Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO)
Netherlands Development Finance Company

Position Statement on Impact and ESG for Financial Intermediaries

FMO (the Netherlands Development Finance Company) is the Dutch entrepreneurial development bank. Since 1970 we have been a driving force behind investments, enable entrepreneurs in emerging markets. It is our role and mandate to create local prosperity in some of the world's most challenging economies.

This Position Statement is an integral part of the FMO Sustainability Policy framework that steers FMO's activities. The Position Statements explain FMO's choices in relation to major global sustainability issues and further explain how we select investments, work with customers and other stakeholders, and monitor performance. They reflect our objective to apply the highest possible standard of ethics and integrity to our business activities.

Scope

This Position Statement on Impact and ESG[1] for Financial Intermediaries is intended to provide an overview of FMO's key considerations for its approach to impact and ESG risk management for investments in Financial Intermediaries[2]. It is complementary to the Sustainability Policy and clarifies how the Sustainability Policy and the thematic Position Statements translate to Financial Intermediaries in case the approach for Financial Intermediaries diverges, how we select our financial sector investments with the objective to reach our impact ambitions and how we work with financial intermediary customers, investees and other stakeholders to create value at the institutional and sectoral level.

FMO's Vision

FMO believes in a world in which, by 2050, more than 9 billion people live well and within planetary boundaries. To deliver this long-term vision, our investments are selected for alignment with our Sustainability Policy and to contribute to the United Nations Sustainable Development Goals (SDGs), specifically to foster decent work and economic growth (SDG 8), contribute to reducing inequality (SDG 10), and help mitigate and adapt to climate change (SDG 13).

Financial Intermediaries

As a Development Finance Institution (DFI), FMO considers its Financial Intermediary customers and investees key partners to create inclusive and sustainable prosperity. A healthy financial sector and accessible finance are cornerstones of a strong economy and private sector enabling entrepreneurs, stimulating economic growth and job creation. Through our investments in Financial Intermediaries, we reach Micro, Small and Medium Enterprises (MSMEs) and increase access to capital, support business growth and channel finance to businesses and end-beneficiaries that FMO otherwise cannot directly finance in an efficient manner. In emerging market economies, MSMEs contribute up to 45% of total

[1] ESG stands for Environmental, Social and (Corporate) Governance. FMO has integrated ESG considerations in its investments processes and the scope of this Position Statement refers to the full spectrum of ESG. In this Position Statement, also the term E&S (Environmental & Social) is used when the scope is explicitly E&S and Corporate Governance is not included.

[2] Investments in Financial Intermediaries include debt, equity, mezzanine and guarantee transactions made to Financial Intermediaries, including Banks and Non-banking Financial Institutions (e.g., Micro Finance Institutions (MFI), leasing companies), but also Private Equity (PE) Funds. Given the large variety of fund-like structures, such as debt and mezzanine but also permanent capital vehicles and liquidity structures, this Position Statement only covers classic PE Fund structures and hence we use the term 'PE Fund' going forward. For other fund-like structures, the ESG approach for a PE fund is the starting point but details may vary depending on ownership structure, lifetime of the fund vehicle chosen and other diverging criteria.

employment and 33% of GDP[3]. As such, MSMEs contribute to economic growth and job creation, and have the potential for promoting decent work and entrepreneurship. Furthermore, MSMEs play an important role in achieving the Sustainable Development Goals. However, in our target markets 65 million enterprises, or 40% of formal MSMEs, have an unmet financing need of USD 5.2 trillion every year[4].

Through our Intermediary Financing, we impact financial flows that are many times the size of our own lending. Through investments with customers or investees of their own, Financial Intermediaries have great potential to positively contribute to development and to support the proper management of Environmental, Social and Governance (ESG) and Human Rights risk, both as individual organizations and at the sectoral level. As FMO intends to create value for the economies in which we, our customers and our investees operate, we promote and stimulate the adoption of good international industry practices in Impact and ESG by our Financial Intermediary customers and investees. We aim for impact at scale by leveraging our strong network and relationships. We also collaborate with other DFI's globally and/or mobilize other commercial funding for emerging markets, which enhances our overall impact.

The end-beneficiaries of our investments in Financial Intermediaries are debt customers and equity investees ranging from micro enterprises to larger businesses. Our Financial Intermediary customers are responsible for and make decisions on how FMO's funding is used. Importantly, these decisions need to be within the boundaries established by their contract with FMO. The relationship between FMO and the end-beneficiary of our financing via Financial Intermediaries is indirect by nature. The benefit of this is that it enables us to finance a larger number and more types of high impact beneficiaries that we could otherwise not reach. The drawback is that FMO's influence is limited as there is no direct (contractual) relationship with those beneficiaries. For this reason, FMO applies a structural approach when working with (and through) Financial Intermediaries, where FMO may require (and help) the Financial Intermediaries to build additional capacity at the institutional level. The aim is to ultimately, over the tenor of FMO's financial involvement, reach a point where the institution can adequately manage ESG risks in line with applicable national and international standards.

