

Environmental and Social Management Report
Banco de Guayaquil (Ecuador) SME Financing Partnership
(EC-L1137 and EC-L1138)

I. Project Description and Background

- 1.1 The project's objective is to support the financing of small and medium enterprises ("SMEs") in Ecuador, with special focus on the agricultural sector, including livestock and crops. SCF/FMK and OMJ have identified Banco de Guayaquil (BG) as a strategic partner to achieve this goal, and will provide a senior unsecured loan of US\$50 million (US\$10 million from OMJ and US\$40 million from SCF). The program will also include the participation of CAF. Strategically, this operation includes the involvement of anchor companies at the local level with the objective to span a range of sectors.
- 1.2 Coordination between these two private sector windows will allow IDB to provide Ecuador's second largest commercial bank with a dedicated agribusiness line. The use of funds will be directed towards working capital loans primarily with a smaller portion in investment loans. Coupled with this loan will be the possible provision of technical assistance through a number of specific local corporate partners with the aim to support producers in increasing productivity and accessing new markets. La Fabril S.A., a producer of refined vegetable oils, has been identified as one such partner in its capacity as a supply chain buyer of raw palm oil, and exporter of finished product. A second anchor company in sugarcane has been identified but remains unconfirmed in its role as a partner with BG.¹ BG is also considering anchor companies in corn, cocoa, dairy and livestock.

II. Project Status and Compliance

- 2.1 Based on Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), this Project is classified as a financial intermediary and as such is not categorized according to its potential environment and social (E&S) impacts and risks.
- 2.2 BG has indicated that it is committed to comply with Directive B.2 (country laws and regulations) of IDB Environmental and Safeguards Compliance Policy, complying with all applicable legal and regulatory environmental, social, health and safety, and labor (ESHS&L) laws and regulations and expects the activities it finances to comply as well.
- 2.3 BG will apply its existing environmental and social management system (ESMS), and make necessary adjustments to address environmental and social risk in agricultural operations under \$500,000 but above US\$250,000 and has specific procedures for on lending through anchor companies in palm oil and sugar. Both anchor companies will also be applying an ESMS to producers receiving finance and will report to Guayaquil accordingly. Based on the portfolio in medium to high-risk sectors, loan size and tenor this operation is classified as medium risk (FI-2).

¹ As the sugarcane company remains unconfirmed, detailed E&S analysis was not possible.

III. Environmental and Social Risks and Impacts

A. *Potential risks and impacts associated with BG's portfolio and anchor companies*

- 3.1 As a lender to agricultural SMEs², BG has provided the following forecast of the likely sub-sector borrowers: Bananas (45%), Rice (19%), Sugar (21%), Palm Oil (5%), Cacao (4%), Flowers (2%), and Other (4%). The majority of lending across sectors is oriented primarily at small-scale activities. All OMJ sub-loans will be less than US\$50,000, and the majority of FMK sub-loans will be less than US\$250,000. With regard to palm oil, the anchor company's estimate is that loans will range from US\$15,600 to US\$208,000 (and not to exceed US\$250,000).³ La Fabril estimates that a segment of the loans will be intended as investment capital for renovation of plantations and in some instances expansion, the rest of the loans will be for working capital lending to finance labor, fertilizer, and other variable costs.. While data for the sugar sector is not currently available, BG estimates a similar sub-borrower base. BG has confirmed that sub-loans in collaboration with anchor companies will not exceed 10% of the total value of the line.
- 3.2 The ESHS risks and impacts could include, for example: i) habitat conversion and degradation (agriculture, livestock); ii) poor land use/contaminated land (agriculture, livestock, industry), iii) stress/contamination of water resources (agriculture, livestock), iv) waste management and disposal (livestock, agriculture, industry), v) use of migratory or informal labor (agriculture, livestock), vi) pesticide use and agrochemical management. In the case of high value crops such as sugar and palm, additional impacts could include concerns over food security and a crowding out of traditional crops for human consumption, deforestation and forest conversion in areas of high conservation value, community opposition, and poor labor conditions on plantation sites.

B. *Palm Oil, Sugar Cane and Local Requirements to address E&S issues*

- 3.3 Resulting from the increasing growth of palm oil production in Ecuador, 87% of which is in the hands of smallholder farmers (less than 75 hectares), the government has recently initiated a program to further regulate and standardize the operation and management of palm production. Currently, 240,000 hectares are cultivated with palm oil and annual growth is estimated around 7%. Nearly 80% of production is concentrated in the 'Occidental' area of Ecuador, lying west of the Andean mountain range in what is considered a humid tropical mountain forest environment. The coastal zones of San Lorenzo and Guayas represent roughly 12% and the Oriente the remaining 8%. The sector directly and indirectly employs roughly 170,000 people and accounts for 15% of the value of Ecuador's agricultural production in value terms. There are an estimated 6,000 producers and three primary milling companies.

² SME sub-loans will be for values less than US\$500K, and consistent with IDB's Sector Guideline for SME Finance and Development Programs in LAC (OP-580) definition of SME loans for a C&D country.

