II. Creating Opportunity: IFC's Approach for Greater Development Impact and Additionality

Context

2.1. There is now wide acknowledgement that the private sector plays a vital role in development as the engine of growth and poverty reduction. A strong private sector can bring the benefits of development to a wider population and help ensure the sustainability of economic progress. Whilst international finance institutions (IFIs), including IFC, have responded by scaling up their private sector activities, there are still enormous needs, and there are many segments of society that have not yet participated in the benefits of the recent growth or financial flows. There remain important challenges to poverty reduction and many of these can best be met by a combination of public and private solutions, and by taking a more systemic approach, whether to sectors, countries or regions. IFC must continue to respond to these challenges.

2.2. IFC's strategy must also be seen in the context of the opportunities offered by the external environment in which it operates. The current positive environment allows IFC to extend its activity further to the areas where the needs are the greatest. Whilst continuing to work with its existing clients, IFC must also develop new client relationships and through all its clients try to reach the underserved, particularly in frontier and rural areas. IFC may also have an opportunity, together with the World Bank, to shape regulations and standards that encourage a productive private sector and economic growth.

2.3. In response to both the challenges and the opportunities for significant development impact that the external environment presents, in 2005 IFC embarked on an ambitious growth strategy, which was endorsed and approved by the Board. The growth plan is guided by IFC's five strategic priorities, which have been in place since 2004: (i) strengthening the focus on frontier markets, including small and medium enterprises (SMEs) and, since 2007, agribusiness; (ii) building long-term partnerships with emerging players in developing countries; (iii) differentiating through sustainability competencies; (iv) addressing constraints to private sector growth in infrastructure, health and education; and (v) developing local financial markets through institution building and the use of innovative financial products. These priorities remain equally relevant today, with some additional areas of emphasis, in particular including agribusiness as a focus sector as part of the frontier markets priority. Progress on these priorities is discussed in detail in Annex I.

2.4. IFC is the largest global development financial institution focusing on the private sector, and as part of the World Bank Group, it is at the forefront of efforts to ensure that the public and private sectors work together to maximize the effectiveness of private sector development. IFC's focus on the development impact of its activities and its recent performance reaffirm that it is in a position to take a leadership role in creating opportunities for people to escape poverty and improve their lives.

Achievements

2.5. **Development Impact.** Following discussion with the Board in 2005, IFC introduced a Corporate Scorecard with Board-endorsed development impact targets, which are based on the five strategic priorities. This Corporate Scorecard set out the targets to be achieved by FY08. IFC has made significant progress since FY05 as a result of its growth and the focus on development impact throughout the Corporation (reinforced through incentives and accountability – see paragraph 2.21). IFC will already have achieved many of these targets by the end of FY07: commitments in the frontier countries; in Sub-Saharan Africa; in micro, small and medium enterprises (MSMEs); in infrastructure, health and education; and in the financial sector. IFC is also making good progress towards the remaining targets, including improvement in the Independent Evaluation Group (IEG) development outcome ratings. Table II-1 below summarizes the main results in FY06 and estimates for FY07 together with the FY08 targets originally agreed with the Board. Paragraph 2.7 describes highlights of progress with the five priorities, which are discussed in more detail in Annex I.

Table II-1: Summary of Progress on Key Indicators Compared to Targets

Scorecard Item	FY06	FY07 (Estimate)	FY08 TARGET / BENCHMARK
Ex Post Development Impact Measures			
% satisfactory or better *ex-post* development outcomes (XPSRs) - IEG ratings	55%[1]	55%-60%[3]	65% on projects committed FY06-08
Development Outcome Tracking System (DOTS) Success Rate	56%[2]	61%[4]	-
Ex Ante Development Impact Measures			
Commitments in Sub-Saharan Africa	$700m	$770-850m	$735-875m
Commitments in MSME	$1,550m	$1,100-1,250m	$1,100-1,300m
% of IFC total commitments in frontier countries, compared with the frontier share of developing member country GDP	25%:15% (excl. Argentina)	26%-30%: 14%	Overweight in Frontier
Middle East and North Africa Commitments	$668m	$900-960m	-
Number of projects with new sponsors[5] as % of total project count	50%	45-50%	Larger than 50%
Renewable Energy / Energy Efficiency[6] - IFC Commitments - Total Cost of RE/EE Component	 $393m $1,762m	(actual, half-year) $108m $400m	EIR target for the World Bank Group
Infrastructure, ICT[7], Health & Education Commitments	$1,447m	$1,655-1,800m	$1,500-1,800m
Financial Sector Commitments[8]	$2,468m	$2,800-2,900m	$2,100-2,500m

[1]*FY06 results are based on a three-year rolling average for projects approved during calendar year (CY)98 to 00 (projects are typically evaluated 5-6 years after approval).*
[2] *FY06 DOTS results are based on a three-year rolling average for projects approved in CY98-00.*
[3] *FY07 estimates for IEG results are based on a three-year rolling average for projects approved in CY99-01.*
[4]*FY07 DOTS results are based on a three-year rolling average for projects approved in FY99-01.*
[5]*Based on new projects, excluding rights issues, A/B loan increases and secondary commitments.*
[6] *In FY06, the total project cost of projects with RE/EE components was $5.9 billion, of which $1.7 billion was invested in RE/EE components. IFC invested $866 million in these projects, of which $393 million was targeted to RE/EE components. In the first half of FY07, the total project cost of projects with RE/EE components was $2.2 billion, of which the RE/EE component was $400 million. IFC invested $293 million in these projects, of which $108 million was targeted to the RE/EE components.*
[7]*Information and Communications Technologies.*
[8] *Not including investments in private equity funds.*

2.6. **Development Outcome Tracking System (DOTS) Results**. In addition to the *ex ante* and *ex post* impacts tracked in the Corporate Scorecard, the DOTS system allows for aggregate *ex post* results tracking at the department level. Table II-2 gives some highlights, and IFC will be discussing development results in more detail with the Board as part of the Annual Report deliberations.

