

### SECTION III. IMPLEMENTATION UPDATE

3.1 IFC has continued to make significant progress in pursuing its five strategic priorities, and has scaled up its activities in line with its ambitious growth plan approved last year. In order to deliver development results and fulfill its corporate goals, IFC must leverage its involvement by scaling up through partnerships with its clients, other members of the WBG, financial market partners, including ‘Equator’ banks, and developing and donor member countries. For private sector clients this means continuing the strategy of becoming a partner of choice, and placing greater emphasis on the range of value-added products and services it can provide to clients, as well as on staying close to clients to assist in delivering results throughout the life of a project. For other partners, this means closer working relationships, with efforts focused on improving the investment climate and setting standards in areas such as environment, social, corporate governance and anti-corruption. The scaling up also requires IFC to leverage its own strengths of being an institution with a culture of innovation, pragmatism and market discipline. IFC must continue to respond to development challenges through market-driven initiatives and innovations, many examples of which are presented throughout the rest of Section III. IFC will also need to address certain challenges if it is to maximize the development impact of its growth strategy, in particular in the areas of human resources, risk management and management of TAAS.

#### **Highlights of Achievements, FY05-FY06 (to-date)**

3.2 **Development Impact Targets.** Following discussions with the Board last year, IFC now has Board-endorsed development impact targets in its Corporate Scorecard which are based on the five strategic priorities. The Corporate Scorecard also reports on profitability and client service. Table 3.1 contains a summary of FY06 progress in the key development impact indicators. The full FY05 Scorecard can be found in Annex 2.

**Table 3.1. Summary of FY06 Progress on Key Indicators**

Scorecard Item	FY05	FY06 Estimate as of 3/24/06	Target FY08 (Board)
% Satisfactory or Better Ex-post Development Outcomes (XPSR)	60%	NA	65% on projects committed FY06-08 <sup>1</sup>
Africa Commitments	\$445m	\$500m-\$600m	\$735m – \$875m
SME Commitments (incl. Micro)	\$1,099m	\$0.8bn-\$1.1bn	\$1.1bn – \$1.3bn
IFC Frontier % vs. Frontier GDP %	28%:18%	31%:17%	Overweight in frontier
New Client %	56%	50%	Larger than 50% of projects
Renewable Energy/Energy Efficiency IFC Commitments <sup>2</sup>	\$221m	NA	EIR target for the World Bank Group
Total RE/EE Component	\$832m	NA	
Infrastructure, ICT <sup>3</sup> , Health and Education Commitments	\$880m	\$1.2bn-\$1.4bn	\$1.5bn – \$1.8bn
Financial Sector Commitments <sup>4</sup>	\$2,183m	\$2.0bn-\$2.2bn	\$2.1bn – \$2.5bn

1 There is generally 5-6 years’ lag for ex-post results.

2 Based on commitments as of end FY05. The total project cost of projects with RE/EE components was \$2.9 billion. IFC invested \$705m in these projects, of which \$221m was targeted to the RE/EE components. FY06 estimates are still under preparation.

3 Information and Communication Technologies.

4 Not including Funds.

**3.3 World Bank Group Collaboration.** As illustrated throughout this paper, IFC and other members of the WBG already work effectively together on a number of fronts. As acknowledged by WBG Management in recent announcements, however, there is considerable scope to enhance collaboration further, focusing on improving services on-the-ground by effective use of the institutions' respective business models. With IFC's and MIGA's focus being primarily on the private sector whilst IBRD and IDA work primarily with governments, their activities can reinforce each other, especially when responding to clients' needs and well coordinated. In addition to initiatives covered elsewhere in this paper, this paragraph outlines some further examples of the steps already taken to increase the effectiveness of collaboration.

-At the regional and country level:

- In Sub-Saharan Africa, IFC and the World Bank worked together on the private sector component of the Africa Action Plan (approved by the Board in September, 2005). IFC is now working with the World Bank Africa region's private sector group to develop a framework for scaling up collaboration.
- In Brazil, the two institutions have an extensive cooperation program, including work on infrastructure, the financial sector, agribusiness, environment and the business climate.
- Joint CASs are under preparation with significant engagement between the World Bank and IFC for China, Senegal, Mauritania, Madagascar and South Africa.

-At the transaction level: there are increasing opportunities for collaboration, particularly in infrastructure and other areas where it has been recognized that a combination of public and private involvement will be key to success. Several of such projects have already been closed and a number are in the pipeline. See Boxes 2.1, 3.1 and 3.2 for specific examples in Sub-Saharan Africa.

-At the thematic level: IFC and the World Bank are already cooperating on themes such as good governance, HIV/AIDs policy, sustainable development and business and clean and renewable energy, as these are areas where the WBG as a whole can provide value to both public and private sector interests.

**3.4 Technical Assistance and Advisory Services.** The ability to offer technical assistance and advisory services to clients, either together with or separately from an IFC investment, has become an increasingly important factor in IFC's development impact, as well as in its competitive advantage. Over recent years, TAAS have expanded rapidly in scope, geographic coverage and staffing: at the end of 2005, there were 457 active TAAS projects. In addition to helping IFC clients, IFC is increasingly offering TAAS targeted to help improve the investment environment to encourage a strong private sector to develop. Much of IFC's TAAS is carried out through IFC's facilities. There are now about 800 facilities' staff based in forty-five countries and in Washington, and in FY06 IFC rolled out training for these staff to help enhance their understanding of the investment side of IFC's operations and thereby their ability to recognize possible synergies with IFC's investments. IFC has now taken steps to align the facilities with the regional strategies and to clarify the TAAS principles and business lines. This has enabled IFC to prioritize funding allocations for TAAS in line with its strategic objectives.

**3.5 Principles and Business Lines.** With the growth in TAAS described above, IFC is moving quickly to improve TAAS selectivity, operational accountability and efficiency in resource allocation. IFC has therefore developed a set of Principles to be applied to all TAAS and has set out five TAAS Business Lines under which all operations will be aligned: business enabling environment, focused on frontier markets; value-addition to firms, focused on corporate governance; environmental and social sustainability; infrastructure, focused on public-private partnerships and privatization; and access to finance. Each Business Line has a leader and a committee process to bring objectivity to the review of funding proposals and allocation of resources. TAAS portfolio

supervision and monitoring systems have also been strengthened. The management principles involved include the separation of decision-making on funding from implementation (to handle conflicts of interest), more intellectual leadership and quality control from headquarters, implementation to the extent possible through TA facilities in the field and leverage of donor funds where possible. This structure is aimed at enhancing strategic focus, providing better governance and results measurement of TAAS and ensuring consistency in funding decisions across regions.

**3.6 New Environmental and Social Performance Standards Adopted.** In February, 2006 the Board adopted revised environmental and social standards, along with a new policy on disclosure. The new outcomes-based approach of these standards will help to make IFC's investments more sustainable and developmental (see paragraph 3.34). The Equator Principles are now expected to be updated in line with the new standards, which will also extend the development impact of IFC's approach to environmental and social issues.

**3.7 Advances in Measurement.** IFC is continuing to work on its evaluation and measurement systems, and is particularly focusing on how better to measure its development impact. IFC established the Development Effectiveness Unit in the Private Sector Development vice-presidency in July 2005 to spearhead and coordinate efforts to measure IFC's development impact. Until now, IFC's main measurement of *ex post* development impact was through the Expanded Project Supervision Report (XPSR) system, which is considered best practice among multi-lateral development banks (MDBs). However, the XPSR system only measures development results once in the lifetime of a project, and only for a random sample of projects (about 50% of projects are covered by XPSRs). To supplement the XPSR system, IFC has introduced a new Development Outcome Tracking System and briefed CODE about the new system in December, 2005.

**3.8 Development Outcome Tracking System.** This system will allow for systematic tracking of development results throughout the project cycle, from identification of clear, monitorable development objectives up front, to ongoing tracking during supervision, and will thereby provide for earlier learning and feedback into IFC's operations. With guidance from the Development Effectiveness Unit, investment departments have started to develop monitorable indicators specific for their types of operations and are starting to track them in DOTS. IFC plans to brief the Board on progress in July, 2006. IFC has also committed to report on its development results in a new Development Effectiveness Report, with the first report likely to come out in spring, 2007.

**3.9 TAAS Measurement.** Significant steps have been taken on the measurement of the impact of TAAS on several fronts. First, in FY06, IFC established a system for monitoring and evaluating the impacts of its technical assistance activities through deployment of TAAS supervision reports and standard performance indicators. All active TAAS projects have gone through the first corporate supervision cycle. Secondly, IFC has now launched the first TAAS project completion reports and results will be available by the end of the fiscal year. These reports include development effectiveness ratings akin to those used for investment operations. Thirdly, in order to gain insights into project performance and provide recommendations on the design and implementation of current and future projects, IFC has completed a number of operational reviews of TAAS programs, for example the Linkages Program and the SME Toolkit. In addition, several Facility-specific evaluations have been conducted during FY06 by both external evaluators and IEG. Finally, IFC is one of the leaders amongst providers of TA in implementing several experimental designs in order to have a more rigorous assessment of impacts as well as to inform design of TA interventions from lessons learned. This approach involves experimental and control groups for measurement of the impact of IFC's interventions. Key findings and lessons from these activities will be shared with staff, donors and external evaluation experts during the Monitoring and Evaluation Conference on TAAS which IFC will be hosting in May, 2006.

3.10 *Measuring Environmental and Social Sustainability.* IFC is developing a new system to track project compliance with IFC's new Performance Standards, as well as to monitor environmental and social performance throughout the project cycle. IFC is developing a matrix of environmental and social performance indicators, matching the Performance Standards, which aims to fulfill IFC's commitment to articulate expected development results systematically at project approval and track them during supervision.

3.11 **Investment Commitments.** IFC continued to experience strong growth in FY05 and FY06 to date, with new commitments increasing 13% to \$5.4 billion in FY05. At the end of March, FY06, commitments already stood at almost \$3 billion, compared to \$1.7 billion at the same time the previous year.

3.12 Looking forward, IFC has revised upwards its commitment targets for FY06-FY08 compared to those presented to the Board last year, and has extended its growth path into FY09. Table 3.2 shows the projection for FY06 and indicative figures for FY07-09, which are subject to developments in IFC's markets, in particular liquidity and demand for credit. Indicative figures for each region are shown in Annex 1.

