ending up backing fossil fuels, as evidenced in the case of the IFC Emerging Asia Fund. For example, one client, Summit Power in Bangladesh, has a portfolio that is 100 per cent fossil-fuel based.

[2] See: https://www.inclusivedevelopment.net/wp-content/uploads/2018/09/Moving-beyond-rhetoric_FINAL.pdf and https://www.inclusivedevelopment.net/wp-content/uploads/2019/01/Financing-development-in-Myanmar-FINAL.pdf
[3] See: https://bic-europe.org/wp-content/uploads/2018/06/Risky-Venture_FINAL.pdf
[4] See: https://www.cenfa.org/publications/briefing-note-aiibs-investment-in-the-niif-why-is-it-a-risky-venture/

- **Delegation of control to FI clients/co-financiers:** the AIIB delegates decision-making around risk classification and E&S management entirely to the FIs in which it invests. Such lack of oversight can exacerbate problems and can lead to risks being ignored or overlooked, as has happened at the IFC. Research[5] demonstrates that many FIs do not put adequate environmental and social management systems in place and fail to apply standards at the project level. This can result in projects causing harms – such as land conflicts – even when investments appear 'green', such as large-scale renewables.

Such issues with implementation arise in part because of policy gaps. To date, the AIIB has not disclosed any documents that reveal how it assesses, prepares and finalises potential FI investments. It is important that the AIIB adopt a systematic and transparent approach to its FI lending. As mentioned, the forthcoming review of the AIIB's ESF provides an ideal opportunity both to address these gaps and to ensure that AIIB staff are equipped with the guidance they require to ensure FI investments do no harm.

We urge the AIIB to address these concerns by: enhancing information disclosure in FI lending; expanding the ESF to include detailed requirements for FI lending; ensuring that FI lending does not open the door further to fossil fuel investments; and introducing ring-fencing of FI investments to support specific projects that are low-E&S risk and have genuine development impact, ensuring this ring fencing is legally enforceable and traceable. In the enclosed Annex, we identify examples of existing good practice at the AIIB's peer institutions relating to these common concerns, as well as recommendations on how the AIIB could begin to address policy and implementation gaps.

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.

Yours sincerely,

Kate Geary,
Co-Director, BIC Europe

and the following organisations:
350.org
Abibiman Foundation
Accountability Counsel

[5] See: http://www.cao-ombudsman.org/newsroom/documents/FIAUDIT.htm and https://www.inclusivedevelopment.net/what-we-do/campaigns/outsourcing-development/

Action Paysanne Contre la Faim
Aksi!
Alliance Sud
Amnesty International
Asian Peoples Movement on Debt and Development
Bangladesh Poribesh Andolon (BAPA)
Bangladesh Working Group on External Debt (BWGED)
BankTrack
Both Ends
Buliisa Initiative for Rural Development Organisation (BIRUDO)
CAFOD
Centre for Environmental Justice
Centre for Financial Accountability
Centre for Human Rights and Development
China Latin America Sustainable Investments Initiative
Christian Aid
CLEAN (Coastal Livelihood and Environmental Action Network)
Conseil Régional des ONG de Développement
Equitable Cambodia
Eurodad
Friends of the Earth Japan
Friends of the Earth US
Gender Action
Global Responsibility (AG Globale Verantwortung)
Green Advocates International
Inclusive Development International
Indian Social Action Forum
Initiative for Right View
International Rivers
Lumière Synergie pour le Developpement
Machimar Adhikar Sangharsh Sangathan
Manushya Foundation
NGO Forum on ADB
Odisha Chas Parivesh Sureksha Parishad
Oil Change International
Oxfam
Rivers without Boundaries
Shankar Sharma (individual)
Social Justice Connection
Sri Lanka Nature Group
Srijan Lokhit Samiti
Umeedenoo
Urgewald
Witness Radio Organisation
Working Group on IFIs (network of organisations working on IFIs in India)

Youth for Environment Education and Development Foundation

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ANNEX: Financial intermediary lending: existing good practice at peer institutions and recommendations for how to address gaps

Information disclosure

Current AIIB policy: The ESF only commits to disclose information about projects supported via FIs in a "timely manner". FI staff at AIIB are proposing to interpret this as disclosing sub-projects within 12 months of their approval.

Best practice at peer institutions:

International financial institutions recognise the importance of transparency not only in improving accountability to shareholders and citizens, but in helping to avoid and manage risk. According to President Jin, "Transparency and accountability are the two main pillars of AIIB's governance." Transparency has been a particular challenge in financial intermediary lending, given the longer chain from investor to project; conversely, transparency is all the more important in this type of lending given its higher risk profile. When risks are spotted early on, they are more easily avoided or mitigated, leading to better project outcomes and lower reputational risk.