Table II-2: Examples of Development Outcomes

Department	Development Outcomes
Global Financial Markets	• IFC fostered $98.5 million of South-South transactions through the Global Trade Finance Program. • IFC committed $1.8 billion in housing finance during the FY00-FY06. • Clients disbursed 7.6 million MSME sub-loans for $51.8 billion in 2005. • Clients paid $3.8 billion in taxes to governments in 2005.
Health and Education	• During FY06, IFC-supported projects reached 2.4 million patients and 320,000 students. • 65% of these projects made substantial contributions to increasing fire and life safety standards.
Oil, Gas, Mining and Chemicals	• 85% had community development programs; together they spent $218 million on community development activities in 2005. • Two-thirds had strong local supply linkages; together they purchased about $1.8 billion worth from local suppliers. • The fifty-nine client companies provided almost 50,000 direct jobs and contributed $4.5 billion to government revenues in 2005.
Global Information and Communication Technologies	• Between 1996 and 2006, IFC investments in telecommunications firms have helped 80 million people gain access to phone service. • Since 2000, IFC investments in IT companies have created more than 21,000 employment opportunities in emerging markets.
Private Equity and Investment Funds	• Invested in fifty-five companies in frontier markets. • Invested in eighty-seven MSMEs. • Supported sixty-five high-growth companies (growth over 20% *per annum*). • Created 88,495 jobs.
Agribusiness	Expected incremental development impact for committed projects in FY05-FY06: • 29,500 additional jobs (total reach: 88,000) • 53,000 upstream farmers (total reach: 346,000) • 48,500 downstream SMEs (total reach: 88,000)
Infrastructure	In calendar year 2005: • The forty power generation companies in IFC's portfolio collectively produced 88 TWh, enough to meet electricity demand of over 75 million consumers in thirty-one developing countries and equivalent to total power generation in the Netherlands. Fifteen of these companies are located in frontier countries. • Investments in power distribution and water distribution companies reached 12 and 9 million customers, respectively. • Eight airports, which were used by 10 million passengers, and five toll roads, which were used by 60 million vehicles. • Three airlines with a particular focus on national and regional integration, which collectively transported over 16 million passengers. • Eleven container ports, which moved 3.3 million containers, equivalent to throughput at Tokyo port, ranked 22nd among world container ports; and ten general cargo/grain ports, which moved 10 million tons of goods.

2.7. Highlights of Progress on the Five Strategic Priorities

- *Frontier Markets*: In FY06, IFC's investments in frontier countries[10] rose by 19% to $1.5 billion (excluding Argentina, which reverted to non-frontier status late in FY06); these investments are forecast to increase to around $1.6-1.9 billion in FY07. There continues to be a strong focus on Sub-Saharan Africa and Middle East and North Africa (MENA),

[10] Frontier countries are countries which are either high risk (0-30 on a scale of 0-100) according to the Institutional Investor Country Risk Ratings, or low income according to the World Bank classification. IFC is proposing to adjust this definition to include all IDA countries as well as high-risk non-IDA countries, starting in FY08. See Annex 1 paragraphs 3.1-3.4 for further discussion and Annex III for a full listing of countries.

which were the two regions with the fastest commitment growth in FY06, although from a relatively low base. IFC is focusing not only on frontier countries, but also on frontier regions within middle-income countries. If these regions are included, frontier commitments for the first half of FY07 represented 51% of the total (excluding commitments to regional and global projects).

- *Building Long-term Partnerships*: IFC aims to nurture both new and existing clients with a view to helping clients grow and, in many cases, expand to other developing countries: through South-South investments. In FY06, South-South investments reached $673 million and IFC again met the 50% target for new clients. Further decentralization should enable IFC to serve all its clients more effectively and thereby enhance the development impact of its operations.
- *Differentiate through Sustainability*: IFC has continued its strong focus on sustainability following the implementation of the new Performance Standards in 2006. The Equator Principles have now been adopted by forty-five financial institutions. IFC is working with institutions in emerging markets and other IFIs to encourage further adoption of the principles.
- *Infrastructure, Health and Education*: IFC has dedicated substantial resources to these important sectors, and this effort is now showing results. Commitments grew from $880 million in FY05 to almost $1.5 billion in FY06, but the needs remain substantial. IFC is therefore continuing to develop new ways to encourage investment in these sectors, including through public-private partnerships (PPPs) and more upstream work together with the World Bank.
- *Local Financial Markets Development*: Access to finance and a thriving financial sector are essential for sustainable private sector development. IFC's financial markets projects now account for around 35% of IFC's portfolio, and in FY06 they represented 37% of new commitments (almost $2.5 billion). The expanding strategic areas for IFC are: (i) SME finance; (ii) microfinance; (iii) housing finance; (iv) trade finance; (v) local currency finance; (vi) structured finance; and (vii) sustainability finance.

2.8. **Advisory Services**. IFC Advisory Services (AS), formerly called Technical Assistance and Advisory Services, are an essential and growing part of IFC's business. IFC has devoted considerable attention to AS during FY06 and FY07 and undertaken a number of activities aimed at further increasing their effectiveness, including better alignment with both IFC's strategic priorities and with the World Bank Group. These achievements are discussed in paragraph 2.8 in Annex 1 and throughout this paper.

2.9. **World Bank Group Cooperation**. Greater World Bank Group cooperation is a key IFC corporate goal, and is being further increased in order to enhance the World Bank Group's effectiveness. IFC's strategy is consistent with the World Bank's objectives and leveraging the strengths of the whole World Bank Group will become even more important as IFC aims to increase its development impact in client countries and increase its systemic interventions (see paragraph 2.32 on Systemic/Programmatic Approaches).

Box II-1: Examples of World Bank Group Cooperation

Sub-Saharan Africa. *Africa Region* – Joint World Bank-IFC program funded by Swedish International Development Bank (SIDA), to improve the capabilities of securities markets; World Bank/IFC collaboration on access to energy through the joint Light Up Africa initiative. *Ghana* – World Bank-led housing finance policy work was complemented by IFC investment in a new housing finance institution. *Uganda* – A three-year World Bank-managed pilot project, delivered under a public-private partnership, to improve water supply to twelve small Ugandan towns and rural growth centers. *Liberia* – Joint program between FIAS/PEP-Africa/MIGA providing support to improve the climate for private sector-led development.

Middle East and North Africa. *Algeria* – Advisory services to improve Doing Business indicators. *Egypt* - World Bank/IFC joint technical assistance assignments related to investment climate, SMEs, and financial markets. *Yemen* – World Bank/PEP-MENA/IFC joint effort on gender chapter of 2006 Investment Climate Assessment and its dissemination. *Egypt and Yemen* – Joint activities in financial sector projects, advisory services, and oil, gas, mining and chemicals sectors.

Latin America and the Caribbean. *Strategic Response* – Closer coordination has allowed for a more strategic response in various areas/countries: Amazon Initiative, housing, Bolivia, Peru, Haiti, and Guatemala. *Brazil* – World Bank-IFC cooperation program including work on infrastructure, the financial sector, agribusiness, environment and the business climate. *Peru* – Joint World Bank-IFC focus team to build an integrated approach to support the private sector. *Haiti* – Cooperation between World Bank and IFC to provide technical assistance for the financial audit of Electricité de Haiti, enabling the effective use of donor financing, which in turn facilitated the disbursement of the World Bank's Economic Governance Reform Operation Project.

East Asia and the Pacific. *Frontier Markets* – In rural China, the Philippines and Indonesia, the World Bank provided support to policy reforms and IFC provided complementary support for the implementation of Doing Business indicators and related reforms at the sub-national level. *Indonesia* - World Bank/IFC/FIAS collaborated on the draft of the new Investment Law. *Vietnam* – The World Bank/IFC are working together to support the reform of Vietnam's investment regime. *China and the Philippines* – The World Bank supported policy dialogue and public sector financing for energy efficiency and renewable energy, and IFC supported specific reforms, providing financing for energy efficiency through client banks, and made equity investments for privatizations.