To build sustainable businesses and safeguard positive impact, it is important that key (potential) impacts and ESG risks are adequately identified and managed, both by FMO and our customers. FMO's efforts in this area are guided by its Sustainability Policy, including the Exclusion List and related Position Statements. FMO is committed to harmonized and common practices in impact investment, and revises its policies, Position Statements and internal processes regularly to remain aligned with international best practice.

FMO has made commitments to integrate human rights explicitly into its investment process, as outlined in our Position Statement on Human Rights. Nonetheless, despite our policies and practices being geared towards avoiding harm, FMO's investments in Financial Intermediaries may at times be associated with adverse impacts. In the context of its commitment to the UN Guiding Principles for Business and Human Rights (UNGPs) and the OECD Guidelines for Multinational Enterprises, FMO recognizes its role, and will use its leverage where possible to stop such adverse impacts and to foster an ecosystem where those affected by projects of Financial Intermediary customers and investees we finance, have access to remedy.

[3] OECD (2017). 'Enhancing the Contributions of SMEs in a Global and Digitalised Economy'

[4] International Finance Corporation (2017) 'MSME Finance gap. Assessment of the shortfalls and opportunities in financing Micro, Small and Medium enterprises in emerging markets.'

FMO's choices

FMO believes that with a structural approach to Financial Intermediary financing, we can advance durable improvements, creating value and building the intermediaries' capacity to identify risks and address adverse impacts when they occur. FMO makes choices in structuring its customer relationship, by balancing our development mandate to deliver positive impact and improvements in practices from a level that is often not yet in line with international standards at the inception of our relationship, with the prevention and management of negative impacts that can occur from time to time. FMO shapes its customer relationships in various ways (as described below) to reach our impact ambitions and manage (potential) ESG risks related to our specific transactions. In each case, we engage with our customers and investees at the institutional level to raise awareness of principles regarding Impact, ESG and Human Rights. Each Financial Intermediary engagement starts with an assessment of the (potential) risks of their portfolio, and their institutional capacity and willingness to identify, mitigate and manage risks. The conclusions of this initial assessment are part of the considerations that drive the decision to continue with the investment process. In instances where we decide to continue, the risk assessment, balanced with the customer's needs, drives FMO's choice on A) how to shape the future customer relationship and how to view FMO's responsibility, and B) FMO's risk appetite to work with the customer towards compliance with ESG standards.

A) Shaping the relationship based on either a general portfolio or a specific assets approach.

We consider our responsibilities in alignment with the UNGPs, and in particular with principle 13(b) that businesses "seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts." However, as the OHCHR has clarified for financial institutions[5], the existence of a business relationship between a bank and a customer does not mean that there is a direct linkage between an adverse impact and the bank's financial product or service per definition. Whether there is a direct link as described in UNGP 13(b) is specific to the context of the use of that financial product and its relationship to the adverse impact. This also holds for FMO's indirect financing activities. Whether FMO is linked or not linked to the adverse impact in a Financial Intermediary customer's portfolio depends on the circumstances, including (but not exclusively), whether the assets related to the adverse impact are financed by FMO's funding line and the quality of actions, interactions, and inactions of both the customer and FMO regarding this adverse impact.

<u>FMO's approach to ESG risk management regarding a general portfolio:</u>

Historically, the majority of FMO's customer relationships with Financial Intermediaries are based on general on-lending loans[6], asset class loans[7] or equity (fund) investments, where the eventual destination of the on-lending or sub-investment is not specified. In these relationships, FMO works with and supports the Financial Intermediaries to improve institutional capacity across the board through our ESG requirements and expert support. Through the loan contracts and fund documentation we require them to commit to and implement robust ESG and human rights practices based on good international industry standards and commensurate to the risk profile of the full (or expected) portfolio. Throughout the investment cycle, we focus our engagements on the quality, implementation and improvement of

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[5] OHCHR response to request from BankTrack for advice regarding the application of the UN Guiding Principles on Business and Human Rights in the context of the banking sector (2017) and confirmed in UNHCHR "Remedy in Development Finance. Guidance and Practice" (2022).

[6] Our funding is usually directed towards the financing of the FIs loan portfolio, often further specified as their productive loan portfolio.

[7] Under an asset class approach, the use of funds is restricted to a certain asset *class* of the portfolio, such as SMEs or Green, without specifying the specific underlying assets.

the policies, frameworks and systems in place as agreed per Environmental and Social Action Plan (ESAP). We monitor performance and progress on agreed improvements through frequent and systematic client and investee engagement.