**Table 3.2. Total Commitments (US\$m)**

	<b>FY05</b>	<b>FY06 Proj.</b>	<b>FY07 Plan</b>	<b>FY08 Plan</b>	<b>FY09 Plan</b>
Commitments	5,373	5,600-6,000	6,000-6,800	6,500-7,800	7,000-8,200
Projections in FY05	--	4,810-5,720	5,275-6,270	6,015-7,150	--
% Change from FY05	--	4%-12%	12%-27%	21%-45%	30%-53%

3.13 **Financial Performance: Third Year of Record Profitability.** IFC's operating income for FY05 was \$1.95 billion, representing a substantial increase over FY04. The growth reflected strong equity markets leading to significant realized gains on sales of equity, robust dividend income, greater loan portfolio income and the positive impact of a release of loss reserves. IFC's FY05 Return on Net Worth was 22.6%, up from 13.7% in FY04. IFC is anticipating continued strong profitability in FY06 due to the positive market environment.

### **Progress with the Five Strategic Priorities**

#### **1. Strengthen the Focus on Frontier Markets**

3.14 IFC has continued to focus on increasing its activities in frontier markets. In FY05, commitments in these markets rose 24% to almost \$1.3 billion, and are forecast to increase to over \$1.7 billion in FY06. In terms of numbers of projects, frontier projects account for a somewhat higher percentage of IFC's total projects than the percentage of dollar volume commitments, representing about one third of IFC projects in number, due to the lower average project size in frontier markets. In addition, there are regions of several non-frontier countries which meet frontier criteria, for example north-east Brazil, where IFC is also focusing its activities. When commitments in these frontier regions are included in the total, the frontier market figures for FY05 account for 38% in terms of volume and for FY06 (first half) 37%. As noted in IFC's Independent Evaluation Group's *Annual Review of IFC's Evaluation Findings: FY2005* (see Box 3.4), the percentage of IFC's approvals in the frontier are now more than twice as concentrated as FDI, and also relatively more concentrated there than GDP.

**Table 3.3. IFC Commitments in Frontier Countries**

	<b>FY03</b>	<b>FY04</b>	<b>FY05</b>	<b>Estimate FY06<sup>3</sup></b>
Frontier Country <sup>1</sup> Investments (\$m)	\$874	\$1,032	\$1,278	\$1,738
IFC Frontier Commitments as a Percentage of Total IFC Commitments <sup>2</sup>	28%	26%	28%	31%
<i>IFC Frontier Commitments excluding Argentina<sup>6</sup> %</i>	26%	24%	25%	26%
<i>IFC Frontier Commitments including frontier regions<sup>4</sup> %</i>	NA	NA	38%	37% <sup>5</sup>
Frontier GDP as a Percent of Total Developing Country GDP	24%	22%	18%	17%

1 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 IBRD classification.

2 % Commitments excluding commitments to regional and global projects.

3 As of 3/10/06.

4 Based on a pilot analysis of frontier commitments in IFC's top ten non-frontier countries (in terms of recent commitments). Countries covered were Russia, China, Turkey, Mexico, Brazil, Indonesia, Philippines, Ukraine, Colombia and Romania. Frontier regions were identified based primarily on *per capita* income with adjustments by IFC staff to reflect prevailing business risk issues in the country.

5 Based on actual commitments for the first half of FY06.

6 Argentina entered into the frontier category in FY02 due to its high investor risk rating. It is expected to be back in the non-frontier category in FY07.

3.15 Some of the main obstacles to increasing frontier volume significantly remain the investment climate and the absorptive capacity of these markets. IFC is therefore stepping up its advice to governments in order to try to speed up establishment of an environment which is more hospitable to the private sector, both through greater collaboration with the World Bank and also through its TAAS and privatization work. The work with the Government of Senegal on the Kounoune power project, described in Box 3.2, is a recent good example of this.

3.16 **Progress in Sub-Saharan Africa.** Over the past two years IFC has significantly scaled up its capabilities on the ground. As a result, commitments grew to \$445 million in FY05, from \$140 million in FY03. Commitments in FY06 are again projected to increase substantially, to between \$500 and \$600 million. In FY06 and looking forward over the FY07-09 period, financial markets investments are projected to contribute significantly to new commitments in the region. Trade finance, MSMEs and housing finance will be the three main pillars of the financial markets strategy in Sub-Saharan Africa. Box 3.1 describes some of the financial markets initiatives in the region. Other activities in the region are discussed elsewhere in this paper, in particular in Box 2.1 and paragraphs 3.22 (Post-Conflict Countries Initiative) and 3.48 to 3.55 (Infrastructure).

3.17 The FY04-06 Strategic Initiative for Africa is ending, and will be reported on to the Board around mid-2006. While IFC considers that the three strategic pillars of this initiative remain valid (investment climate, SMEs and proactive development of large investments), some adjustments are necessary. In particular, IFC is proposing to add another pillar, trade and regional integration, and to extend its reach and strengthen partnerships. This is discussed further in Annex 1.

3.18 The last year saw the full launch of PEP-Africa as the primary vehicle for IFC TAAS in the region and the integration of PEP-Africa with IFC investment operations. PEP-Africa's structure is directly aligned with IFC's new TAAS business lines and there are Business Line Managers for each business line identified. PEP-Africa is ahead of targets in donor fund-raising, and in March, 2006 the Board of the African Development Bank approved \$7 million in funding to support PEP-Africa

programs. The programs concentrate on the three strategic pillars of IFC's Sub-Saharan Africa strategy. i) *Investment climate improvement programs*: the activities cover five main market needs (streamlining business start-up procedures, simplifying tax regimes, improving private sector property rights and addressing gender bias in property rights and access to finance) and the focus is on program implementation through on-the-ground teams complementing the work of the World Bank and Foreign Investment Advisory Services (FIAS). ii) *SMEs*: activities focus on improving SME access to finance and strengthening SME competitiveness through building financial institution capacity for SME lending, developing alternative sources of financing, such as leasing, providing business planning and capacity building for SMEs and implementing SME "cluster" competitiveness strategies. iii) *Proactive investment development*: PEP-Africa contributes to creating or supporting investments by providing TA services that add value to IFC's financial products. These services include SME linkages and supply chain development, business risk mitigation of HIV/AIDS, corporate governance, gender equity and the range of IFC's environmental and social programs.

3.19 The biggest challenge in the region remains implementation, especially attracting qualified staff, but here also IFC has made substantial progress, strengthening the eight regional offices throughout the continent and increasing staff from 140 in July, 2005 to 195 by the end of January, 2006. IFC's overall recruitment target for FY06 (75 new staff) is therefore well on track in the region, including achievement of diversity objectives.

### **Box 3.1. IFC Financial Sector Initiatives in Sub-Saharan Africa**

Financial markets investments in Sub-Saharan Africa are expected to represent a significant proportion of new commitments over the next few years. As of December, 2005, the financial markets portfolio in the region stood at \$362 million, consisting of 47 projects across 24 countries. Despite this growth, IFC has recognized that it needs to leverage its involvement in this sector in order to increase its impact, and it is pursuing several initiatives in this regard. Below are some examples.

- **IDA/IFC Africa MSME Pilot**: this program, approved in June 2003, was aimed at providing an integrated approach to supporting micro, small and medium enterprises. This program has now grown to potentially in excess of \$400 million, considerably more than originally envisaged, but implementation remains an issue. As of January, 2006, IFC had committed \$49 million to 6 associated projects, with a pipeline of around another \$15 million, and \$7 million had been approved for linked investments, with a further \$90 million of such directly linked investments in the processing pipeline.

- **Africa SME Finance Program**: under the Performance-Based Grants Initiative described in paragraph 3.23, IFC is proposing to use \$30 million of the \$250 million designation of retained earnings to provide TA and performance-based grants to financial institutions, provided that they meet pre-defined targets in lending to SMEs. Due to its replicable and scaleable approach, the initiative is designed to deliver on the objectives of deepening and broadening the African financial sector and raising the standards of financial services provided to SMEs.

- **Greenfield microfinance initiative**: working with KfW, this program is intended to create seven new microfinance institutions in Sub-Saharan Africa. The total package is expected to be \$103 million over a five-year period, with IFC's share being around \$16 million in investments and TA.

- **Trade Finance**: IFC's \$500 million Global Trade Finance Program was approved by the Board in FY05. Africa has been a key focus of this business, projected to account for 50% of the program in FY06 with twenty African issuing banks participating. The program is an effective platform on which to build new relationships with banks, and IFC expects that some of the banks will become strategic partners with IFC in other types of projects, such as SME lending and housing finance. See paragraph 3.66 for more on Trade Finance.

**3.20 Progress in Middle East and North Africa.** Historically a region where IFC has not expanded rapidly, MENA was the region with the second highest growth rate of commitments in FY05, 33.5%, although the level was still relatively low at \$315 million. For FY06, IFC is predicting significant growth, which could be more than 40% over FY05. Growth in investment activity is accompanied by enhanced capacity to deliver TAAS through PEP-MENA, the region's TA facility. MENA regional staffing has increased over 50% since the beginning of FY06, driven by significant hiring in PEP-MENA.

**3.21** Although the region has significant needs, there are several constraints facing IFC, of which the key ones are: i) relatively unsophisticated financial markets in many countries; ii) challenging governance environments; and iii) excess liquidity in some of the markets. IFC's strategy will focus on improving the investment climate, strengthening the financial sector, developing the infrastructure and energy sectors and supporting regional and South-South investments. This region is a significant source of South-South transactions, with seventeen committed between FY03 and FY05 for a total of over \$276 million. (See paragraph 3.25 for more on South-South transactions). In countries with more developed financial markets, IFC is focusing on underserved niches with significant development impact, such as microfinance. A recent example is the IFC partial credit guarantee program, combined with TA, provided to the Foundation for Local Development and Partnership, a microfinance institution in Morocco, offering services to about 45,000 beneficiaries.