South Asia. *Bangladesh* – The World Bank and IFC worked together in private investment in power generation and investment climate reform. *India* – The World Bank and IFC worked together on India's financial sector reform, with the World Bank providing analytical and advisory activities on financial sector regulation and policies and IFC providing investments and technical assistance in private banks. *Nepal* – The World Bank and IFC co-managed the Investment Climate Assessment. *Bhutan* – Promoting SME development, the World Bank met the capital costs of industrial estates and IT parks, while IFC provided AS to advise on the design of industrial estates, IT parks, improving the business enabling environment and increasing access to finance.

Central and Eastern Europe. *Regional* – To remove critical business enabling environment constraints, the World Bank and IFC, through their FIAS and Doing Business initiatives, have agreed to hold bi-annual joint coordination meetings to improve regional decision-making. *Armenia* – Armenia Secured Transactions Reform represents a joint IFC-IDA funding for a technical assistance project, and is supported through work done by IDA under two Poverty Reduction Support Credits (PRSC) and planned under a pending third PRSC. *Russia* – The World Bank and IFC worked closely together in the area of sub-sovereign finance in providing support for the Chuvash Republic bond issue. *Ukraine* – IFC's Business Enabling Environment and Corporate Governance operations are closely linked with the World Bank's Development Policy Loan and Private Sector Development programs.

Southern Europe and Central Asia. *The Balkans* – In coordination with the World Bank, IFC's PEP-Southern Europe Infrastructure is promoting public-private partnerships in infrastructure to create future projects. *Kosovo* – The World Bank and IFC are working together to develop a lignite-fired power generation project with significant importance to the economic development of the country. *Tajikistan* – The World Bank is taking the lead in developing the power sector, primarily for the export markets, and IFC is working with the World Bank, providing input on what would be needed to make the projects viable for public-private partnerships.

2.10. Over the past year several steps have been taken to maximize the synergies available, from increased focus by IFC Senior Management (including again inviting senior World Bank staff to join IFC's strategy discussions), to including World Bank Group cooperation as part of the performance appraisal for managers in Sub-Saharan Africa, to a World Bank Group review of advisory services to assess overlaps and synergies. In addition to the WBG joint Management positions (Chief Financial Officer, Chief Information Officer and General Counsel) there are joint departments working in a number of core sectors: oil, gas, mining, information and communication technology and sub-nationals. These are integrated into three departments co-managed by IFC and the Sustainable Development Network (which has anchor responsibilities but also helps manage and support these teams operating in the market). Box II-1 gives examples of recent World Bank Group cooperation in IFC's seven regions. This cooperation is further discussed in Annex I, paragraph 2.4 and throughout this paper.

2.11. **Partnerships.** IFC works with many financial and development institutions, in addition to other members of the World Bank Group: from the banks that participate in its B Loan program and those that have adopted the Equator Principles, to partnerships with other IFIs in many of IFC's investment and advisory projects, to work with donors and other philanthropic organizations. The B-Loan program (see paragraph 4.1 in Annex I) grew to $1.6 billion in FY06, from $1.1 billion in FY05, and IFC is now working to develop new investor bases for the program, bringing pension funds, insurance companies and certain select hedge funds to emerging markets. In advisory services, IFC has ongoing relationships with many partners, especially relating to investment climate work, for example with the Investment Climate Facility (ICF) in Africa and with the United Kingdom Department for International Development (DFID) in Bangladesh. In addition, there is a group within IFC that develops and manages IFC's relationships with foundations, for example the joint study with the Bill and Melinda Gates Foundation discussed in paragraph 3.66 in Annex I.

2.12. **Anti-Corruption.** IFC is working with the rest of the World Bank Group in the area of anti-corruption. Several types of IFC engagements are naturally strong elements of an anti-corruption approach, including efforts that enhance openness and competition, that facilitate diversification of the domestic asset base, and that help build better governance systems, e.g. "Doing Business" reforms. IFC's corporate governance and Anti-Money Laundering / Combating the Financing of Terrorism initiatives are part of this work. IFC is also strengthening its corruption risk management in investments and advisory services as part of a larger World Bank Group effort to combat fraud and corruption. This is in the areas of: (i) selection of investments (including sponsor selection and award/procurement process); (ii) contract design and remedies; and (iii) supervision and exercise of remedies. Alongside the World Bank Group's broader-based policy work on the Extractive Industries Transparency Initiative (EITI), IFC has required that all its extractive industries projects make public their payments to the government. Annex I, paragraph 2.25 provides more details on IFC's work in anti-corruption.

2.13. **Equity Strategy.** Over the past year, IFC has been working on implementation of a more focused equity strategy and has built up equity specialization within investment departments. IFC has recently created a central Equity Department to help implement the equity strategy. IFC will focus on opportunities that can lead to significant development impact and where it can provide additionality by assisting companies realize their potential through IFC's expertise and value-added services. The equity strategy is further discussed in Annex I, paragraph 2.28.

2.14. **Growth and Profitability**. In FY06, IFC exceeded its commitment goals ($6.7 billion compared to a high-end projection of $6 billion), and it is expecting a similarly strong performance in FY07. These $6.7 billion of direct investments raised a further $1.6 billion through the B Loan program and mobilized around another $1.3 billion through structured finance transactions, bringing to a total of $9.6 billion IFC's own account funding and mobilization. Mirroring the increase in commitments, the growth rate of the disbursed portfolio has recently improved – 9% between FY05 and FY06 and a further 12% in the first half of FY07 alone – following a significant increase in disbursements in FY06.

2.15. IFC's financial position strengthened further in FY06 through continued high profitability, although this was not as high as in FY05 ($1.41 billion compared to $1.95 billion). IFC's FY06 Return on Net Worth was 13.7%, down from 22.6% in FY05. In FY07, IFC is anticipating another year of strong profitability due to the continued positive market environment and large capital gains on a few investments.

2.16. As IFC grows, it is also becoming more productive, with a 10% increase per investment officer in the number of projects in its pipeline between January 2006 and January 2007, as reported in the Monthly Operations Report.