³ The hectare size of farms is 3 for micro (60% of the sub-borrowers), 20 for small (30% of the borrowers), and 40 for medium (10% of the sub-borrowers).

- 3.4 Sugarcane has not experienced the same rapid growth as palm oil. Cultivated over an area of roughly 80,000 hectares and concentrated in primarily two areas, Guayas and Cañar, annual growth is estimated at around 4%. Lower growth level relative to palm oil is due to more constant less volatile prices, and smaller profit margins relative to costs. Of the total produced, roughly 70% is for human consumption and 30% for industrial in the form of ethanol. Ecuador produces a surplus of roughly 8% over domestic demand. The sector is dominated by three main sugar mills, including Valdez Azucar, and employs roughly 20,000 people.⁴
- 3.5 The Ministry of Environment (MAE) has established a special permitting process to better manage the expansion of agricultural sectors including palm oil production and sugarcane. Agricultural producers are categorized into one of four impact areas with corresponding licensing requirements. Specific to palm oil, the permitting process segments producers into three categories: (i) those with less than 75 hectares require a ‘Ficha Ambiental’; (ii) producers with 75-150 hectares must present a ‘Declaracion de Impacto Ambiental’; and (iii) those above 150 must submit an Environmental Impact Assessment. With the majority of producers categorized as small, the MAE will issue the required Ficha when a producer submits the ‘certificado de interseccion’, which determines the precise geographic location and ensures that the operation is not located within a nationally protected area. A certificado de interseccion is also required for sugarcane producers of any size.

IV. Environmental and Social Management

A. BG’s Management of Environmental and Social Risks

- 4.1 BG developed with the support of a local consultant and implemented an ESMS⁵ in 2011 and has made various adjustments throughout the years in both refining the operation of the system and aligning with other DFI donor requirements and suggestions. The current ESMS applies local law and an exclusion list to all operations with financing from DFIs, and for those above US\$500,000 a more thorough environmental and social evaluation is carried out. The system categorizes operations above this amount into A, B, and C, and includes the following procedures:
- Screening Checklist – An initial form is completed by the client and includes environmental and social details specific to sector, location, proximity to natural habitat, effluent types, waste management, and resource use. The checklist must be signed by the client’s legal representation.
 - Categorization – BG applies a formula to calculate the environmental categorization of the operation. The information input into the calculation includes economic sector, effluent and residual waste type, sector, corporate footprint, and location. The combination of these variable and points assigned determines the corresponding environmental and social risk level.
 - Documentation Requirements: For operations categorized as A, BG requests that the client submit an EIA, Environmental Management Plan, Environmental Audit, Public Consultation report, and Environmental Licenses. The ESMS includes a

⁴ USDA Gain: Ecuador Sugar Annual 2013.

⁵ Manual de Polititca y Metodologia de Gestion de Riesgo Ambiental, Cod.No. UR RA 2011 001.

guide with descriptions of the minimum expectations for each document presented. A risk official within BG reviews material presented and prepared, and presents findings in the context of an operation's credit review meeting. For Category B operations BG requires presentation of an EIA. Category C operations do not require E&S analysis beyond the initial screening.

- Roles and Responsibilities – The credit officer is assigned to providing all documentation and categorizing the operation based on the formula assigned. An Environmental Manager who sits within the Risk Department evaluates the preparation of all material. BG also has an internal audit team within the Risk Department that evaluates the effectiveness of the ESMS and the monitoring and management of E&S issues within any specific operations.

- 4.2 With respect to palm oil and sugar cane on-lending, BG's manual is being updated to address additional environmental and social risks. Specifically, it will require that in both sectors, producers must present the 'certificado de intersección' prior to being considered eligible. As noted earlier, the inclusion of a sugar cane anchor company as a component of this loan remains unconfirmed. Section V of this document details additional requirements as a condition for this loan.

B. Anchor Company's Management of Environmental and Social Risks

- 4.3 La Fabril is one of Ecuador's largest 20 companies with operations in food, cleaning, and personal care products. Palm oil and its derivative products for both human and industrial use represent its primary business. It exports internationally to clients including Unilever, Nestle, FritoLay and others. It has both ISO 9001 and ISO14001 certification, and in 2009 became a member of the Round Table on Sustainable Palm Oil (RSPO).
- 4.4 As an RSPO member, it has worked within the Ecuadorian palm oil sector to further introduce and encourage good environmental and social management practices. Recently, it has initiated a program to certify 500 of its palm oil producers to RSPO standard by 2016. Additionally, it requires that every producer it works with have the minimum environmental certification (la Ficha Ambiental) in place in order to sell to its mills. This certification, licensing and environmental training work began in 2012 in partnership with Asociación Nacional de Cultivadores de Palma Aceitera (ANCUPA), and forms the basis for requiring through this IDB loan that all sub-borrowers in palm oil have at a minimum the required ficha ambiental and that a defined percentage be certified to RSPO standards within two years of having received the loan. This requirement will be implemented through an action plan to be agreed with IDB and will be the focus of an impact assessment described in Section C below. La Fabril sources palm oil from roughly 2,000 producers across the country, except for the Oriente where it does not harvest palm oil.
- 4.5 The second potential, though unconfirmed anchor company, Valdez Azucar was founded in 1922 and purchased by the Noboa conglomerate in 1922. It is also one of Ecuador's largest companies, controlling 33% of the sugar milling market and sourcing sugar over a land area of 20,000 hectares. Valdez owns a large number of sugar plantations and also purchases from smaller producers. It has introduced within its operations a four point certification program to introduce improved environmental and social management practices.