**3.22 Post-Conflict Countries Initiative.** IFC has an important role to play, in full collaboration with the World Bank and other development partners, in fragile states and countries emerging from conflict in order to help them catalyze economic growth through establishment of a dynamic private sector. To this end, IFC is launching a pilot Post Conflict Countries Initiative in the Democratic Republic of the Congo (DRC). Phase 1, now underway, involves an intensive effort to define short, medium and longer term interventions in all key sectors of the fledgling DRC private sector. The objective is to be ready to launch several initiatives following the election in June, 2006. This work is being fully coordinated with the World Bank, MIGA, the U.N. and key donors. IFC will then be in a position to define the nature of a more proactive approach to a Post Conflict Countries Initiative including target countries, resources, as IFC will need to deploy additional resources in order to carry out the program of initiatives, types and amounts of funding and operating principles. This is expected to provide the basis for bringing a proposal to the Board.

**3.23 Performance-Based Grants Initiative.** The Board recently discussed<sup>7</sup> IFC's innovative Performance-Based Grants Initiative, whose primary objective is to scale up IFC's impact in priority sectors in frontier markets. The pilot \$65 million is to be divided into two tranches, one of which, the Africa MSME Finance Program, is discussed in Box 3.1. For the other tranche of \$35 million IFC is proposing to partner with the Global Partnership for Output-Based Aid (GPOBA). Even prior to this collaboration with GPOBA, IFC has been working with GPOBA to identify private sector projects which might benefit from GPOBA's approach. IFC is now working with GPOBA on one such IFC project to try to put in place an incentive scheme to encourage expansion of gas connections in poor areas through connection subsidies.

**3.24 Staff in Frontier Markets.** IFC has significantly expanded the presence of senior staff in frontier countries, particularly in Sub-Saharan Africa, in order to be proactive through intense business development efforts. In addition, as indicated in last year's paper, business developers have now been placed in frontier regions of India and China. For example, in India, as part of a concerted effort to diversify its investments regionally, IFC first undertook an analysis of 16 states and subsequently categorized them into three groups, with a view to adopting a different business

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<sup>7</sup> "IFC Performance-Based Grants Initiative" IFC/R2006-0042.

development strategy for each. In order to facilitate business development in these states, IFC opened a new office in Chennai in Tamil Nadu, South-East India, and added business developers in Mumbai to cover Western states. IFC has also opened an office of the South Asia Enterprise Development Facility (SEDF) in Guwahati in Assam to manage TA activities in North-East India.

## **2. Build Long-term Partnerships with Emerging Global Players in Developing Countries**

**3.25 South-South Investments.** IFC's global presence enables it to support developing country companies which want to invest in other developing countries and IFC has made this type of activity a priority. IFC's financing support is accompanied by the ability to help client companies raise their standards of business practices through its expertise on environmental, social and corporate governance standards. IFC's South-South investments have been growing steadily for the past three years, reaching \$484 million in FY05. Examples in FY05 include an infrastructure services company in Angola with Constructora Norberto Odebrecht of Brazil, a hotel investment in Burkina Faso with a Malian investor and a telecoms company in Ghana with a Lebanese sponsor.

**3.26 Building Long-Term Relationships.** Through the greater dedication of resources to the field IFC aims to move closer to, and increase activity with, both new and existing clients and IFC must be mindful to balance these two groups as both are important. In the 2005 client survey, the prospect of long-term partnership remained one of the top reasons clients came to IFC, and was one of the most highly scored features identified as important in IFC's services. IFC must continue to help its clients not only with innovative financial products but also value-added services, some of which are described below. The ability of IFC to continue to support them through positive and negative changes in their environments is also an important advantage often cited by clients.

**3.27 Corporate Governance.** Corporate governance assessment is now an essential part of IFC projects and IFC's assistance in this area has increasingly become important value-added for its clients, as evidenced by the scores in the Client Survey. Corporate governance is also important where IFC is proposing an equity investment, as good corporate governance is essential to protect the long-term interests of minority shareholders. IFC regards its involvement in assessing governance and working with companies on improvements to be an important value-added contribution to both portfolio quality and long-term investee performance. In addition to working directly with the private sector, the joint World Bank/IFC Corporate Governance Unit is looking at how to apply the lessons of modern corporate governance to the structuring of state-owned enterprises.

**3.28** The web-based methodology developed by IFC is used not only by IFC staff, but is also seen as a standard for other development banks. It goes beyond diagnosis and helps companies come up with solutions to improve their governance, and is therefore increasingly valued by clients. IFC's corporate governance methodology is employed, for example, by Banco Real in Brazil for the new corporate governance tranche of the Sustainability Credit Line. IFC is also proposing a similar approach to encouraging good governance amongst credit line sub-borrowers in the Philippines and Indonesia. The methodology has recently been refined by the addition of a special financial institution governance tool-kit. Also in the realm of governance, IFC often nominates directors to the boards of its investee companies (136 of IFC's 625 equity investments, or 22%, had IFC nominees at the end of November, 2005), and through them IFC can play an important role in guiding the company to better governance. At the same time, this level of representation exposes IFC to reputation risks, and IFC has improved its policies and procedures for directorships and rolled out a revised training program for all nominees.

**3.29** IFC also advises governments, regulators, stock markets, institutes of directors and other private sector players on corporate governance issues. IFC played an important role in the design and promotion of the Novo Mercado, the Sao Paulo stock exchange's (Bovespa) special listing

segment for well-governed companies. Since 2003, Novo Mercado has become the recognized gold standard, attracting the vast majority of the recent boom in IPOs in Brazil. It now accounts for 15% of the number of companies that trade, and 43% of the market capitalization, and has out-performed the general market index by more than 100% since June, 2001.

**3.30 Linkages.** IFC's Linkages program is designed to strengthen small and medium enterprises linked to IFC investment projects and thereby bring employment and other opportunities to local communities. A lot of this work is related to the supply chain to help increase local sourcing opportunities for IFC's clients, but it also involves facilitating access to finance for local entrepreneurs, improving SMEs' access to new markets and promoting local economic development in the communities around the projects through income-generating opportunities. In order to maximize the impact of this program, IFC hopes to replicate industry experience in one region in other regions. For example, IFC is in discussions to replicate a successful program carried out in Peru in an African project with the same sponsor, and is also pursuing discussions with clients in the mining sector. As at the end of March, 2006, the program had 27 projects being implemented or scoped related to total IFC investment commitments of over \$1.5 billion.

**3.31 AIDS.** IFC's AIDS program – IFC Against AIDS – was started in 2000 and aims to protect people and profitability by being a risk management partner, HIV/AIDS expert and catalyst for action where HIV/AIDS is threatening sustainable development. The program also aims to support IFC's business development by providing value-added services and contributing to IFC's brand. The program has been most active in Sub-Saharan Africa and this region will remain a priority for FY07. IFC will launch an innovative program to reach SMEs and will undertake capacity building efforts with clients and others, for example NGOs that work with IFC's clients. In India, IFC is aiming to show that private enterprises can be partners with governments, NGOs and international organizations to curb the epidemic, focusing on three areas: i) the workplace, by raising awareness; ii) in companies' clinical facilities; and iii) in the community, particularly in the trucking industry and migratory workforce. The program is also starting to become active in Russia and China. In all this work, and particularly in India, IFC has cooperated closely with the World Bank Institute and it is intending to build on this in a more systematic way in FY07.

**3.32 Developing New Clients.** IFC is further enhancing business origination capability and strengthening client service by being closer to local sponsors. IFC has continued to decentralize, not only to be more responsive to its clients but also to enhance its business development capacity through greater local knowledge and presence. Between June 30, 2005 and the end of February, 2006 the number of senior (Grade G+) staff in the field increased 13% and IFC is still actively recruiting for field positions, particularly in light of the decentralization pilot in Asia described in paragraph 2.10. In FY05, 66% of projects were with domestic sponsors, compared to 52% in FY04, and the expanded field presence should lead to an increase in the number of domestic sponsors going forward.

### **3. Differentiate Through Sustainability**

**3.33** IFC has continued its strong focus on promoting its sustainability agenda through improving policies and processes and developing sustainability strategies in sectors which have large environmental, social and governance impacts.

#### **Improving Policies and Process**

**3.34 *New Performance Standards.*** Following an extensive consultation process, in February, 2006 the Board approved IFC's new Policy and Performance Standards on Social and Environmental Sustainability and Policy on Disclosure of Information, reinforcing IFC's role as a global standard

setter for private finance in emerging markets. The new framework marks a considerable strengthening of the safeguards, both due to their increased scope and the new outcomes-based approach. The policies will become effective on April 30, 2006 and around 40% of IFC investment staff had already been trained by the end of March, 2006. Experience from the in-house training will provide the platform for IFC to formulate a training approach for external stakeholders. In order to ensure that the changes in client requirements are well understood, IFC is implementing an intensive external communications strategy. IFC will also provide clients with reference, guidance and good practice materials to help them meet the new standards and, in certain circumstances, technical assistance to defray some of the up-front costs. The additional resources needed for these efforts will be considered in formulation of IFC's FY07-FY09 Business Plan and Budget. IFC will closely monitor implementation of the new policies, and will provide a progress report to the Board eighteen months after the effective date.

3.35 *Equator Principles.* The adoption of the Equator Principles by a significant number of financial institutions is a prime example of IFC's leadership in sustainability and standard setting. The 41 EPFIs are expected to adopt a new set of principles reflecting IFC's new Performance Standards. IFC is working to address the significant training and communication needs in order to facilitate this and is reviewing the associated resource implications. IFC, together with the EPFIs, is also promoting adoption of the Principles by other financial institutions, including bilateral, multilateral and export credit agencies.

3.36 *Mainstreaming.* In order to mainstream sustainability into IFC's investment work, mitigate environmental and social risks and ensure sustainability in clients' operations, 63% of IFC's environment and social specialists are now co-located in industry or regional departments. This will increase to 66% by the end of FY06 with enhanced field presence in Latin America, East Asia and Sub-Saharan Africa. The 'Building Better Business – Sustainability Learning Program' has now been offered nine times, including three times in the field, and over 500 staff have now been trained. Following this intensive up-front effort, training on sustainability will be mainstreamed via integration into other IFC programs, including the credit training courses, to encourage staff to approach the assessment of projects in an integrated way.

## **Developing Sector Strategies**

3.37 *Renewable Energy and Energy Efficiency.* Renewable energy (RE) and energy efficiency (EE) investments are important components of IFC's strategy. IFC is committed to scaling up its activities in these areas in order to contribute to the overall World Bank Group target of increasing its RE/EE portfolio by an annual average of 20% over five years, FY05-09. IFC is also playing an important role in the World Bank Group's undertaking, together with other IFIs, following the July, 2005 Gleneagles Summit, to prepare an "Investment Framework" to accelerate investments in low carbon energy systems and to increase assistance to developing countries in order to help them adapt to climate change. IFC has now established a unit within its Infrastructure Department which focuses on investments in renewable energy projects, in coordination with the Environment and Social Development Department.