THE WAY FORWARD

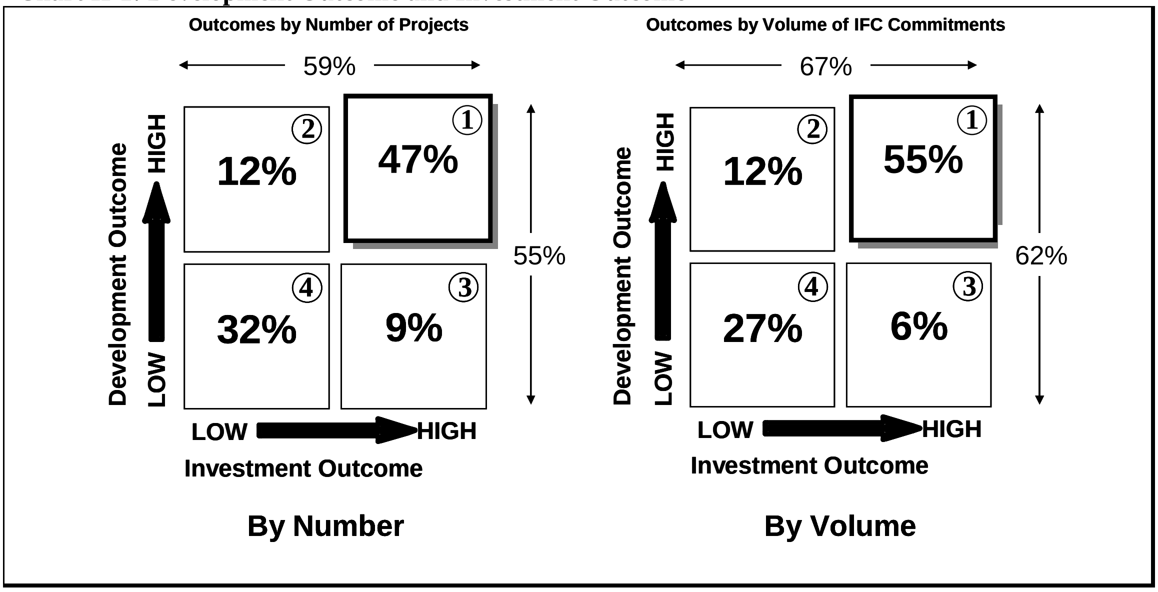
2.17. Two years ago, IFC was at a turning point in its evolution and, with Board support, chose the path towards scaling up its activities and development impact. As already discussed, IFC has reached many of the development impact targets of its growth plan in two years rather than three, yet the call for IFC to play a greater role is stronger than ever. This includes going further into the frontier, introducing innovation, promoting more systemic impact and addressing the enormous unmet development needs, especially in the poorest areas and riskiest markets. Today IFC again has a choice: it can use its achievements as a springboard to a leading role in developing well-functioning private sectors. Alternatively, it could restrict its growth. As in 2005, Management believes that IFC should choose the first course of action, pursuing the growth proposed in this paper, which includes the possibility of scaling up further as circumstances warrant, and with much greater focus on development impact and additionality.

2.18. As IFC embarks on the next stage in its evolution, it does so guided by the five Board-endorsed strategic priorities, which are summarized in paragraph 2.7 and discussed in detail in Annex 1. To sharpen the focus on these priorities, IFC last year set out several goals. These were: (i) greater development impact, in particular through greater focus in Sub-Saharan Africa, MENA, and other frontier markets, as well as strengthened measurement of development impact and better alignment and management of IFC's advisory services; (ii) better World Bank Group cooperation (see paragraph 2.9 and Annex I paragraph 2.4); (iii) improved client satisfaction; (iv) leadership in standard-setting (and, added this year, thought leadership); (v) maintain sound finances; and (vi) good, diverse and motivated staff. IFC Management has confirmed these corporate Goals, adding one additional Goal: ensure effective implementation of IFC's decentralization initiative.

Development Impact and Additionality

2.19. **Development Impact**. Development impact is core to IFC's mission. As a private sector development institution IFC has always considered the development impact and financial success of its investments to be closely interrelated and this view is supported by the work done by IEG (Chart II-1) and by the DOTS results. As IFC has grown, and the quality of its portfolio has improved, the development impact of its activities has become even more significant. IFC's move to increase its decentralization will help staff focus on delivering greater development impact, particularly in the more difficult frontier markets which have been harder to serve in a more centralized organization.

Chart II-1: Development Outcome and Investment Outcome

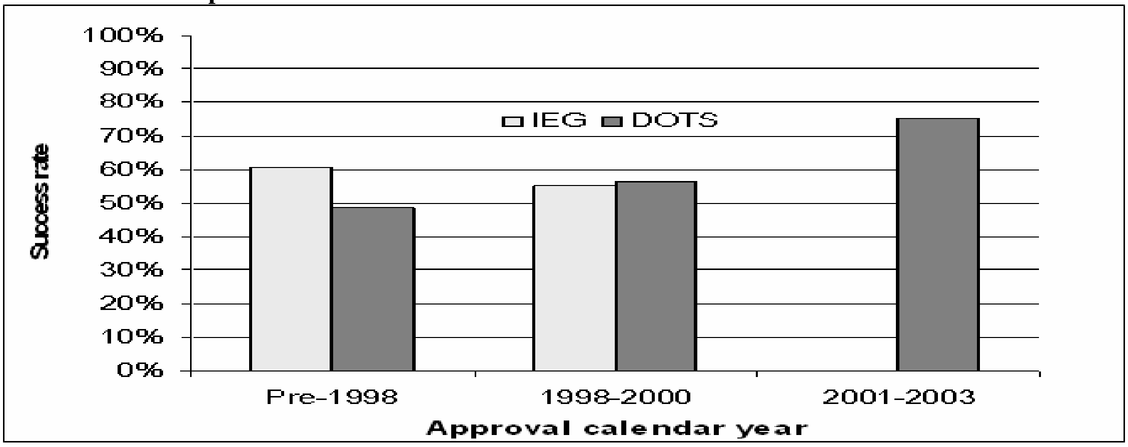


Source: IEG Annual Report 2005. Based on 210 projects approved 1997-1999 and evaluated from CY 2002-2004.

2.20. Most of the Corporate Scorecard indicators discussed above (see Annex V for the full Corporate Scorecard) measure IFC's *ex ante* development impact in line with the strategic priorities agreed with the Board. As illustrated in Table II-1, the FY06 Scorecard results and FY07 estimates show substantial progress on many of these measures. IFC measures *ex post* development impact through both the Expanded Project Supervision Report (XPSR) system of IEG, which is considered best practice among multi-lateral development banks[11], and through DOTS. Whilst there are some differences in approach, DOTS results are broadly consistent with IEG evaluation results for comparable time periods (Chart II-2) and for the overall development outcome rating as well as for the four underlying performance indicators (financial performance, economic performance, environment and social performance and private sector development impact). DOTS provides continuous assessment of performance and offers preliminary insights into more recent approvals.

[11] This refers to the "Good-Practice Standards for Evaluation of Private Sector Investment Operations" agreed by the multilateral development banks' (MDBs) "Evaluation Cooperation Group". IFC ranked the highest of all participating MDBs when mapping evaluation standards against these good practice standards. IFC's score from the 2004 benchmarking review was 92%.

