

# IFC STRATEGIC DIRECTIONS

**MARCH 11, 2003**

Vice President

Director

Project Team:

Assaad J. Jabre

Bernard Sheahan

Anita Ahmed

Arthur Karlin

Dianne Garama

Azucena Estacio-Seguis

**IFC** INTERNATIONAL FINANCE CORPORATION

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# IFC STRATEGIC DIRECTIONS

## EXECUTIVE SUMMARY

1. This year's Strategic Directions Paper signals continuity in IFC's strategic priorities, although evolving responses to the challenges of implementing these priorities. The economic and financial environment for our developing country client countries in the period ahead is expected to continue to be difficult and unpredictable. IFC believes that the key strategic priorities for maximizing its development impact in this environment continue to be (i) frontier markets, (ii) high-impact sectors such as financial markets, infrastructure, health and education, and (iii) SMEs and sustainability. The implementation challenges for IFC in these areas, where it has already built considerable expertise and comparative advantage, continue to evolve and IFC's efforts to maximize its impact accordingly are the main focus of this paper.
2. Directors are particularly requested to give Management their views on the following three elements of the strategy recommended by Management:
  - In paragraphs 3.1 – 3.6 Management outlines a revised strategy for IFC in frontier countries, with a stronger focus on improving investment climates and building capacity through technical assistance and advisory work, not as a substitute for investment but to make our investment projects more effective, and to build a pipeline of stronger projects for the future. Do Directors view this as appropriate?
  - IFC Management has been implementing efforts to help members in the current environment with increased flexibility in terms of products, structuring and country engagement. Do Directors agree with these efforts ?
  - Do Directors support Management's view that the introduction of the proposed incentives framework, outlined in paragraphs 3.27-3.34, will strengthen IFC's development impact by improving staff accountability for results?
3. As has become normal practice, IFC Management intends, after Board discussion, to make its strategy publicly available as a means of better communicating its objectives and priorities.

## SECTION I: THE CONTEXT

### External Context

1.1 **Economic Environment.** Slow growth and lack of investment in key developed markets over the past two years have adversely affected developing country growth and investment prospects, and also led to the continuing retreat of strategic investors from developing country markets, with a few exceptions (e.g. China). Uncertainty is a major factor looking forward. Output for developing countries as a group registered only modest growth, estimated at 3.2% during 2002,<sup>1</sup> little changed from weak 2001 results. Excluding China and India, GDP growth of developing countries was only 1.8% in 2002, and 1.7% in 2001. The World Bank expects growth to strengthen somewhat in 2003, although to remain subdued overall because of the background of strains in financial markets, region-specific pressure points, and geo-political tensions. Growth performance and prospects differ substantially across regions, however. In

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<sup>1</sup> See *Global Development Finance 2003*, World Bank, (Executive Board Draft, February, 2003), from which this paragraph is drawn, for further discussion of the economic outlook; 2002 figures are estimates.

East Asia, South Asia and Eastern Europe and Central Asia, GDP growth strengthened last year, partly helped by higher growth in China, India, Russia and Turkey,<sup>2</sup> and prospects remain relatively good for 2003. In Latin America, at the other end of the growth spectrum, GDP declined 0.7% in 2002, and, excluding Argentina, registered only 1.2% growth. In the Middle East and North Africa and Sub-Saharan Africa regions, growth declined to 2.3% and 2.7% respectively, and growth in GDP per capita in both these regions was only 0.3% last year. In these regions, but also in many countries in the other regions<sup>3</sup> per capita growth rates are well below their long-term potential, and accelerated growth will be required in order to achieve the Millennium Development Goals (MDGs).

**1.2 Private Capital Markets.** The weak economic growth prospects, combined with uncertainty in key international financial markets and continued risk aversion among private investors, has contributed to prolonged weakness in net capital flows to developing countries. Long-term cross-border debt flows to the private sector in developing countries have declined significantly and even turned negative, with no expectation of a return to the levels of 1996/97. This poses major problems for the private sector to play the role expected of it in reaching the MDGs, outside of countries with large domestic savings bases, as not only is there minimal debt available to back new investments, but existing assets are in jeopardy in many instances due to refinancing problems. Although foreign direct investment (FDI) flows have been fairly resilient, they are also down from a peak of \$179 billion in 1999 to about \$143 billion in 2002, remain highly concentrated<sup>4</sup> and could be vulnerable because of reduced financial returns. Sustaining current FDI levels will depend on corporate profitability and further improvements in investment climates. Private sector companies in most developing countries that depend on cross-border financing are therefore expected to face continuing difficulties in financing the new investment needed to raise economic growth rates.<sup>5</sup>

**Table 1.1: Net Capital Flows to Developing Countries**

(\$ billion)	1997	1999	2000	2001	2002e
<b>Net equity flows</b>	<b>196</b>	<b>194</b>	<b>187</b>	<b>177</b>	<b>151</b>
Net FDI flows	169	179	161	171	143
Net portfolio equity inflows	27	15	26	6	9
<b>Net debt flows</b>	<b>102</b>	<b>14</b>	<b>-1</b>	<b>3</b>	<b>11</b>
Private creditors	89	1	5	-25	-3
Net M-L term debt flows	84	22	14	-9	4
Bonds	38	30	17	10	18
Banks and others	46	-8	-3	-19	-14

Source: *Global Development Finance 2003*, World Bank, (Executive Board Draft, February 2003).