3.38 In FY05, IFC committed \$705 million in 21 projects that had an RE/EE component. The total value of these projects was \$2.9 billion, of which \$832 million were invested directly in RE/EE components, and IFC's investment in the RE/EE parts of these projects is estimated at \$221 million. In order to enhance identification of new opportunities, whilst also tracking the impact of IFC's existing RE/EE portfolio, IFC is building a tracking system. The resulting analysis will be updated annually.

3.39 IFC has now closed its first two direct investments in wind power projects, in the Dominican Republic and Brazil, and is actively pursuing wind investments in Mexico and China. It also recently closed a small hydro project in India. As in other areas of infrastructure, IFC is working closely with the World Bank in the RE/EE field, and for example the World Bank's efforts in China have helped to open up large concessions for wind projects of 100-200MW. There are similar joint World Bank-IFC initiatives involving RE under discussion for Russia and other countries. Generally, IFC's focus remains on directly investing in RE projects in those few countries where: i) the government is supportive and is putting in place the necessary regulations; ii) the private sector is responding to these initiatives; and iii) the projects are large enough to have a significant impact.

3.40 IFC currently manages \$100 million (soon to become \$150 million) in two carbon finance donor-funded facilities, of which 40-50% is expected to be committed by the end of FY06. The private sector is key to the development of carbon markets, as it is already the most significant seller of carbon credits and will soon be the most significant buyer. IFC's carbon finance strategy focuses on IFC moving beyond intermediation to take risk for its own account by leveraging its ability to manage and take long-term project and credit risk in emerging markets, working with financial institutions (see paragraph 3.44) and developing new risk mitigation and structured finance products.

3.41 *Extractive Industries.* IFC is facing strong demand for its services in the extractive industries sector, especially from local and smaller international companies, partly driven by persistent high oil and mineral prices. IFC's activities continue to be guided by the Management Response to the Extractive Industries Review and IFC will make its second report to the Board on implementation progress at the end of 2006. This remains a difficult sector, however, especially in some regions where governance issues are problematic, but IFC is keen to address the challenges by: i) ensuring more effective coordination of private sector investment support and policy work to help mitigate governance risks to expected benefits at the national level; ii) managing the increased complexity involved in ensuring sustained development impact at the community level; and iii) increasing the value-added which IFC can bring to the sector. In order to help address some of the governance issues, the World Bank Group is actively engaged in helping about twenty countries implement the Extractive Industries Transparency Initiative, which is aimed at increasing the level of transparency regarding tax and other payments to governments from the extractive industries sector.

3.42 *Agribusiness.* IFC continues to support two initiatives launched in FY04: "better management practices" for commodities and an "animal welfare" program that addresses humane treatment of livestock. Both programs have mobilized a wide range of stakeholders, including IFC clients, and have established roundtables to come up with a consensual view of better management practices in their respective industries. At the project level, IFC is active in raising its clients' awareness of issues critical to the sustainability of their operations and providing technical assistance as needed. IFC has also been helping its clients in the poultry industry facing the dangers of avian flu. It has provided technical advice and financial support to its clients in affected countries, and improved the preparedness of clients in other countries still spared by the disease. IFC has also joined forces with the World Bank to ensure that private and public initiatives in this area remain fully aligned and complement each other in an effective fashion.

3.43 The agribusiness sector continues to face challenges across several dimensions that need to be addressed in order to strike a balance between the need to secure increased food production and the need to safeguard finite resources. Based on the work with stakeholders following from the Better Management Practices work initiated in FY04, on a selective basis IFC will engage in countries and sectors where there is a perception that economic development and sustainability concerns may diverge. The objective is to help the private sector define sustainable solutions that will be of value due to their demonstration impact and ability to be replicated.

3.44 *Sustainability in Financial Markets.* IFC has been engaging with the financial sector on sustainable lending and investment issues beyond corporate governance and anti-money laundering. Many financial sector clients have come to appreciate the value of more sustainable approaches. IFC has been facilitating the growth of sustainability finance as a key business differentiator, and has established a Financial Markets Sustainability (FMS) unit to promote this effort. IFC has provided training and best practice guidance to financial institutions on sustainable banking through its Sustainable Financial Markets Facility, funded jointly by donors and IFC. For example, IFC's support to financial institutions in Central Europe to help them build sustainable energy lending businesses has yielded a substantial portfolio of small-scale renewable (wind, hydro, biomass cogeneration) and energy efficiency projects, totaling \$65 million to date. IFC will continue to expand its credit enhancement and finance facilities for local financial institutions across the globe, where market conditions support such business. In addition, IFC is focusing on the development of innovative environmental finance products in emerging markets which financial institutions can provide to sub-borrowers: carbon finance, sustainable energy finance, supply chain finance and corporate governance finance.

3.45 IFC's efforts in promoting sustainable investment also go beyond the project level. For example, in 2005, IFC helped the Sao Paulo stock exchange, Bovespa, to launch a corporate sustainability index, the second in emerging markets. The Index will track the environmental and social, economic, financial and corporate governance performance of leading companies listed on the Sao Paulo Stock Exchange. As another example, in November, 2005, IFC and the Financial Times launched the FT Sustainable Banking Awards, the first global awards program recognizing banks that have actively integrated social and environmental objectives into their operations, while maximizing financial gain for their shareholders. More than 80 entries were received.

3.46 *Gender Entrepreneurship Markets (GEM).* GEM was launched in December, 2004 to mainstream gender issues throughout IFC's operations, and at the same time better leverage the untapped potential of women in emerging markets. The three main goals of the program are: i) to provide advisory services to financial intermediaries on the delivery of financial services and business support to women; ii) to add value to IFC's investment projects; and iii) to address gender barriers in the business enabling environment. The initial focus has been on the financial markets and SME business lines, with a primary regional focus on Sub-Saharan Africa, where women run between 25% and 40% of registered businesses, yet face greater constraints than their male counterparts in accessing finance. One example of an integrated access to finance project is IFC's work with Access Bank in Nigeria, where IFC is extending a \$15 million line of credit to support the bank's lending activities to women entrepreneurs. This investment will be complemented by technical assistance to the bank, combined with enterprise-level capacity building activities. GEM will implement this program in partnership with PEP Africa and local business development support providers. The original funding of this program is due to expire in mid-FY07 and IFC will be proposing that the pilot be continued with an additional funding request.

3.47 *Sustainability Innovation.* With a view to encouraging innovation in environmental and social sustainability, IFC is managing a donor-funded portfolio to help develop new products, business models and instruments. Successfully tested products become new business lines for IFC. Practice areas include sustainable energy, carbon finance, cleaner technologies, biodiversity, social responsibility and sustainable finance. Some of these projects are co-financed with mainstream IFC investments, several are developed in coordination with the World Bank, and others are stand-alone.

## 4. Address Constraints to Private Sector Growth in Infrastructure, Health and Education

### Infrastructure

3.48 Given the huge need for better infrastructure in many developing countries, infrastructure remains a priority area for IFC, but it has become clear that new approaches to infrastructure investments are needed. Large, traditional infrastructure sponsors from developed countries have retreated from emerging markets. At the same time, many countries are caught between wariness of what they perceive as the potential political costs associated with privatization and their own lack of capacity and fiscal resources to undertake projects effectively. As a result, many infrastructure projects have been cancelled, particularly in the sensitive water sector.

3.49 These developments reinforce the need for IFC to demonstrate that private involvement in infrastructure can be successful. With its decades of experience in infrastructure, and as a trusted partner for both investors and governments, the Corporation is uniquely capable of designing and helping implement investment projects that address the concerns of both sides. Although the level of commitments in FY05 decreased somewhat, to \$879 million from \$983 million in FY04, the pace has picked up and IFC is expecting to commit around \$1.1-\$1.3 billion in FY06. This year will see a large investment program in infrastructure in Sub-Saharan Africa, in particular, including expected new commitments in power projects in Cameroon and Ghana.

3.50 The investment growth reflects increased commitment of resources by IFC to upstream development and shaping of infrastructure projects. The needs remain great, however, and IFC is therefore seeking new ways to support infrastructure projects, particularly in Sub-Saharan Africa where the private sector is especially cautious, and in the less easily financed sectors such as power, roads and water, focusing on enhanced project development and shared public and private responsibility. Upstream project development can involve engaging earlier with infrastructure companies that may be exploring opportunities, advising governments on the introduction of private participation and the structuring of public-private partnerships (PPPs), or working with development companies that launch projects and then bring in longer-term partners. The Performance-Based Grants Initiative discussed in paragraph 3.23 will also provide an important element in IFC's ability to help member countries meet their infrastructure needs, particularly in those areas where user fees alone cannot provide a sufficient basis for covering service delivery costs.

3.51 **Project Development.** Lack of bankable project structures is increasingly seen as a significant obstacle in infrastructure, and a key aspect of IFC's strategy in these sectors is to become more proactive in project development, and to continue its close work with the World Bank in this regard. IFC has begun providing support to an innovative entity named InfraCo, a donor-sponsored infrastructure development company. InfraCo is expected to play a significant complementary role to IFC's in working with companies and governments in the development of bankable infrastructure transactions. Both InfraCo's and IFC's advisory work benefit from significant support from the Private Infrastructure in Development Group (PIDG), a group of donors including the UK, the Netherlands, Switzerland and Sweden. IFC is also considering innovative structures to support project development, for example employing a small pool of money specifically to cover development costs in projects, which would then be converted into IFC equity should the projects proceed. In order to accomplish its business development goals, IFC has located several infrastructure staff in the field and is planning to increase this presence.

3.52 **Public-Private Partnerships.** IFC has made development of PPPs a priority, and has a specialized unit within its Infrastructure Department to focus on them. This requires close collaboration between IFC, the World Bank and MIGA to ensure both that the sector frameworks are amenable to private involvement and that the public sector participation is appropriately structured,

be it through earmarked receipts, in-kind contributions, IDA and donor funding or other mechanism. In addition to financing and the demonstration effect of these projects, as the only IFI with substantial capacity in this area, IFC's role in PPPs includes balancing the needs of investors with the public policy considerations, and ensuring that the projects have financially, economically and politically sustainable structures. Box 3.2 describes a recent PPP project, Kounoune Power in Senegal, in which IFC was involved from project concept through to financing, and which was a joint undertaking on the part of IFC and IDA.