Chart II-2: Development Outcome – DOTS vs. IEG

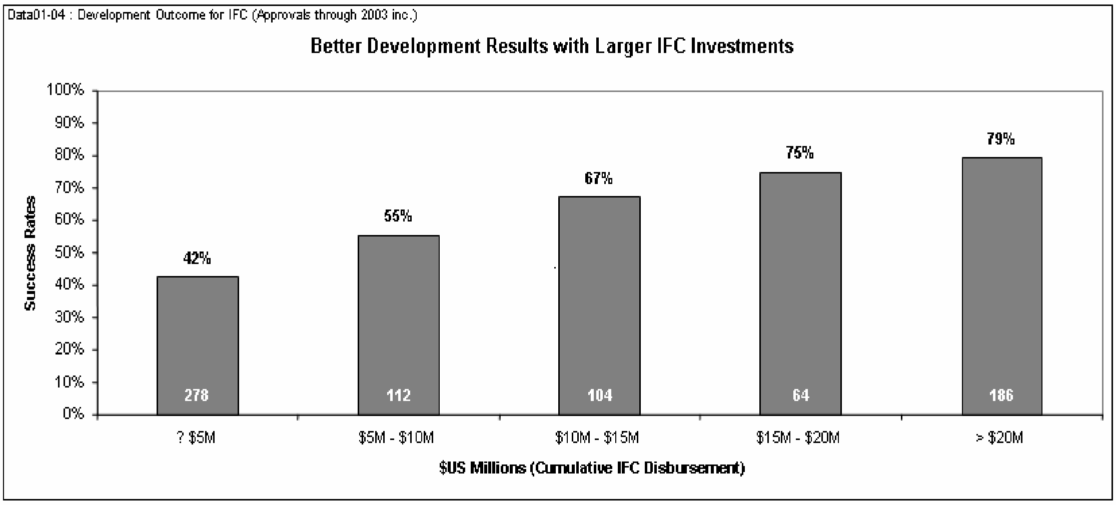


2.21. **Development Impact Incentives – the Cascade Effect.** IFC ensures that the importance of achieving strong development impact is reflected in incentives at all levels of the Corporation, from the Corporate Scorecard by which Senior Management is held accountable to staff implementing projects on the ground. By linking corporate performance and staff performance, and aligning individual and corporate goals to strengthen accountability, IFC aims to ensure that the whole Corporation is focused on development impact. This "cascade effect" is further discussed in paragraph 3.12 in Section III.

2.22. **Additionality**. IFC has always placed great importance on its additionality in projects but there is nonetheless scope to do more and to articulate better its goals and accomplishments in this area. A significant aspect of IFC's additionality, as anticipated by IFC's Articles of Agreement, is the provision of financing to support productive private enterprises where sufficient private capital is not available on reasonable terms. IFC also brings additionality to clients in many other ways, including through its expertise and value-added services, its preferred creditor status and objectivity, its results measurement (which leads to accountability and therefore performance), and its strong client relationships. Furthermore, different types of clients and projects will benefit from different types of additionality: smaller and less sophisticated clients benefit from financing and expertise not readily available from the private sector, whereas larger clients benefit from more complex financial products and value-added services, IFC's global knowledge and from its reputation, particularly in difficult sectors such as the extractive industries.

2.23. Working with large clients can help IFC achieve important development objectives, for example championing of the sustainability agenda, introducing innovations, supporting South-South investments, replicating sound business models in less developed markets and developing SMEs through linkages programs. The Lonmin project discussed in Annex I - Box 1 is a good recent example of IFC's strong additionality for a large client. Furthermore, both IEG's past studies and DOTS show that, as illustrated in Chart II-3 (DOTS data), larger projects tend to have better development outcomes than smaller projects.

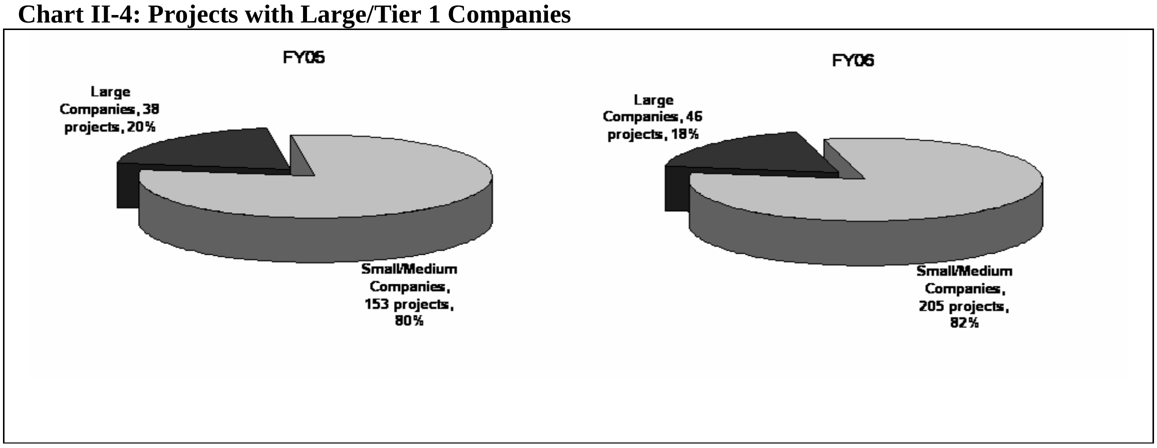
Chart II-3: Development Results and Investment Size



Source: DOTS

2.24. Nonetheless, as a percentage of the total number of projects committed in IFC's top fifteen exposure and non-frontier countries, large or tier 1[12] companies accounted for only 20% and 18% in FY05 and FY06 respectively (Chart II-4). In terms of dollar volume, the percentages were 43% in FY05 falling to 30% in FY06.

Chart II-4: Projects with Large/Tier 1 Companies



2.25. Over the past several years, IFC has striven to add real value to its clients in many new ways, from introducing local currency and other innovative financing, to building expertise in environment, social and corporate governance areas, to scaling up its advisory services offerings. It has also increased its frontier commitments, from $619 million in FY02 to $1.5 billion in FY06, and its local clients from 48% in FY03 to 63% in FY06. Furthermore, as indicated in the Matrix in Chart II-7, additionality can be viewed not only in the context of a given transaction but also in terms of how the transaction fits into the broader

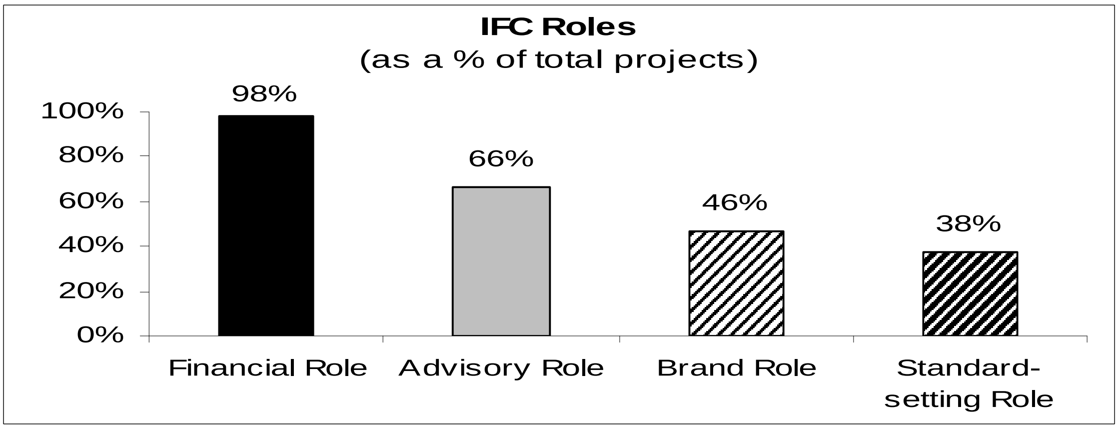
[12] Large/tier 1 companies are defined as companies which are either in the top fifty companies in the real sector or top twenty banks in the country, determined by asset size or number of employees. Also included are leading companies in their respective industries in the country even if they were not in the top fifty and projects with a large developed country sponsor.

picture of what IFC is trying to achieve in the country and sector and with the particular client.