The Green Climate Fund

The Green Climate Fund (GCF) is a highly relevant institution for the purposes of comparison with the AIIB's FI lending, since 100 per cent of its lending is carried out through intermediaries (or as the GCF calls them 'Accredited Entities'). The GCF has adopted a high degree of disclosure in line with international best practice, including time-bound disclosure of crucial project information – such as environmental and social impact assessments – ahead of approval. The degree and timing of disclosure is calibrated according to the risk profile of the investment: with more and better disclosure for the highest risk (Category A). The following excerpts from its 2016 Information Disclosure Policy describe the degree of disclosure:

> **"Environmental and social reports.** With respect to project and programme funding proposals that have an environmental or social impact, the Accredited Entities (AE's) shall disclose and announce to the public and, via the Secretariat, to the Board and Active Observers:
>
> (a) in case of Category A projects, the Environmental and Social Impacts Assessment (ESIA) and an Environmental and Social Management Plan (ESMP) at least 120 days in advance of the AE's or GCF's Board decision, whichever is earlier;
>
> "(b) in the case of Category I-1 programmes, the Environmental and Social Management System (ESMS)2 at least 120 days in advance of the AE's or GCF's Board decision, whichever is earlier;

"(c) in the case of Category B projects, the ESIA3 and an Environmental and Social Management Plan (ESMP)4 at least 30 days in advance of the AE's or GCF's Board decision, whichever is earlier; and

"(d) in the case of Category I-2 programmes, the ESMS at least 30 days in advance of the AE's or GCF's Board decision, whichever is earlier."

The GCF expects its conditions to be met when working with other multilaterals, raising the possibility of the AIIB being obliged to improve disclosure if it works with the GCF. For example, in the case of the GCF's involvement with the European Bank for Reconstruction and Development's Green Cities Project, the GCF's Board stipulated additional conditions:

> "In relation to each Category A public sector sub-project to be funded under the Facility, the Accredited Entity shall disclose the Project Summary Document, Environmental and Social Impacts Assessment (ESIA) and Environmental and Social Action Plan (ESAP), and, as appropriate, inclusive of the Resettlement Policy Framework (RPF) and/or Land Acquisition and/or Resettlement Action Plan (LARAP or RAP), and any other associated information required to be disclosed in accordance with the Accredited Entity's Public Information Policy ("Project Disclosure Package"). The Accredited Entity, 120 calendar days in advance of its Board meeting, shall disclose, in English and the local language (if not English), the Project Disclosure Package on its website and shall require that the Borrower does so in locations convenient to affected peoples, and provide the Project Disclosure Package to the GCF Secretariat for further distribution to the Board and Active Observers and for posting on the GCF website."[6]

The World Bank

The World Bank invests in FIs and requires and practices a high degree of disclosure, including of sub-projects supported through commercial banks. Under the disclosure clause of the World Bank's 2013 Operational Procedure BP 4.03, the World Bank requires its FI clients to disclose as well as permit, in writing, the World Bank to disclose the summary of the Environmental and Social Impact Assessment (ESIA) of any sub-project considered high risk (Category FI-1 and FI-2). In practice, however, the World Bank seems to go beyond summaries by disclosing full reports of impact assessments, mitigation, and resettlement plans.[7]

Examples include the World Bank's investments in Turkish banks, TKB and TSKB, for which the World Bank disclosed 208 documents relating to the investments and their sub projects.

The International Finance Corporation

6 Green Climate Fund GCF/B.21/34 p 71 Annex XV List of conditions and recommendations.

7 Oxfam (2018) Open Books See https://oxfamilibrary.openrepository.com/bitstream/handle/10546/620559/bp-financial-institutions-disclosure-161018-en.pdf

The International Finance Corporation (IFC) discloses different information depending on the type of FI client. It has made several significant reforms over the past five years, largely in response to civil society pressure and a number of highly-damaging cases.[8]

For **private equity fund clients:** in its 2012 Performance Standards, IFC committed to "periodically disclose a listing of the names, locations and sectors of high-risk sub-projects that have been supported by IFC investments through private equity funds, subject to regulatory constraints and market sensitivities." This was updated in 2015 when in response to pressure from civil society, IFC started to disclose all sub projects supported via its private equity fund clients, stating: "with input from CSOs and other stakeholders, we have improved transparency by now disclosing all private equity fund sub-projects."[9] In 2017, the IFC applied this new rule retrospectively to all PE fund clients since 2012: "We publish the name, sector and location of every investment of our funds' portfolio companies. In 2017, IFC fulfilled 100 percent of this requirement for the 63 fund investments initiated since 2012, and published information on more than 387 funds' portfolio companies."[10]