**3.53 Advisory Services to Governments.** IFC provides transactional and advisory services to governments, both in designing and executing privatizations and to help them structure private participation in infrastructure. IFC's Advisory Services often acts as a nexus between World Bank and IFC work. Through cross-support, this group makes regular use of World Bank staff as specialists, and staff from this group is increasingly working alongside investment staff in order to help structure projects with a public component. Its work, which often follows sector reform work carried out by the World Bank, lays the groundwork for subsequent private investments, and has led to projects both for the World Bank and IFC. Demand for advisory support is growing rapidly. The number of advisory mandates underway has gone from 12 at the end of FY04 to 28 at present. Advisory activity is most concentrated in Africa and the Middle East. Recent high profile structuring work includes the cross-border Kenya/Uganda railway concession, for which IFC advised on the tender and bidding process and World Bank lending is supporting resettlement and labor restructuring elements, the concessioning of Madagascar's largest port, off-grid power supply in the Philippines and the Moatize project in Mozambique.

**3.54 Sub-national Finance.** The recent trend towards decentralization of government services has provided new opportunities for the WBG to finance these services, by providing support to various clients in the sub-national sphere. The IFC Municipal Fund, established in 2003, represents the first phase of the WBG's response to the demand for sub-sovereign products without sovereign guarantee. During FY06, approval was obtained for transactions in South Africa, Mexico, Guatemala and China and IFC's Board has so far approved six operations which will help to mobilize around \$500 million in investments. The transaction in Guatemala comprised an IFC local currency partial credit enhancement to a local bank (which had previously never taken municipal risk) through a risk-sharing facility of up to the equivalent of \$6.7 million, which will help to mobilize the equivalent of \$46.2 million for the Municipality of Guatemala City. The Municipality will invest the proceeds to finance part of the first phase of the TransMetro mass transport system and other infrastructure-related projects.

**3.55** Having determined that the sub-national business could be profitable as well as having significant development impact, IFC is scaling up its support and is pursuing opportunities in many other markets. The future shape of this business for the WBG, including still greater collaboration between the World Bank and IFC, was recently considered by the Board at an informal meeting.<sup>8</sup> Further discussions are anticipated at a Board Meeting in May, and one of the possibilities under consideration is a joint Department. In the meantime the IFC Municipal Fund will continue to build further on the strong partnership with the World Bank and thereby scale up and broaden its involvement in the sub-national sector.

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<sup>8</sup> "Sub-National Development Program", IFC/SecM2006-0001

### **Box 3.2. Kounoune Power, Senegal**

The recently approved 67.5 MW Kounoune I independent power project (IPP) in Senegal illustrates the importance of developing a creative public-private partnership to ensure a successful transaction. The assistance IFC provided to the Government of Senegal proved invaluable in reaching the final financial commitment for the project. The Government of Senegal had taken bold steps to reform the power sector in the late 1990s, with a view to privatizing Senelec, the national electricity company. The first privatization was completed in 1999, but it was cancelled after 18 months as the privatization failed to improve electricity services in the country substantially. In 2002, a second attempt also failed as a result of a lack of agreement between the Government and the preferred bidder on the financial terms. The main problems were that: i) private investors were unwilling to commit to the massive investment needs necessary to meet the Government's stated objectives; ii) tariff levels were not high enough to cover investment and operating costs without substantial concessional financing; and iii) the universe of investors interested in the Senegalese power sector dwindled substantially along with the overall retreat of investors from emerging markets at that time.

Nevertheless, some appetite remained for smaller and well structured private sector projects despite Senelec's failed privatizations. IFC took an active role in assessing the market potential. Along with the World Bank, IFC worked closely with the Government and Senelec to develop the Kounoune I IPP. With their input, the Government hired a reputable firm to advise on the IPP development process. Throughout the bidding process, IFC and the World Bank remained involved, providing the Government and the advisor with valuable feedback to make the IPP project bankable. From those that expressed interest, three companies participated in the bidding process, with the Mitsubishi/Matelec consortium selected as preferred bidder. IFC helped the winning bidder raise financing from a syndicate of financial institutions comprising African Development Bank, Banque Ouest Africaine de Developpement, Compagnie Bancaire de l'Afrique Occidentale (CBAO), Proparco and IFC. The commercial tranche provided by CBAO will benefit from a partial risk guarantee from IDA which will back-stop certain Government obligations in the project. Loan Agreements were signed in November, 2005 and commercial operations are expected to start in the second half of 2006.

The success of the Kounoune I IPP is expected to have a strong demonstration effect. Future IPPs structured along the same basis are expected. IFC's role in bringing the project to fruition demonstrates the importance of developing strong partnerships with the Government and close coordination of the different arms of the World Bank Group.

## **Health and Education**

3.56 In the health and education sectors, IFC continues to build on its experience financing healthcare and education through traditional project financing for capital expenditures on hospitals, clinics, schools, universities, colleges, curriculum and information and communication technology-assisted education services. In addition, IFC has begun to implement, and continues to develop, new tools for more innovative financing of social sector projects, for example developing 'wholesaling' structures such as the Ghana school finance facility and the student loan program described in Box 3.3 below. In all cases, IFC seeks out and supports institutions that introduce innovations to the market, demonstrate best practices or are directly aligned with public sector objectives. Regionally, IFC's efforts in East Asia (particularly in China) and Sub-Saharan Africa have begun to bear fruit, with two projects signed in China in FY06 and two in Africa. IFC has also established a strong pipeline with much greater geographical diversity than was historically the case. IFC is projecting FY06 commitments of over \$120 million, a more than 50% increase from FY05.

3.57 Technical assistance remains a critical component of IFC's work, both in exploring markets, which are predominantly local in orientation, and in assisting clients. During FY06, at the request of

and in conjunction with China's Ministry of Finance, IFC organized a conference on public-private partnerships in education, as well as a workshop on technical and vocational education and training. In partnership with a large foundation, IFC is also launching a major work program on the private health sector in Africa. The aim is to develop an action plan to prioritize and guide future IFC activities, as well as develop an advocacy framework to raise awareness of the pivotal role of the private sector in Africa. IFC also seeks to use its experience in private health care and education—unique among bilateral and multilateral development institutions—to establish itself as a center for networking and information dissemination among private institutions and investors worldwide.

### **Box 3.3. New Approaches in Health and Education**

In light of the traditionally small size of IFC's investments in these sectors, IFC recognized that it needed to develop a different approach to projects in order to increase its impact in health and education. IFC is therefore introducing innovative financing schemes to meet the increasing demand for finance among smaller institutions and consumers and is considering the potential of PPPs.

- **School finance facility.** IFC piloted the early implementation of a project to provide financing to small private schools in Ghana by extending a partial credit guarantee to a local bank covering its school loan portfolio. This project also has a TA component, providing both business development and educational services to private primary and secondary schools. IFC is seeking to replicate this model elsewhere in Africa, and is currently establishing the groundwork in Kenya and Senegal. The lessons learned from this pilot will be incorporated as IFC seeks to replicate this project structure elsewhere.

- **Student loans.** IFC is exploring innovative ways to promote student loan initiatives, for example by using foundation money to cover first losses and to leverage commercial financing in the sector.

- **Private/public.** Finally, IFC is supporting private companies that work directly with public institutions to provide much needed services. Ongoing projects include the private provision of information technology services to public universities in Nigeria, which currently do not have access to such services, and the use of distance education technology to provide medical training to nurses in public hospitals throughout China. IFC will continue to pursue such opportunities in the future.

## **5. Local Financial Markets Development**

3.58 IFC plays an important role in enabling greater access to finance in its developing member countries, through a combination of loans, equity and TA. Financial sector investments have recently accounted for 30-40% of IFC's commitments, and this level is expected to continue. IFC has adopted a three-pronged approach to developing financial markets: i) it invests in, and provides TA to, financial institutions; ii) it helps to build the necessary financial infrastructure for such institutions to operate effectively, for example rating agencies and credit bureaus; and iii) it works alongside the World Bank to create supportive policy, legal and regulatory frameworks. On a selective basis, IFC will also participate in financial institution privatizations. The key strategic areas for IFC are SME finance, microfinance, housing finance, trade finance, local currency finance, structured finance and sustainability finance. These are discussed below, other than sustainability finance which is discussed in paragraphs 3.44 and 3.45.

3.59 **MSME Finance.** Micro-enterprises and small and medium enterprises are critical to the development of the private sector in IFC's client countries, yet rarely have access to the financial services they need. Recognizing the importance of reaching a large number of these firms, IFC has moved away from direct investments to a more focused and effective approach, relying on financial institutions to reach them. This allows IFC to scale up significantly the amount of support it gives to MSMEs. MSME commitments in FY05 were \$1.1 billion, more than triple the figure in FY00. As

an indication of the reach of this approach, in calendar year 2004, IFC's clients disbursed an estimated 4.4 million MSME sub-loans for \$27.8 billion. The outstanding MSME portfolio stood at \$1.9 billion for IFC's account at the end of FY05 and represented around 15% of IFC's disbursed portfolio. IFC targets MSMEs both through encouraging financial institutions to downscale into SME lending and by investing in microfinance institutions, as described more fully below. See also Box 3.1 which describes two innovative programs in Sub-Saharan Africa which target MSMEs.

3.60 *SME Finance.* In FY05, just over \$1 billion was targeted to SMEs. IFC's work in strengthening credit infrastructure, for example through support of rating agencies and credit bureaus, and TA to improve credit assessment and monitoring capabilities, is also important in laying the groundwork to encourage banks to lend more to SMEs. (See paragraph 3.71)

3.61 *Microfinance.* IFC promotes microfinance globally by: i) creating new "greenfield" microfinance institutions; ii) helping micro-credit non-governmental organizations transform into financial intermediaries; iii) encouraging commercial banks to enter the microfinance segment; and iv) setting up commercially managed microfinance investment vehicles to attract and channel private sources of capital. Investments typically combine financing with well-targeted TA to microfinance institutions, banks and strategic partners. Microfinance commitments in FY05 were \$55 million in 12 projects, and this is expected to increase significantly in FY06.