2.26. Whilst additionality – beyond being the only provider of finance on reasonable terms – can often be hard to measure, IFC has undertaken a pilot study of FY06 investment approvals, grouping its expected role and contributions into the four categories below, illustrated in Chart II-5. A preliminary analysis of FY07 commitments (excluding projects approved in FY06 to avoid double-counting) shows similar results but with much greater emphasis on the standard-setting role.

(i) *Financial Role*. Providing financial products and services not readily available elsewhere, and willingness to be a long-term partner. This includes the ability to create innovative structures designed to meet client needs and help them overcome regulatory barriers, which in turn helps to develop the business-enabling environment.
(ii) *Brand, or "IFC" Role*. This includes IFC's ability to introduce clients to other financial institutions and investors as well as the perceived political and country risk protection and "stamp of approval".
(iii) *Advisory Role*. This covers IFC's expertise in areas such as corporate governance, privatization, cross-country expertise and industry knowledge.
(iv) *Standard-setting Role*. Under this category, clients valued IFC's environmental and social standards as well as expertise in energy efficiency and renewable energy.

Chart II-5: IFC Roles (as a % of total projects) – FY06 Approvals



2.27. This analysis is supported by the results of IFC's annual client survey, which shows the top reasons clients choose IFC (in the most recent survey from 2006, these were financing terms, expertise, long-term partnership and perceived stamp of approval). IEG's analysis (Box II-2) shows that IFC's Role and Contribution has generally achieved the highest success rating among the three indicators of IFC work quality.

2.28. *Additionality with Advisory Services*. IFC's Advisory Services enable the Corporation to reach locations and sectors where it would be difficult to provide investment services alone and often play a catalytic role in facilitating private sector investment. Advisory Services are in many cases integrated with investments (e.g. for access to finance, infrastructure, linkages, corporate governance, environment and social programs, etc.). This unique integration of high-quality investment and advisory services becomes a key element of IFC's additionality, and IFC uses a combination of in-house and outside expertise to provide the best service to clients. Another group of advisory assignments consists of advice to governments on investment climate issues. IFC has focused on some key product areas where it has strong expertise and value-added (e.g. regulatory simplification and investment promotion) and primarily in areas relating to implementation of reforms in specific sub-sectors (e.g. leasing). IFC provides additionality by leveraging these key areas of expertise, as well as the Corporation's position as a global development investor, its pioneering role in investment climate diagnostics (e.g. the *Doing Business Report*), and links with the World Bank. IFC coordinates extensively with the World Bank in participating in this segment, with the World Bank generally providing the broad policy dialogue. IFC also provides transaction structuring advice to governments (e.g. for PPPs) providing a unique service where government and private sector issues converge. Further, IFC provides advisory services in private sector capacity building for SMEs, and here it provides additionality by focusing on key products where it has a particularly strong and replicable position, drawing on its global credibility and investment culture, and on-the-ground expertise. IFC is undertaking extensive work to streamline and further focus this part of IFC's Advisory Services business on the areas of highest additionality.

Box II-2: IEG-IFC Evaluation Findings: Informing IFC's Strategic Directions

As in previous years, IEG-IFC's evaluation reports this year feature data, analysis, and findings with strategic significance to IFC. These include:

- *Achieving Greater Development Impact*. IEG-IFC's independent evaluations reconfirmed that IFC's development impact has been positive overall. The majority of IFC's investment operations have consistently generated good development outcomes amidst market volatility and country financial crises. Investment operations evaluated in 2006 (approved in 2001) show above average success. Large projects have better development impact success rates and overall, strategic sectors have been generating good results. IEG-IFC's evaluation of the Transport Sector found that IFC achieved a significantly higher proportion of successful development outcomes in transport compared with other sectors. By and large, IFC's projects yield positive development impacts when IFC achieves good investment results. IFC is increasingly managing internal key success drivers well, i.e., work quality has improved, risks are better mitigated, and investments in strategic high impact sectors increased. Positive trends in investment climate suggest greater development impact in the future. Past IEG-IFC evaluations have shown that IFC achieved higher development impact success rates when investment climates improved. Continued IFC and World Bank support for improving the investment climate should result in broader development impacts.

- *Country Priorities*. Country priorities based on a country's development needs make good business sense. IFC has a role to play in both frontier countries and middle-income countries. IFC could give priority to addressing country-specific investment climate issues, e.g., addressing impediments in strategic sectors in frontier countries and enhancing competitiveness in middle-income countries. In its review of IFC's operations in Honduras, Madagascar and Yemen as part of the IEG-World Bank Country Assistance Evaluation (CAE) for each of these countries, IEG-IFC found that investment climate issues hampered the growth of private sector development in general and of IFC's investment operations in particular. To address this issue, IFC and FIAS conducted advisory services operations, a number of which led to enactment of laws aimed at creating a conducive environment for doing and expanding business. IEG-IFC country evaluations also found that an appropriately structured multi-country approach could be effective in addressing regional issues.

- *IFC Additionality (Role and Contribution)*. IEG-IFC measures the success of IFC Role and Contribution – defined as the extent IFC played a catalytic role and made a special contribution – as part of the self-evaluation of project operations (XPSRs). IFC's Role and Contribution is the equivalent of IFC additionality in the XPSR framework. This indicator has generally achieved the highest success rating among the three indicators of IFC work quality. In the few cases where role and contribution was rated low, it was largely because IFC was unable to deliver its needed contribution to enhance project success post-approval or because IFC overestimated its expected contribution.

2.29. IFC's aim is to maximize its development impact and additionality in all its projects. IFC must also strike a balance between taking risk, which is part of IFC's role, and achieving good development results: whilst investments in risky environments can lower IFC's development impact due to their higher probability of failure, it is important that IFC pursue investments where its role is critical. There are many risk factors affecting results, and IEG evaluations have shown that where IFC combines too many risk factors in one project, it is more likely to fail (IEG Evaluation Brief Number 7, April 2006).

2.30. In selecting projects, IFC Management seeks to balance these aspects, together with the need to invest in projects that meet IFC's other investment criteria, such as predicted financial success, sustainability and sponsor selection. Whilst IFC will continue to be guided by its five strategic priorities, the Matrix in Chart II-7 is a useful framework to think about striking a balance as IFC makes decisions on priority activities. The Matrix helps to explain IFC's additionality as it moves to add a more systemic/programmatic approach to its business. This illustrates the range of activities from firm level to systemic interventions (bottom to top); IFC can see priority activities in each of these quadrants. Firm-level interventions will tend to be more difficult in frontier markets, and there is therefore likely to be a greater need for investment climate advisory services to lead the way and thereby catalyze subsequent investments.