In case of insufficient progress, or (signs of) material or recurring adverse impacts in the portfolio, we intensify our engagement with our customers and investees and seek to further build and use our leverage with our customers aiming to cease and mitigate adverse impacts and, as feasible, apply our leverage for remedy.

FMO's approach to ESG risk management regarding specific assets:

There are debt transactions where FMO's funds are traceable and intended for a specific end use (specific assets) which is clearly distinguishable from the remainder of the general portfolio of the involved Financial Intermediary. For example, when FMO aims to reach specific targeted end-beneficiaries and impact objectives through (innovative) dedicated credit or guarantee lines, or when we follow trusted partners who apply this approach. In these instances, we may tailor our relationship and focus our approach on Impact and ESG to cover and apply only to the specific assets targeted for such end use. This gives FMO the ability to focus our engagements and to better understand and monitor the impacts, risks and ESG risk management of that specific part of the (general) portfolio. It enables increased transparency and allows FMO to stipulate more tailored ESG requirements that adequately match the specific risk profile of the specific financed assets. Complementary to the focused specific assets approach and requirements, FMO continues to promote the application of robust ESG risk management and the adoption of good international industry practices by the institution across the board.

In case material impacts happen within the boundaries of the specific assets we finance, this approach allows for adequate action and leverage over those specific assets. If progress is insufficient or there are (signs of) material impacts in the specific financed assets, then we will intensify our engagement with our customer(s). In those instances, we would also seek to further build and use our leverage with our customer(s) aiming to cease and mitigate the adverse impacts, and apply our leverage for remedy to the extent possible. Whilst our contractual leverage will be limited in case we identify sustained patterns of material adverse impacts outside the boundaries of specific asset we finance (thus the remainder of the general portfolio), we will strive for a proportionate, risk-based response to the situation. We will engage with our customer(s) and seek to build and use our relationship leverage to influence our customer(s) to work towards the cessation and mitigation of such patterns of impact and if appropriate the provision of remedy by the client.

Both the general portfolio approach and the specific assets approach have their own merits and challenges. The more appropriate approach depends on the characteristics of the transaction, which is context-specific and therefore needs to be assessed on a case-by-case basis.

B) FMO's risk appetite to work with customers towards compliance with ESG standards

As a DFI, we consider it part of our development mandate to not only work with best-in-class Financial Intermediaries, but to also partner with those that only have basic practices in place but who in our view, show clear commitment to Impact and ESG. FMO helps these Financial Intermediaries to improve their practices over the time of its involvement. As part of our commitment to adhere to international standards, FMO accepts that at the inception of our relationship, a Financial Intermediary may not be compliant with all the standards we seek adherence to, as building ESG risk management capabilities typically takes time. This is part of our risk appetite provided the customer or investee is committed to work towards improvement. We can agree on relevant ESG covenants (for debt transactions) toward general adherence to local legislation and applicable international standards and ESAPs, focusing on the most important gaps with the aim to close these within the tenor of the investment period.

In cases where FMO reasonably believes we cannot apply or build the leverage at the client or investee level that would lead to the required improvements, we would refrain from investing further or consider exploring solutions for responsible disengagement. We seek to include a legal option in our contractual debt agreements to call an event of default in case of systematic non-compliance with covenants. FMO would consider disengagement for this reason only as a last resort, given potential negative impact to parties involved of such a course of action.

Implementation

Impact Steering

We steer towards a high impact portfolio of Financial Intermediaries. We improve access to finance, for instance focusing on small and medium-sized enterprises (SME) financing in countries where this is generally lacking, by providing long-term funding, risk capital and local currency financing. We restrict our Financial Intermediary portfolio exposure to coal activities, promote and advise on green credit lines or green bonds that support Climate Action, and promote and advise on social credit lines which support business models that serve the unbanked to reduce inequalities. FMO targets a wide range of different end-beneficiaries by dedicating its finance to certain sectors, geographies or themes. Examples are MSMEs, renewable energy, energy efficiency, agriculture (including forestry), youth and female entrepreneurship. Furthermore, FMO supports innovation through the promotion and support of fintech and agritech.

ESG Risk Management

FMO is committed to conduct effective ESG screening and due diligence, appropriate to the potential risks for all our transactions with Financial Intermediaries. We use our own Sustainability Policy and related Position Statements as a point of reference in our assessments of Financial Intermediaries, as well as to support them in developing their own policies and procedures, tailored to their country and regulatory context and practice. FMO applies and builds leverage to contribute to avoiding and reducing negative impacts by our clients and their investees by, for example, including the most important ESG commitments and reporting requirements in contracts and fund documentation. FMO actively monitors progress and adherence to FMOs ESG requirements for Financial Intermediaries during the investment period. For PE fund investments, we exercise our influence by defining ESG requirements in the fund documentation, at times participating in ESG Advisory Panels and Limited Partner Advisory Committees, and giving feedback and advice based on ESG due diligence and monitoring reports. Throughout, we engage with our Financial Intermediaries structurally, to build their capacity and intensify engagement when necessary.