3.62 **Housing Finance.** Housing finance is a growing focus of IFC's activities. IFC sees access to house ownership and housing finance as a contributor to economic prosperity at the individual and sector level, and it contributes to social stability. Housing finance also plays an important role in the World Bank's overall financial sector strategy, and IFC works closely with the World Bank to develop an integrated approach to this sector. There is close coordination on many TA activities and the two institutions have recently been collaborating on joint sector assessments for Saudi Arabia and the Government of Nigeria. In both cases the focus was on making policy recommendations to create an institutional structure that can more efficiently deliver housing finance while reducing risk in the financial system.

3.63 IFC has invested in more than 80 housing finance-specific deals in over 40 countries. This represents a marked growth in its investment portfolio: in FY00, commitments in this sector were approximately \$30 million, but in FY05 this had grown to \$565 million in housing finance-related projects, with a similar level expected in FY06. IFC's approach is to address strategically each country's needs in concert with its financial sector development, providing long-term lines of credit and partial guarantees of local currency credit issues to foster local currency mortgage lending, and warehouse lines to support securitization activities.

3.64 While IFC continues to see significant growth potential in its activities, there are still several challenges which are creating new areas of focus for IFC's housing finance work, for example, expanding the availability of mortgages to the lower income segments of the population and frontier markets. IFC is exploring ways to address this, including working with lease arrangements and microfinance for housing. Another important challenge is to find innovative ways to address housing needs. Given the lack of bankable housing stock in many countries, IFC is looking to bolster the supply of quality housing stock through support to construction companies and property development. A recent example is the Filinvest transaction in the Philippines, where IFC agreed to provide a 2.25 billion peso loan (approximately \$41 million) to one of the leading local housing development companies. IFC is also exploring wholesale vehicles to provide funding for construction finance, including a Real Estate Investment Trust (REIT), an investment vehicle in Africa to support property development, property management and a portfolio of rental stock. IFC is also exploring work in other niche products, such as housing products consistent with Islamic finance

principles, sustainable housing constructions and energy efficiency/home renovation products that are key for meeting housing needs in selected markets.

3.65 In order to promote an environment hospitable to private home ownership, IFC's housing finance technical assistance work is also growing, and IFC provides support both for institution-building amongst selected financial institutions and for sector reform through advisory services. In the case of the former, IFC will focus on institution-specific TA to improve the mortgage operations of client companies, underwriting guidelines and standardization and servicing techniques. In the case of sector-related TA, the focus is on legal and regulatory frameworks, for example land titling and registration, which has been carried out in conjunction with the World Bank.

3.66 **Trade Finance.** IFC's Global Trade Finance program of \$500 million, approved in FY05, is already starting to show significant results. Total commitments for FY06 are estimated at \$200 million, with over 50% of this being in Sub-Saharan Africa. The objective is for IFC to be in a position to provide guarantees on a variety of trade instruments quickly where and when they are needed and to assist local banks in developing credit relationships with international commercial banks. The program also provides banks with appropriate funding for capital goods imports, assists in pre-export financing and arranges training and TA where most needed to improve their trade finance capabilities. The program plays an important role in IFC's efforts to stimulate South-South trade with a third of the transactions having been between emerging market countries, and to assist SMEs, which are estimated to have benefited from three-quarters of the program's guarantees.

3.67 **Promoting Local Currency Financing.** IFC promotes local currency financing through both structured finance and derivatives-based local currency products. Total local currency financing commitments increased in FY05 to \$820 million. To date, IFC has provided local currency products in 18 emerging market currencies. Box 3.4 provides more details on structured finance and local currency products.

#### **Box 3.4 Structured Finance and Local Currency Products**

*Structured Finance.* IFC has developed three primary structured finance products: partial credit guarantees (PCG), securitization credit enhancements and risk sharing facilities. The focus of all three products is to promote and support local currency financing. Cross-border transactions are also pursued, but the focus remains on domestic markets. Mobilizing local currency through the bank or bond market helps domestic borrowers to match assets and liabilities, and eliminates the foreign exchange risk associated with borrowing in foreign currency. Local currency financing through IFC's structured products provides benefits not only to local clients but also to domestic institutional investors who are generally in need of high quality assets for portfolio diversification.

*Derivatives based Local Currency Products.* IFC uses long-term derivatives markets to provide local currency loans and hedges to its clients, and can offer these products in any currency where it can hedge the local currency loan cash flows back into US dollars using the derivatives markets. The number of emerging markets where long-term swaps are available continues to increase, with over 20 such countries as of the end of February, 2006. There is significant interest and demand from IFC's clients for these products, especially in China, Colombia, India, Indonesia, Mexico, Romania, Russia, South Africa and Turkey. In FY05, IFC committed over \$700 million equivalent in derivatives-based local currency products in 8 currencies to 23 clients. In frontier markets especially, IFC works closely with market counterparts and government regulators to structure swap instruments that enable the Corporation to provide local currency loans. This effort requires modifying or introducing international swap legal documentation in many of these markets. A priority over the next year is to develop derivatives-based local currency products in Sub-Saharan Africa where possible, and to obtain regulatory approval to provide such products in China, Pakistan and Ukraine.

**3.68 Developing Local Securities Markets.** There is growing demand by IFC's client countries for long-term, local currency financing for projects as diverse as housing, infrastructure, privatization, health and education, agribusiness and SME growth. Nonetheless, the local financial markets continue to be dominated by the banking sector in many developing countries, and the lack of alternative financial intermediaries still presents constraints to private sector development. In order to help develop domestic securities markets and improve access to longer-term local currency funding, IFC participates in domestic and cross-border securitizations, generally by taking on the mezzanine portion of risk. This investment takes the form of either a PCG on the senior tranche or a PCG on the investment vehicle. Moreover, investors also benefit from IFC's direct involvement in structuring the transaction. This includes a thorough initial due diligence process, modeling the transaction, contributing to the documentation, negotiating with rating agencies when applicable, as well as ongoing monitoring of the borrower throughout the life of the guarantee instrument. To date, the majority of IFC's clients have returned to the market after their first successful issuance without further need for IFC's support. Some examples of IFC's innovative securitizations include the first securitization of non-performing loans in Latin America, the first cross-border securitization of residential mortgages in Central and Eastern Europe, the first future flow securitization of student tuition payments in Peru and the first mortgage bond issuance in South Africa. Another example of a new initiative aimed at developing local securities markets is the work IFC and the World Bank are doing together to establish the Efficient Securities Market Institutional Development Program. The program was initially funded with \$5 million provided by the Swedish International Development Cooperation Agency. Its main priority will be to provide TA to develop domestic securities markets, initially focusing its work on Africa.

**3.69** IFC also helps to build the financial infrastructure necessary for expanding access to finance, both through direct investments and TA. For example, IFC is currently involved in developing credit bureaus in 38 countries around the world under its multi-donor Global Credit Bureau Program, and several transactions with securities firms are under consideration in three regions.

**3.70 Introducing Innovative Products.** IFC is continuing to develop new products customized to meet client needs. Through the use of partial credit guarantees, securitizations and other structured finance products, IFC raised \$574 million in FY04 for clients, increasing to just under \$1.3 billion in FY05, of which IFC's exposure in FY05 was around \$215 million. An example of the use of derivatives to customize products for clients is IFC's ruble-indexed loan product in Russia, totaling over \$250 million equivalent in disbursements to date, through which IFC provides synthetic ruble financing to clients using non-deliverable swaps. As another example of innovation, IFC and the World Bank are working together on a new concept, the Global Index Reinsurance Facility, a special purpose vehicle which would be a commercial risk-taking entity to promote and underwrite indexable weather and disaster risk insurance in developing countries. Whilst this is still at an early stage, the intention is that this facility will promote the development of a global commercial market for index-based insurance instruments for risks in developing countries.

**3.71 Financial Sector Technical Assistance and Advisory Services.** IFC's financial sector TA activities are focused on expanding access to finance to the poor and underserved by increasing the availability of financial services. IFC is approaching this on two fronts: giving help to financial intermediaries and improving the financial infrastructure in a country, for example by supporting new credit bureaus, as described above, and working on bond market and securities market development. In the last three years, IFC's financial markets TA activities have grown significantly, from 86 projects worth \$27 million in funding commitments in FY03 to 135 projects worth more than \$91 million in FY05. As of March 15, 2006, there were 125 active projects worth \$137 million, of which 79% were funds committed to frontier countries. Key sectors include microfinance, banking (including retail and SME finance), housing finance and environment finance.

### **Box 3.5 IEG-IFC Evaluation Findings: Informing IFC's Strategic Directions**

Last year's IEG-IFC evaluation reports included Pakistan and Turkey Country Impact Reviews, Malawi and Senegal Country Evaluation Notes and the two IEG-IFC annual flagship reports, the Annual Review of Evaluation Findings and the Annual Report on Operations Evaluation. Some of the findings of these reports with strategic relevance include:

**Achievement of Strategic Priorities:** IFC has significantly increased its commitments to frontier countries since it first articulated the frontier strategy in 1998. IFC's frontier strategy has resulted in a bigger proportion of projects in high risk countries at approval. To help offset this risk, IFC undertook a number of steps, including engaging in higher work quality at entry through greater IFC review intensity. Development results in frontier country groups have been similar to non-frontier country groups. IFC also actively pursued its strategic sectors (for example financial markets, infrastructure, and social sectors) and overall, outcomes have been better than in other sectors.

**Importance of Developing Local Currency Financing:** Many MSMEs and other end users of IFC financing, such as clients in housing finance and health and education, are unable to bear the foreign exchange risks associated with foreign currency loans. In a number of cases, this has been a key constraint in expanding IFC financing in these sectors. IEG-IFC recommended in at least three evaluation reports last year that IFC help develop the long-term local currency debt markets and mobilize long-term local currency loans, for example via developing guarantee and structured finance markets or supporting development of local financial markets pension and insurance industries.

**Need for Emphasis on Business Enabling Environment:** As in earlier evaluations, IEG-IFC found that development and investment outcomes are better when the business enabling environment is improving. Poor investment climates also limit IFC's opportunities to expand operations in many countries. All four recent country evaluations and this year's Annual Review feature this finding. IEG-IFC has recommended that IFC leverage with the work of the World Bank in addressing investment climate issues.