Chart II-6: Mapping IFC Priorities: Illustrative Framework

Systemic

Systemic Implementation

WORLD BANK
Informative Diagnostics, Policy Dialogue, Detailed Assistance on the Design of Reform Programs and Implementation Plans, etc.

IFC	Frontier Markets	Non-Frontier Markets
Business Enabling Environment	•Business Edge •PEP Facilities •FIAS Advisory •Doing Business	•Municipal Administration Simplification
Standards	•Corporate Governance •E&S	•Equator Principles •Corporate Governance •E&S
Access to Finance	•MSME Finance •Trade Finance •Housing Finance	•Capital Markets Development •Sustainability Finance •Housing Finance
Infrastructure (incl. Health & Education)	•Early Stage Project Development •Investments •PPP •Privatizations	•Direct Investments •PPP •Sub-national Finance •Privatizations
Firm-level Interventions: Direct Investments & Advisory Services	•Direct investments •SME Training and Advisory •Introducing South-South Investments •Investment Climate Advisory Services	•Direct investments/ Linkages •E&S and Corporate Governance •Originating South-South Investments

Firm Level

IFC's Business Model

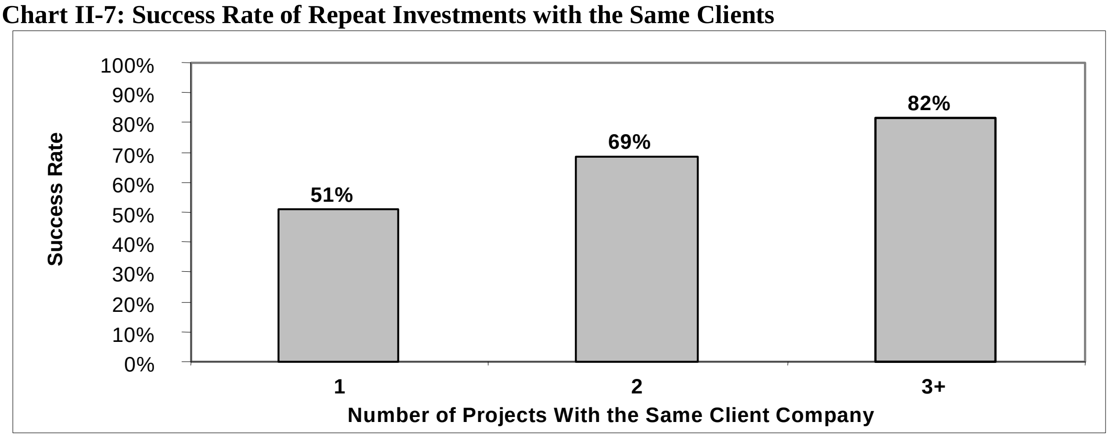
2.31. IFC has now reached a stage in its evolution where it is aspiring to increase substantially the development impact of its activities by adopting new approaches in pursuit of its five strategic priorities: more focus on systemic interventions, innovation in order to reach underserved segments in its markets and greater client orientation to meet the enormous needs in developing countries more effectively.

2.32. **Systemic/Programmatic Approaches.** There is the potential for IFC to have much more development impact through systemic and programmatic approaches to the needs of its clients, both corporate clients and client countries. IFC is already doing this in a number of areas and aims to scale this up significantly. Typically, the systemic approach to a sector would start with upstream advisory work on the business enabling environment and/or privatization, often building on efforts of the World Bank and the government. This in turn encourages downstream private sector investments in which IFC participates, directly and/or by bringing clients from more advanced countries (developing and developed) to stimulate growth of the sector. Recent examples include the AES Sonel project in Cameroon (Annex I - Box 4), Mexico housing finance (Annex I - Box 7), and Peru land titling. Drawing lessons from the past, upstream work involves: (i) a sector approach; (ii) an effective use of advisory services; (iii) up-front involvement of the World Bank; and (iv) early engagement with key stakeholders. However, combining IFC's investment efforts with advisory services and coordinating with the World Bank and the host governments make IFC's work more resource intensive.

2.33. Greater use of financial intermediaries combined with advisory services to address a specific sector will also be an important aspect of this approach, as illustrated by the work IFC did in the Ghana school finance program. IFC intends to adapt this model – using financial intermediaries and other clients to help deliver impact – to other industries, such as agribusiness.

2.34. Building strategic relationships with key clients will also be part of this effort, with a particular focus on supporting them in South-South investments. It is therefore important to view each proposed IFC project in the context of what IFC is trying to achieve through its entire relationship with that client, especially as IFC moves to adopt more systemic approaches to addressing development challenges. IFC's second strategic pillar "Building long-term partnerships with emerging players in developing countries" recognizes the importance of these ongoing client relationships. Furthermore, development results from both DOTS and IEG indicate that repeat investments with the same client tend to have better development results.

Chart II-7: Success Rate of Repeat Investments with the Same Clients



Source: DOTS

2.35. **Reaching the Underserved**. There are many people and businesses in developing countries that are not yet benefiting from global growth and the increased financial flows to these markets. IFC must develop ways to address the needs of the underserved, such as provision of services to the poor (e.g. infrastructure projects, access to basic services) and gender aspects (e.g. access to finance for female entrepreneurs). IFC is now well placed to do this, given its financial strength, its global experience and its mandate to take risks that the private sector would not undertake alone.

2.36. IFC's growing support to MSMEs and continued focus on frontier markets form part of these efforts. The proposals discussed with the Board in the paper "IFC: Creating Opportunity and Update on Capital Position" (IFC/SecM2007-0005) are also primarily aimed at these underserved segments:

- *Local Currency*: providing long-term local currency to markets where hedges do not exist and where there are no alternatives.
- *Infrastructure and Environment*: addressing market failures by: (i) using risk capital to increase the supply of viable infrastructure projects; and (ii) investing in climate-friendly projects outside IFC's conventional scope due to their structure or limited market experience, with the aim of scaling up successful approaches.
- *Innovation and Entrepreneurship*: supplying risk capital (probably through investment vehicles) to support innovation, small SMEs and others not served by the formal financial sector.

2.37. These are proposals with both very high additionality and the potential for strong development impact: by undertaking projects with an even higher risk profile than most of IFC's business and where the private sector is not yet ready to step in, IFC would hope to kick-start investment in several key areas, often in the most challenging environments. IFC will discuss these proposals further with the Board in the papers that the Board requested at the informal Board meeting on February 22, 2007.

2.38. In this context, the recent joint study by IFC and the World Resources Institute[13] suggests that there are significant opportunities for market-based approaches to meet the needs of the four billion low-income people at the base of the economic pyramid – a population that currently spends some $5 trillion each year. IFC is looking at ways it can address these needs with a view to developing approaches which can be replicated and scaled up for broader systemic impact.