To integrate human rights explicitly into our investment process for Financial Intermediaries and to determine the level of due diligence required, FMO has included a contextual risk analysis of country-specific risks, including human rights risks and investment-related human rights risks, in its initial ESG screening process. All our high-risk investments through Financial Intermediaries are assessed from a Human Rights and ESG risk perspective before and during the financing or investment, with the support of qualified ESG resources. Their assessment and advice are included in the investment proposals, annual customer reviews, and decisions in the event of material breaches with FMO’s standards.

FMO undertakes a risk-based Corporate Governance (CG) analysis for every co-investment with a PE Fund in an investee company and every loan to a Financial Intermediary. The focus is on client commitment to good CG practices and assessing the structure and functioning of the (supervisory) board of directors, internal control processes, transparency and adequacy of (minority) shareholder rights.

As part of our risk management, FMO works towards the protection of the most vulnerable end-beneficiaries as they access financial services. FMO promotes responsible financial inclusion by endorsing the Client Protection Principles ('CPPs').

Our Financial Intermediary customers and investees are contractually required to adopt the following approach:

- To comply with relevant national legislation, e.g., labour and banking codes, as well as international best practices for specific transactions depending on the risk profile of the Financial Intermediary or the individual transaction. For example, Financial Intermediaries may additionally be required to apply good international industry practices, such as the IFC Performance Standards for customers or investees that (also) finance high risk business, or the CPPs for customers that offer financial products to natural persons and/or micro enterprises. In instances in which we identify a gap in relevant national legislation, related requirements may be added in the contract documents as an action item.
- To manage underlying ESG and contextual risks (including specific human rights risks), in a manner commensurate to risks in their business activities, by conducting adequate ESG Due Diligence of specific transactions to identify ESG risks and potential impacts and manage and monitor them in line with the FMO ESG requirements for Financial Intermediaries. The level of ESG Due Diligence and monitoring, and need for involvement of qualified ESG professionals, will depend on the risk category of the (prospective) client of the Financial Intermediary.
- To implement any changes required to achieve these goals within a contractually agreed timeframe.

PE Funds commit to proper management of ESG matters, and to work directly with their investee businesses to achieve appropriate risk based ESG targets in alignment with FMO's investment criteria. Investment decisions in a Fund structure are delegated by FMO to the Fund Manager within the investment mandate as per agreement with FMO. We require PE Funds to also develop an Environmental and Social Management System (ESMS) commensurate to the risk profile of the Fund and we aim to build resources and capacity with the fund managers. PE Funds report annually on ESG development in their portfolio and FMO conducts regular monitoring of these ESG developments including visits to investee companies of PE Funds.

Long-term Value Creation at the Sector and Client Level

FMO seeks to advance the institutional capacity of our customers and investees to do sustainable business. Our aim is to leave durable improvements, creating value and building capacity of our clients, investees and the financial sector of a country. We promote a greener and more inclusive economy and look for customers and investees who share this aspiration. We may also assist our customers and investees in achieving these goals through our (grant) funding, advisory support, and other technical assistance. Improvements in Impact and ESG-related attributes can create value for the customer, the investee company as well as its own customers: improved ESG practices are associated with better access to finance, higher valuations and an overall better reputation of the company.

Going forward, we will continue to encourage Financial Intermediaries to adopt the UNEP FI[8] Principles for Responsible Banking or UN Principles for Responsible Investment frameworks, and also look to make strides in helping our customers better identify and address potential human rights risks in their portfolios.

[8] United Nations Environment Program Finance Initiative.

FMO recognizes the need for level playing fields for its clients who are introducing ESG risk management to their market. Where FMO sees that several Financial Intermediaries in a country or region face systemic impediments to ESG risk management, we may choose to launch or support a sector-wide approach as a strategic tool for promoting locally owned change. Such initiatives reach out to all involved stakeholders in their planning phase to address the issues in a way that marries commercial success with effective ESG practices. These initiatives allow us to go beyond our own clients and create a level playing field in the whole sector. Financial Intermediaries in which we have invested may play a key convening and catalysing role.

Feedback

We welcome feedback on our Position Statement. Please contact us at consultation@fmo.nl

This Position Statement has been approved for implementation by FMO's Management Board on 4 October 2022, is in effect as of October 2022, and has most recently been updated in December 2022.