IFC is in the process of developing a new strategy on disclosure, which will include: "a voluntary initiative with our financial intermediary clients exposed to high-risk projects for the next two years to promote disclosure of such high-risk sub-projects initiated from IFC lending, including the name, sector, and host country of the project."[11]

Proposal for reform to ESF: The AIIB should adopt an ESF that commits to principles of disclosure and transparency and enshrines best practice, including:

- ⇒ Requiring **time-bound disclosure** of project information in advance of approval, in line with best practice;
- ⇒ Disclosure of the **name, sector and location of higher risk sub-projects** financed via FIs on the AIIB's website and on the client's website;
- ⇒ Disclosure of the AIIB's involvement in sub-projects at the **project sites**, ensuring that it is clearly visible and understandable to affected communities.

Risk categorisation, ring-fencing and supervision

8 See for example: AgriVie case in Uganda (http://www.cao-ombudsman.org/cases/case_detail.aspx?id=180); GMR Kamalanga case in India (http://www.cao-ombudsman.org/cases/case_detail.aspx?id=165); RCBC bank in the Philippines (http://www.cao-ombudsman.org/cases/case_detail.aspx?id=1266); Ficohsa Honduras (http://www.cao-ombudsman.org/cases/case_detail.aspx?id=209) and Dragon Capital Cambodia (http://www.cao-ombudsman.org/cases/case_detail.aspx?id=212).

9 IFC (2015) IFC's Work with Financial Intermediaries; see: https://www.ifc.org/wps/wcm/connect/1c3013804a260251bf70bfe54d141794/IFC_FI_FactSheet_April2015.pdf?MOD=AJPERES

10 IFC (2017) Sustainable Practices for Private Equity Funds Business see: https://medium.com/@IFC_org/sustainable-practices-for-private-equity-funds-business-5d841850f7c5

11 Le Houérou, Philippe (2018) in Devex see: https://www.devex.com/news/opinion-a-new-ifc-vision-for-greening-banks-in-emerging-markets-93599

Current AIIB policy: The ESF delegates responsibility from the AIIB to the FI Client to categorize sub-projects as Category A, B or C and monitor the corresponding E&S risks associated with these sub-projects.

Best practice at peer institutions:

Given the documented problems with FI mis-categorisation of projects (the incentive is to categorise the projects at a lower risk level to avoid costly due diligence), the European Bank for Reconstruction and Development has developed a 'referral list'[12] for higher risk projects, to ensure it both assesses risk categorisation and monitors E&S standards implementation itself in higher risk sub-projects.

Proposal for reform to ESF:

- ⇒ Adopt a **'referral list'** approach, where higher risk sub-projects are automatically flagged and given higher attention, including by bank staff. This should include all large-scale infrastructure, including large-scale renewables projects.
- ⇒ EBRD language **requires the bank to engage** as follows "EBRD will assist FIs with the appraisal of these [referral list] subprojects. EBRD environmental/social specialists will review the due diligence information collected by the FI, determine any additional information needed, assist with determining appropriate mitigation measures and, if necessary, specify conditions under which the subprojects may proceed." The AIIB could adopt a similar approach.
- ⇒ Additional requirements should be included in the ESMP/ESM Planning Requirement for FI projects to **have clearly defined responsibilities for the FI Client, sub-project client and the Client's contractor.** The AIIB and its FI client must ensure that the hired contractors are also adequately equipped to implement the ESF.
- ⇒ Implement **ring-fencing of FI investments** to support specific projects that are low-E&S risk and have genuine development impact and ensure this ring fencing is legally enforceable and traceable.

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12 The EBRD referral list is as follows: **PR9 Annex 2 The FI Referral List**

The financing by FIs of the following environmentally or socially sensitive business activities financed with EBRD funds is subject to referral to EBRD:

The principal Performance Requirement that proposed transactions will be expected to meet is indicated in italics.