2.39. **Becoming More Client Centered (with both country and private sector clients)**. As IFC strives to do more and increase its development impact further, particularly in the more difficult frontier markets, it needs a different operating model. The decentralization pilot in Asia agreed with the Board at the time of last year's Budget discussions represents the first phase in IFC becoming a more client-centered organization, and IFC has already deployed staff with key skills to the field as part of this effort. By 2010, IFC aims to process most of its investments in the field and to give decision-making authority to managers in the field enabling processing to happen in the most effective way, including introduction of appropriate risk management practices. Whilst this approach will help nurture new clients, it may also lead to an increase in business with existing clients, in particular those identified as able to help IFC deliver the most development impact and where IFC's additionality is greatest. This could require reconsideration of the new client target currently in the Corporate Scorecard. (In addition to development impact and additionality criteria, any increase in

[13] "The Next 4 Billion – Market Size and Business Strategy at the Base of the Pyramid".

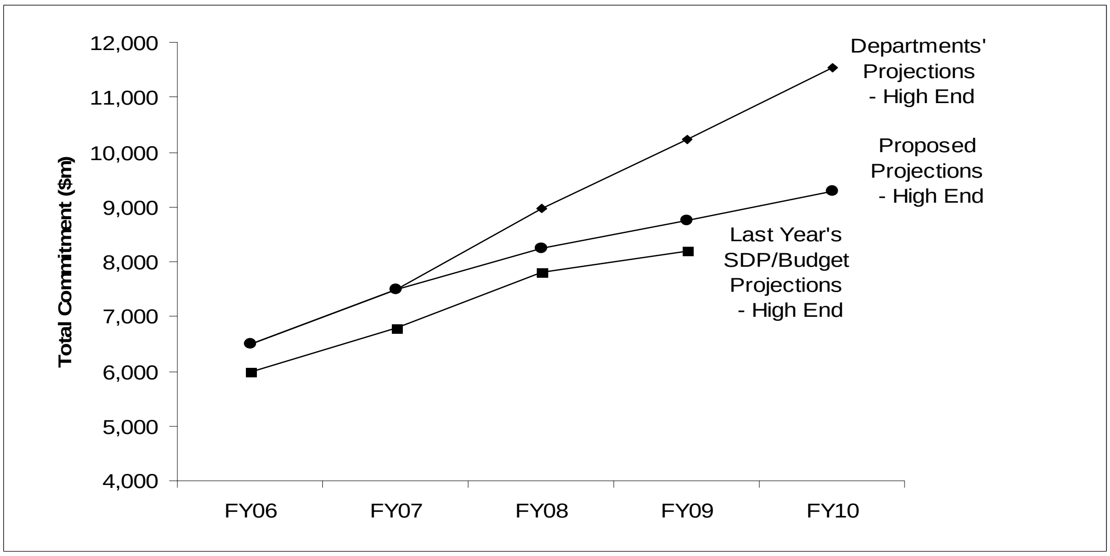
business with existing clients will be subject to IFC's exposure guidelines.) Through Advisory Services, IFC is also working towards being more client-driven, being selective in the services it offers and ensuring that its services are world-class.

2.40. The Business Process Review currently underway is part of the effort to make IFC more responsive and to enable its staff to focus on adding value to its clients, on helping clients in more difficult frontier markets and on creating development impact rather than focusing on internal processes. Introducing a risk management framework that is aligned with this new model will be an important part of this endeavor (see paragraph 3.14 in Section III for more on Risk Management). Whilst these initiatives should help IFC to become a more effective development institution, there are challenges ahead, and these are discussed in Section III.

Pace of Growth

2.41. Increased scale allows IFC to create more opportunities and permits more systemic impact, provided this growth focuses on projects with strong development impact. IFC therefore proposes to continue its growth path into FY10. The proposed growth rates are lower than those proposed by IFC's investment departments[14] at the recent internal strategy discussions in recognition of the fact that there may sometimes be tensions between very rapid growth on the one hand and development impact and additionality on the other, and to allow IFC to pursue its decentralization in a considered way. The proposed growth rates are in line with those discussed last year with the Board, although starting from a higher FY07 base (Chart II-9): growth rates of 10%, 6% and 6% for each of the years FY08-10, compared to growth rates of 15% and 5% for FY08 and FY09 shown in last year's Business Plan and Budget Paper (Table II-3).

Chart II-8: Commitments Projections Comparison



[14] These proposed commitment levels were arrived at without factoring in budget implications.

2.42. In light of the tremendous needs in its markets, the important role of the private sector and the value of more systemic approaches, in FY08 IFC will consider accelerating growth further. This will be done in consultation with the Board, reexamining the balance of development impact, additionality and financial success and taking into account IFC's increased field presence, enhanced measurement of development impact, the quality of projects through better risk management practices, and productivity improvements.

Table II-3: Comparison of Commitment Volume Ranges: FY06 Business Plan and Budget, Current Projections and Departments' Projections

	FY05 (Actual)	**FY06** (Actual)	**FY07** (Estimate)	**FY08** (Projected)	**FY09** (Projected)	**FY10** (Projected)
Projected commitments shown in last year's Budget Paper	5,373	5,600-6,000	6,000-6,800	6,500-7,800	7,000-8,200	-
%YoY change – High end		12%	13%	15%	5%	-
Current Projections		6,703	6,800-7,500	7,400-8,300	7,900-8,800	8,500-9,300
%YoY change – High end		25%	12%	10%	6%	6%
Departments' Projections - High end		6,703	7,500	8,980	10,233	11,550
%YoY change		25%	12%	20%	14%	13%

2.43. The situation could change should there be a significant downturn or adverse event in any of IFC's markets and a need for IFC to play a more countercyclical role, such as it did in the early 2000s in Brazil and Argentina through provision of trade lines and other support to selective clients, particularly in the financial sector. It is difficult, however, to predict the precise impact on growth that such circumstances might have: while some projects would not proceed, others would emerge from the increased need for IFC to resume its countercyclical role.

2.44. As discussed in Section I, far from being over-ambitious, IFC's recent rate of growth is around the average for all private sector development financial institutions analyzed (Chart I-7). Furthermore, the pace of growth IFC is proposing is in fact slower than in recent years and may result in further reduction in IFC's share of IFI financing to the private sector in developing countries. It is also below the historical average: an examination of the compound annual growth rates[15] (CAGR) of commitments since 1960 reveals the following:

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[15] Compound annual growth rate is the year-over-year rate of growth over a specified period of time: in the context above it describes the rate commitments would have grown if they had grown at a steady rate each year.

Table II-4: Compound Annual Growth Rate of IFC Commitments

Fiscal Years	CAGR %
Actual	
1960 – 1970	16.8
1970-1980	16.4
1980-1990	8.3
1990-2000	10.2
2000-2007	17.6
Projections	
2007-2010 (Current projections – high end)	7.4
2007-2010 (Departments' projections – high end)	15.3

MEASURING SUCCESS

2.45. The DOTS system provides much useful information that should allow IFC to move to specific development results targets, although IFC must remain sensitive to the escalating costs to its clients that could stem from increasing demands for data. With the increased focus on development impact and additionality, and as IFC moves to new approaches to its business, IFC will engage with the Board to consider how best to measure IFC's performance, in particular what might be appropriate benchmarks, which development impact success rates to target, how to look at repeat clients and development of systemic impact measures.