**Improved Measurement:** The overall quality of XPSRs has improved and IFC's newly-developed Development Outcome Tracking System should increase the timeliness and coverage of development results measurement. The TAAS evaluation system, which has been piloted and is ready to be launched in the coming fiscal year should provide a systematic measure of TAAS' development results. IEG-IFC expects to play a role in both investment and TAAS operations evaluation and measurement systems.

A number of new initiatives in IFC are consistent with recommendations in recent IEG-IFC's evaluation reports. Given the higher risks and more challenging investment climates in frontier countries, IFC has undertaken several steps to enhance its capability to manage risks and help improve business enabling environments. In this regard, IFC has been moving staff closer to clients through increased decentralization and enhancing field-based project facilities. In Africa, for example, staffing in IFC's eight regional offices has been significantly strengthened and the recruitment of 75 additional staff is on track. IFC also recently launched PEP-Africa as the primary vehicle for technical assistance and advisory services. PEP-Africa has developed a strategy aimed at improving investment climates.

### **Working with Other Financial Institutions**

3.72 IFC nurtures relationships with other financial institutions, both private and public, in order to enhance its ability to deliver on its development mandate. Through its B Loan program, in addition to catalyzing funding, IFC gives emerging market companies access to international banks which they would not otherwise have, and helps the banks get comfortable in markets which they might otherwise not have approached. Through promoting adoption of the Equator Principles, IFC has extended its environmental and social standards beyond its own projects. By working with

emerging markets financial institutions on corporate governance and sustainability finance, IFC helps them become leaders in their markets and improve the business environment for investors and companies. Lastly, by working with other IFIs, IFC can address some of the more pressing needs in the most difficult markets.

**3.73 International Banks.** IFC's B Loan program is a critical part of its catalytic role, and IFC continues to "crowd in" private sector financing through this mechanism. There has been significant recent growth in the program, with over \$1 billion in B Loans signed in the first half of FY06, only just under the amount for the whole of FY05. Despite the liquidity in the bank market, tenors available to most emerging market borrowers are still limited, and an important part of IFC's role with B lenders is enabling them to stretch maturities, helping clients to achieve better balanced debt profiles. Furthermore, in many countries, international lending is only available for trade-related activities, and through the B Loan structure IFC can mobilize bank lending for capital expenditure, acquisition finance and project finance.

**3.74** The current global economic environment, strong liquidity and compression of spreads present IFC with a unique opportunity to lead international banks towards more frontier countries and second tier borrowers. Consistent with IFC's strategy to scale up its impact on the ground, the nature of IFC's relationships with international banks is changing to one of partnership to mobilize funding for emerging and frontier markets, and several banks now approach IFC to help them address their clients' needs in terms of both funding and sustainability initiatives.

**3.75 IFIs.** In addition to work with other members of the World Bank Group described throughout this paper, IFC is increasingly working alongside other IFIs. Examples include infrastructure development work with PIDG (see paragraph 3.51) and initiatives in Sub-Saharan Africa with the United Kingdom Department for International Development (DFID) and the African Development Bank. IFC is seeking to enhance these relationships in all its regions.

**3.76 Mobilization.** In furtherance of its catalytic role, IFC seeks to mobilize funding for developing countries in a number of ways. In FY05, in addition to the \$1.1 billion raised through the B Loan program discussed above, IFC mobilized around another \$1 billion through structured finance transactions and a further \$2 billion in project financing using derivative-based products. The total size of all projects which IFC's investments supported in FY05 was \$25.2 billion.

### **Strategic Communications**

**3.77** Several factors point to the importance for IFC of a broader and more intensive approach to communications: i) the Corporation's growth strategy, and especially the focus on new markets and clients, necessitating more focused communications efforts; ii) IFC's leadership role in several areas, particularly in environmental and social standards, which leads to increased attention being paid to IFC's projects, especially in politically contentious environments; iii) the commitments which the Corporation has made to improve its public disclosure, local community outreach and handling of community relations; iv) the need to educate and assimilate large numbers of new staff in an ever more decentralized structure; and v) the key role that TA is set to play in IFC's activities.

**3.78** In light of the above challenges, IFC is putting in place an enhanced communications function in order to support IFC's role and growth strategy more effectively. This will be approached on several fronts: i) sustaining and extending IFC's leadership role as an agenda-setter on environmental, social and corporate governance issues; ii) improving IFC's ability to engage in productive dialogue with civil society at the corporate level and with communities at the project level; iii) improving familiarity with IFC's products and services amongst smaller, rising companies in developing countries, as well as Part I multinationals that are still unfamiliar with IFC; iv)

improving awareness and understanding of IFC's role, especially among agencies, foundations and civil society organizations that are donors, partners in delivery of services, or both; v) increasing awareness of IFC's development impact among all stakeholders; and vi) improving internal communications across the Corporation so that staff can be better aligned with IFC strategy.

3.79 The year 2006 marks IFC's 50<sup>th</sup> Anniversary, and IFC has a program of internal and external events to mark the occasion, aimed primarily at supporting its business. These include, for the first time, a full day of private sector programming during the Program of Seminars, which takes place in advance of the WBG-IMF Annual Meetings in Singapore.

### **Implementation Challenges**

3.80 We believe IFC has made good progress in implementing its five strategic priorities and its multi-year growth plan, particularly in frontier markets, including Sub-Saharan Africa. The share of new clients, although within the target range of 50%, should be increased. The enhanced decentralization should help to address this. There are some areas where the pace of implementation needs to accelerate, such as field recruitment and completion of the development impact tracking system to enable full reporting of IFC's institutional impact. IFC is focusing on these activities. IFC is also facing some significant challenges. As highlighted in discussions last year, the ability to grow is largely dependent on scaling up resources, particularly in the field, and recruitment in the field is lagging behind targets, as noted above. This problem will be heightened as IFC moves towards greater decentralization. There are also information technology implications of growth and decentralization which need to be addressed. In terms of its financial capacity, although IFC is currently in a relatively strong position, it needs to be prudent in order to maximize its development impact whilst also remaining able to accommodate market downturns, crises in its member countries and potential increased volatility in its net income reporting as it moves to adopt International Financial Reporting Standards.

### **Human Resources**

3.81 Over the last few years, IFC has strengthened its operations capacity and core expertise by implementing a human resources (HR) strategy based on the principles of performance-based differentiation and results measurement. The objective of this strategy is to support IFC's business goals and priorities. Going forward, IFC's HR strategy will focus on the three pillars of: i) building and developing diverse talent; ii) enhancing corporate and staff incentives; and iii) accelerating decentralization. Please also see Annex 3, which is a recruitment update as of March 15<sup>th</sup>, 2006.

3.82 **Building and Developing Diverse Talent.** In order to be equipped to implement its growth strategy and to meet changing market needs, over the last eight months IFC has embarked on the most significant recruitment drive in its history. To date in FY06, IFC has hired over 240 new staff from its administrative budget, including around 137 at Grades F and above; IFC projects to hire a total of around 350 new staff from its administrative budget for FY06, including around 200 at Grades F and above (an additional 300 staff are being hired for IFC's donor-funded operations). In parallel with recruitment, IFC's HR strategy includes a significant training and development program to accelerate the productivity and effectiveness of new staff, and IFC will probably have to increase its investment in staff learning and development in FY07-08.

3.83 *Hiring senior field staff.* IFC's staffing strategy has traditionally been to hire at junior levels and develop staff in-house through an apprenticeship model. IFC's FY06 staffing strategy called for more senior, mid-career staff, particularly in the field, in order to build local expertise in key markets and enhance IFC's leadership capacity to develop new business. Whilst recruitment for Washington-based positions is ahead of target, recruitment in the regions lags behind, with a particular challenge

in recruiting senior local staff. IFC will therefore need to find ways to hire locally more effectively and to continue to move experienced resources from Washington to the field (see Decentralization, below). One of the main challenges facing IFC's recruitment drive in the field is the ever more competitive labor markets in some of the key business hubs, such as China, Russia, South Africa, Brazil and, increasingly, India, where experienced, mid-career local professionals are difficult to attract with local compensation packages. Operational directors are increasingly calling for the possibility to adopt a global, functional pay line for senior investment/finance staff to address this issue.

3.84 *Compensation challenges.* IFC Management is currently working with the World Bank on the comprehensive review of the WBG compensation framework, as requested by the Board. The current WBG compensation framework aggregates and averages pay lines in a structure which is designed to maintain equity and eliminate differences between occupations. A significant constraint of this system is that some occupations are under-paid vis-à-vis the market (investment, risk management and treasury staff) while others may be over-paid. For IFC, this impact is especially pronounced in some of the regional hubs, as noted above. IFC Management believes that this review is an opportunity to develop and implement a modern compensation system with a framework founded on both market and performance. This would ensure a more disciplined and cost-efficient approach to human resources management, while allowing for sufficient flexibility to hire and retain top talent. A results-driven system would also strengthen staff accountability for results. A new compensation framework ought to be based on actual market data for relevant occupational groups. As pressure mounts to contain costs, a more rationalized approach to compensation would ensure that IFC has the appropriate talent, at the right cost, to deliver what clients want.

3.85 *Diversity.* Strengthening diversity and inclusion continues to be a top corporate priority. IFC's FY06 recruitment has been successful in exceeding current WBG diversity indicators and targets for Sub-Saharan African staff, women and recruits from Part 2 countries. An important change from past trends is that IFC's current career management framework provides the same opportunities for advancement and rotation to both international and local recruits and the standards for recruitment are the same worldwide. Over the next year, IFC will continue to strengthen opportunities for local staff as part of the implementation of global career systems. For more on diversity, please see Annex 3.

3.86 **Incentives.** IFC has implemented a number of incentive programs focused on driving results, where staff are differentiated based on performance, skills and behaviors. IFC currently has in place four major programs to measure and reward performance: i) an annual performance, evaluation and planning process (PEP system) which is linked to annual salary increases; ii) a competency-based career framework to provide staff with clear guidelines on what it takes to progress; iii) the Performance Awards program to reward and recognize annual results at the corporate, departmental and staff levels; and iv) the Long Term Performance Awards (LTPA) program for long-term results, introduced in FY05 for new business investment staff and rolled out for portfolio staff in FY06. The Corporation is also aligning its performance measurement and incentive framework throughout the organization. The key elements of the corporate Goals (described in Section II) and the Board-endorsed development impact targets are tracked through corporate, department and director scorecards. The Corporation is also working on refining the performance indicators for TAAS and on enhancing the incentive framework to align the different parts of the organization.