(i) Activities involving involuntary resettlement - *EBRD Performance Requirement 5*

(ii) Activities that occur within or have the potential to adversely affect an area that is protected through legal or other effective means, and/or is internationally recognised, or proposed for such status by national governments, sites of scientific interest, habitats of rare/endangered species, fisheries of economic importance, and primary/old growth forests of ecological significance - *EBRD Performance Requirement 6*

(iii) Activities within, adjacent to, or upstream of land occupied by indigenous peoples and/or vulnerable groups including lands and watercourses used for subsistence activities such as livestock grazing, hunting, or fishing - *EBRD Performance Requirement 7*

(iv) Activities which may affect adversely sites of cultural or archaeological significance -*EBRD Performance Requirement 8*

(v) Activities in the nuclear fuel production cycle (uranium mining, production, enrichment, storage or transport of nuclear fuels)101

(vi) Energy generation using nuclear fuels (excluding electricity import/export)102

(vii) Activities involving the release of GMOs into the natural environment – *EBRD Performance Requirement 6*

(viii) Any micro, small or medium-sized HPPs that do not trigger Category A requirements – *EBRD Eligibility Criteria for Small Hydropower Plant Projects*

(ix) Any Category A projects included as Appendix 2 to the EBRD Environmental and Social Policy

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Climate mitigation

Current AIIB policy: The AIIB's Energy Sector Strategy and the ESF commit to align with the Paris Agreement on Climate Change. Addressing AIIB lending through FIs is crucial in ensuring both direct and indirect investments uphold this commitment. Current policies do not exclude coal and the ESF is weak on climate mitigation.

Best practice at peer institutions:

The International Finance Corporation
The CEO of the IFC, Philippe Le Houérou, is instituting a number of significant reforms at the IFC aimed at reducing its fossil fuel exposure, including in its FI business.

In its Interpretation Note for FIs from November 2018, the IFC states: "The Exclusion List can be extended by adding more excluded activities, as part of the E&S risk management efforts. For instance, in case of any targeted products IFC will **exclude coal related sub-projects including coal mining, coal transportation or coal-fired power plants**, as well as infrastructure services exclusively dedicated to support any of these activities. In case of projects involving collective investment vehicles such as PE Funds, the coal related investments will be either excluded up front or when this is not feasible IFC will opt out from such investments."

The IFC also committed in the Interpretation Note to improve disclosure around coal exposure, including by requiring FI clients to report annually to the IFC: "For an FI, E&S performance reports to IFC should typically include: ... Where relevant, the FI clients' exposures to high risk activities (e.g. coal related activities, palm oil, etc.)"

The IFC also commits to make this information on coal exposure public: "We will require new equity financial intermediary clients exposed to coal projects to publicly disclose their total exposure in this sector."[13]

In February 2019, the IFC went further and shared a draft **Green Equity Strategy** with civil society (it is expected to be finalised soon). Commitments include:
- an aim to reduce coal exposure to zero;
- not to invest in FI clients that do not have a plan to phase out investments in coal;
- a new strategy for equity clients that includes specific targets on phasing out coal in clients' entire portfolios.

The UK government development finance institution (DFI) CDC's policy[14] states "Where CDC invests in banks or other Financial Intermediaries (FIs) and where CDC reasonably expects a significant proportion

[13] Le Houérou, P (2018) A new IFC vision for greening banks in emerging markets, in *Devex* 8 October 2018.

of that FI's funds to be used to fund coal-fired power … the general presumption will be that CDC would seek a 'carve out' to exclude CDC funds being used for any new coal-fired thermal power plants." Significant proportion "means that more than 10% of the FI's current or predicted future loan portfolio is for coal-fired thermal power investments"[15].

The Dutch DFI, FMO, states: "FMO can provide loans to banks and non-bank financial institutions that provide loans to coal-fired power projects, coal mines and dedicated thermal coal transport/infrastructure, to a maximum threshold of 20% of the Financial Intermediary's total balance sheet or total investment portfolio"[16].

Proposal for reform to ESF: In this rapidly-developing space, the AIIB has the opportunity to join the leaders in ensuring the transformation necessary to avert catastrophic climate change. To do so, the AIIB should:

⇒ Adopt a requirement for all FI clients to **track and disclose coal and other fossil fuel investments**;

⇒ Ensure that none of its investments results in an **increase in coal use**: whether for power generation or industrial uses, or for associated facilities such as transmission lines and railways or ports primarily meant for the transportation of coal;

⇒ **Exclude upstream oil and gas**;

⇒ Not invest in clients with more than **5 per cent portfolio exposure to coal**;

⇒ Invest only in FI clients who commit to develop a **portfolio decarbonisation plan** to achieve emissions reductions in line with targets set under the Paris Climate Agreement.

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[14] CDC Group (2014) Policy on coal-fired power generation

[15] CDC Group (2014) Policy on coal-fired power generation

[16] FMO (2016) Position Statement on Coal Power Generation and Coal Mining