C. IDB Impact Assessment and Cost Benefit Analysis

- 4.6 As a complementary activity to this operation, IDB will conduct an ex-ante impact assessment and cost-benefit analysis with the objective to evaluate the environmental and social impacts of certification and establish the business case. The hypothesis of the consultancy is that under the right conditions, the certification of specific agricultural products can deliver improved environmental and social benefits in addition to economic returns at the producer level (as measured by price, yield, or market access). This evaluation will be achieved through two products prepared by the consultancy: i) an *ex-ante* impact assessment of the sub-loans on biodiversity and local livelihoods and ii) a cost-benefit analysis (CBA) of certification for palm oil and sugarcane producers (the latter to be confirmed). Both Guayaquil and the anchor companies will partner with IDB in a study to evaluate the benefits of certification schemes applied to a percentage of sub-borrowers under this IDB line. The specific terms of the consultancy will be agreed in a Memorandum of Understanding.

V. Environmental and Social Requirements

- 5.1 For this operation which involves SME lending through both OMJ and FMK window with sub-loans not to exceed US\$500,000, the Bank will require BG as part of the Loan Agreement to:
- (i) Comply with all applicable Ecuadorian environmental, social, health and safety, and labor regulatory requirements, and in relation to the financing of SMEs to ensure that each sub-loan complies with: (a) in-country regulations; (b) the IDB List of Excluded Activities for Non-Sovereign-Guaranteed (NSG) operations; (c) the Fundamental Principles of the Rights at Work; and (d) the provisions of BG's Environmental and Social Policy and Management System (Manual de Política y Metodología de Gestión de Riesgo Ambiental), including those specific to palm oil and sugar cane described in par. 4.2 above;
 - (ii) Extend the application of BG's categorization, sector checklist and other applicable requirements described in paragraph 4.1 to all sub-loans above US\$250,000 financed through this IDB line.
 - (iii) In addition, for sub-loans of any value through anchor companies, particularly in palm oil and sugar cane, BG and by extension the anchor companies will be required to: (a) screen sub-loans in accordance with the requirements as defined by the Ministry of Environment, and retain on file copies of the certificado de intersección and the ficha ambiental. Both must be obtained prior to first disbursement of any sub-loan. (b) Ensure that proper due diligence is undertaken by the anchor company and that the following environmental and social issues are assessed:
 - i. review of production or activities involving harmful or exploitative forms of child labor,

- ii. on-farm occupational health and safety, and appropriate use of PPE,
- iii. workers' accommodations,
- iv. agrochemical hazards,
- v. WHO banned pesticides and pesticide management,
- vi. fertilizer management,
- vii. water use and effluents management; and
- viii. likelihood of illegal deforestation/land conversion.

(c) Upon completion of the due diligence, prepare a corrective action plan (CAP) where any gaps relative to the above are identified with an agreed timeline to achieve compliance. (d) Within the palm oil anchor company, Guayaquil will confirm that La Fabril has required and initiated the process towards certification to RSPO standards in their relationship with the producers receiving financing with IDB's use of proceeds.⁶

- (iv) Screen out high risk activities as defined in the Loan Agreement with respect to key Bank Safeguard policies including deforestation, resettlement and indigenous peoples.
- (v) Collaborate in the impact assessment being undertaken and paid for by IDB with a focus to evaluate the costs and benefits of on-lending through anchor companies in palm oil and sugar. A memorandum of understanding will be agreed between IDB, the anchor company, and Guayaquil that outlines common expectations and roles and responsibilities.
- (vi) Present an Annual Environmental and Social Compliance Report (ESCR) with information on: (i) the composition and E&S performance of the SME portfolio, (ii) the implementation and effectiveness of the ESMS; (iii) with information on any particular risk issues identified with respect to sub-loans and mitigation or corrective measures agreed with clients and/or taken by BG; and (iv) progress in the implementation of the certification action plans.

5.2 The IDB will supervise the environmental and social aspects related to the use of the proceeds of the IDB loan either by an in-house specialist or with external consultants, with the costs of such supervision to be included in the annual supervision fee paid by the Borrower. If necessary, IDB will require corrective measures to address specific impacts and risks and/or enhance management.

⁶ A similar process would be agreed with the sugar cane anchor company once confirmed.