3.87 **Decentralization.** Over the last five years, IFC has moved from a Washington-centric organization to a global organization. IFC staffing in the field has almost doubled from 669 staff (35% of staff) in FY00 to 1,249 (46% of staff) today. The largest portion of this growth has been a five-fold increase in staffing associated with donor-funded TA operations. In parallel, the number of

investment staff in the field has also increased, primarily through the transfers of over 130 staff mostly in the last three years following the 2002 reorganization. Going forward, IFC will accelerate the presence of core operations staff in the field and will decentralize management decision-making authority for the first time with an East Asia/South Asia pilot. Under the pilot, some transaction processing and decision-making authority for smaller projects which have no complex structuring, environmental or policy issues will be decentralized, and to support this a critical mass of senior staff from the Legal, Credit and CES departments will be located in the field.

### **Risk Management and Financial Capacity**

3.88 IFC is by its nature a risk-taking institution and by mandate makes investments under higher risk conditions than commercial financiers, such as in frontier markets and liquidity crunch situations, while relying on the business fundamentals of the projects. Economic theory postulates that there is a trade-off between risk and reward and IFC's experience bears out this relationship: it has traditionally made some of its largest returns in investments considered amongst the most risky at the time. Examples include investments in the financial sector in Korea immediately following the Asian financial crisis and investments in frontier markets where the investment climate subsequently improves. IFC makes this risk transformation of investing in riskier assets while maintaining its AAA credit rating by: i) diversification in its investments, giving it exposure to a range of risk profiles; ii) maintaining a strong financial structure and capital base; iii) being a long-term investor particularly for its equity investments; and iv) rigorous due diligence, accumulated knowledge and experience in developing countries and sophisticated risk management practices. As IFC scales up its activities under its growth strategy, management of risk, including maintenance of a sound financial structure and appropriate risk management practices, will become an even more critical issue.

3.89 IFC has implemented a review of its risk management practices, as noted in paragraph 2.12, and will be reporting to the Board once this is complete. IFC already has in place the Business Risk Group, to address operational and strategic risks, and the Project Risk Management (PRM) Group. PRM's function is to address operational risk associated with significant portfolio growth, increasing decentralization and ever-increasing dispersion of information sources. PRM has adopted a two-pronged approach: i) Portfolio Inventory Analysis, which is the review of active portfolio projects to identify and quantify existing operational risk; and ii) PRM Operations, which will work with the Industry Departments to help manage operational risk in IFC's pipeline and portfolio projects.

3.90 As indicated in last year's Paper, IFC is piloting and using the new Capital Pricing and Risk (CAPRI) approach for internal risk management purposes such as pricing, risk and concentration measurement, return on economic capital and new product development. The information systems needed for full use of this approach are currently being developed and implemented.

3.91 IFC plans to resume presentation of its financial statements using International Financial Reporting Standards (IFRS) by the year ending June, 2007, subject to resolution of balance sheet presentation issues applicable to IFC and IBRD. Amongst other changes this will require the Corporation to make expanded use of fair value accounting, principally in equity, and derivatives associated with the loan and equity portfolios. This will imply significantly greater volatility in net income reporting, including the possibility of sizeable net losses due to market downturns. IFC estimates that its current capital position would allow it to accommodate a shock in two of its high exposure countries and continue to meet its countercyclical role. However, given the uncertainties in many of its markets, including some high exposure countries, and the future volatility of its net income, IFC is proposing a conservative approach to income allocation. These issues will be discussed further in the Annual Report on Financial Risk Management, which will be discussed with the Board before the end of the fiscal year.

3.92 During FY05, IFC Management decided to adopt new best practice standards on internal controls over external financial reporting, including those promulgated under Section 404 of the U.S. Sarbanes-Oxley Act of 2002 (SOx Section 404), whilst at the same time reviewing and enhancing its core business processes to facilitate accomplishment of its growth strategy.

3.93 IFC is implementing an Action Plan on Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) approved by the Audit Committee and Board early last year. This includes strengthening the due diligence on sponsors to account for potential AML/CFT risks, while also making necessary changes to policies based on the Financial Action Task Force recommendations.

## **Equity**

3.94 IFC's ability to invest in equity has been an important element in its development impact. Partnering with project sponsors as a minority equity investor, IFC brings its global industry knowledge and expertise in corporate governance and environmental and social dimensions, and adds value to investee companies in management and organizational practices. Private equity funds also look for IFC to transfer its knowledge and expertise in the management of governance, environmental and social issues in investee companies and application of institutional best practices. Given its significant development contributions in equity investments, and the persistent absence of risk capital in many developing countries, IFC needs to develop a more proactive and systematic approach to equity investment. In terms of profitability, returns on equity investments have increased substantially due to IFC's risk taking in equity in the past and the recent market trends, but will remain volatile by nature. The last few years have seen a fundamental shift in the sentiment towards some emerging equity markets, and this also calls for IFC to reassess its approach to equity investment. In order to address these issues, over the past year a team has been working on formulation of an IFC Equity Strategy and associated recommendations for how IFC should organize and process its equity investments. Effective implementation of the equity strategy will be a key challenge for the Corporation over the coming years. The working group is also reviewing the resource implications of a new approach to equity investments.

## **Information Technology Implications**

3.95 The alignment of the information technology (IT) functions with the strategic directions for growth has become an important part of IFC's strategy implementation. Last year, the Board approved a new IT work program aligned with these directions and anchored in four main areas: i) improved and expanded client relationship management; ii) more efficient processing and knowledge management; iii) protecting the integrity of the Corporation's balance sheet and financial statements; and iv) measurement and evaluation, including development impact tracking. The aim is to enable IFC staff to enhance their effectiveness in serving clients and to deliver the results efficiently on the ground. Additional mandates, for example IFRS, SOx and new IT infrastructure demands to support accelerated decentralization, have increased the complexity of the overall IT work program. Collectively, they have introduced new challenges linked to work program prioritization and sequencing, IT delivery and business absorptive capacity, upstream business-IT engagement and business process definition and streamlining. Increased collaboration with the World Bank on shared IT challenges, for example document management, telecommunications and out-sourcing, is also underway to leverage synergies in existing investments, new technology platforms and skills across the organizations. To ensure that these challenges are addressed in full, with knowledge of all constraints, the strategy and work program formulation exercise is underway with close coordination with all parts of IFC to

be certain that the right priorities and trade-offs are made. The IT budget, based on this exercise, will be included in the Business Plan and Budget Board Paper.

### **Technical Assistance Funding**

3.96 Much of IFC's TA is funded via donor contributions and the Funding Mechanism for Technical Assistance and Advisory Services (FMTAAS). FMTAAS was established in 2004 to centralize financial support for TA, and is funded by annual designations from IFC's retained earnings on a sliding scale based on IFC's net income for the year. As already discussed, IFC has now taken steps to align its TAAS with its strategic priorities and has introduced a structure and TA business lines to ensure more effective use of TA funds. As part of this rationalization of its management of TAAS, IFC will be proposing some reallocation of previously approved funds to each of the business lines, and once this proposal has been finalized internally, IFC will discuss it with the Board. In any event, IFC would continue to seek Board approval for any proposal over \$2.5 million.

### **Anti-Corruption**

3.97 Corruption is a serious problem in many developing countries, and takes on greater significance for IFC's business the more IFC works in frontier markets and in sectors where the public sector plays an important role, such as infrastructure. Addressing corruption issues effectively is therefore essential for IFC to fulfill its development mandate, and fighting corruption is a priority for the whole World Bank Group. This must be tackled on several fronts: by improving the investment climate through clear and low-cost rules for doing business, the incentives for corruption are reduced; by making activities that can best be performed by the private sector the responsibility of the private sector, there is less scope for corruption; through appropriate use of output-based aid, services that require public subsidies can also be held accountable; by improving corporate governance for commercial activities remaining in the public sector the corruption risks associated with state-owned enterprises can be mitigated; and by checking their choice of partners with appropriate procedures, the members of the WBG can serve as models for tackling corruption.

3.98 IFC has already implemented some measures to address the corruption issue, and the work of the Corporate Governance and the AML/CFT units and some of the TA initiatives discussed earlier in this paper form part of this effort. IFC has strengthened the focus on sponsor due diligence in its projects at an early stage, including the use of investigative firms when appropriate, and this process continues during appraisal of any project. In addition, IFC requires anti-fraud and anti-corruption representations, warranties and covenants in its documentation. It is also encouraging its clients in the infrastructure sector to disclose certain public-interest components of concession-type agreements and is actively engaged in the Extractive Industries Transparency Initiative.

3.99 IFC acknowledges that it needs to do more and therefore, together with other members of the WBG, intends to pursue a leadership role to foster anti-corruption initiatives. IFC Management recently assigned a working group to focus attention further on anti-corruption issues and potential areas of leadership. In pursuit of these efforts, IFC will engage with parties such as the *Partnering Against Corruption Initiative*, which is sponsored by the World Economic Forum, with a view to complementing and strengthening existing initiatives such as the UN Global Compact.

### **Resource Implications**

3.100 In June, 2005, the Board approved a three-year business plan and budget for the first time, covering FY06-08. Commitment targets and budget figures were approved on a definite basis for FY06 and an indicative basis for FY07-08. As noted earlier, the current estimate is that the

implementation of the business plan is ahead of schedule. IFC currently expects that FY06 commitments may even exceed the target range presented in the June, 2005 business plan. IFC anticipates increased investment opportunities over the next several years and this will be reflected in the business plan for FY07-09 to be presented to the Board in June, 2006. Commitment targets are expected to be higher than those in the current plan.

3.101 In order to achieve higher growth with the same resources, intensive efforts will be made to increase cost-effectiveness and productivity, and IFC hopes to benefit from a long-term business process review to facilitate streamlining.

### **Management Structure**

3.102 In light of IFC's growth and decentralization, IFC has recently announced the strengthening of its management structure to enhance its capability to deliver on its strategic objectives. By increasing the number of operational vice presidents to three, with two being regionally focused and one industry focused, and enhancing the risk and control Vice President's function in accordance with modern governance standards, IFC will be better able to serve its clients and focus on high priority areas. These changes will be effective from July 1, 2006.