**1.3 Challenges and Opportunities in Specific Countries/Regions.** Country specific developments have had a major impact on the demand for IFC's services and on IFC's overall financial position in recent years. In Latin America, countries in the region have been affected by the decline in capital flows over the past year, leading to a surge in demand for IFC's

<sup>2</sup> GDP 2002 growth estimates: China, 7.9%; India, 5%; Russia, 4.6%; Turkey, 6.3%.

<sup>3</sup> GDP per capita 2002 growth estimates: East Asia 4.5%, South Asia 3.1%, Eastern Europe and Central Asia 4%, Latin America -2.1%.

<sup>4</sup> China received an estimated 36% of total FDI flows last year, and the ten largest recipients about 70%.

<sup>5</sup> For a more in-depth discussion of the status and anticipated future of private flows, see *The Demand for IFC's Services and IFC's Role and Additionality* (IFC/SecM2002-0015), February 14, 2002.

services. However IFC is experiencing constraints related to exposure in Brazil, and the crisis in Argentina (which caused a serious decline in the quality of the portfolio last year) continues to constrain prospects for new business in that country. Similarly, the political crisis in Venezuela has delayed new commitments, although opportunities remain good in Chile, Peru, Colombia and other countries. In China, the growing role of the private sector and the country's entry into the World Trade Organization are creating an economic transformation, with its own set of challenges in terms of financial sector and state-owned enterprise restructuring, corporate governance, and the need to improve environmental and social standards. But high levels of liquidity in the markets have tended to limit demand for IFC capital. In Southeast Asia, economic growth rates continue to be held back by the unfinished business of corporate and financial sector restructuring, and a challenging political environment in Indonesia. In India, high local liquidity also affects demand for IFC financing, although IFC is able to add value through the longer maturities it provides and the non-financial services, which come with its investments (e.g. expert advice on environmental matters and corporate governance). Also, as reforms are implemented there will be the need to attract substantially larger equity and debt inflows to help finance significantly increased investment in infrastructure.

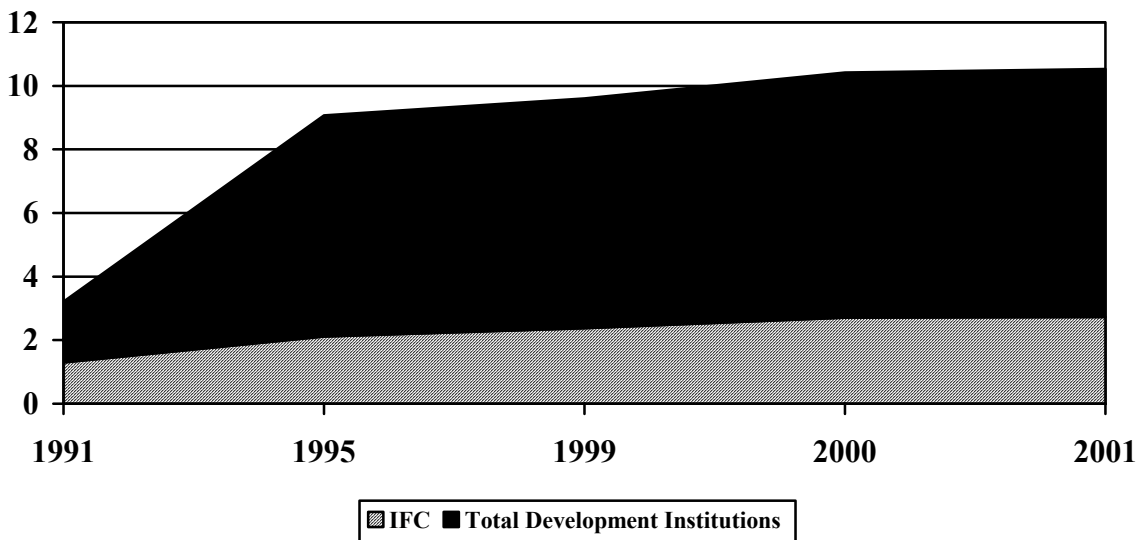
1.4 In the accession countries of Central Europe, the availability of cross-border financing, liquidity in the local markets, and IFC's current policy of limited engagement have constrained IFC's program. Russia continues to be one of the better performing emerging markets, although the investment climate and corporate governance issues remain challenging, despite significant improvements. Turkey transitioned to a new elected government during the year, and the reform program is proceeding, but the country's economy has been affected by the global economic slowdown and continues to have limited access to medium and long-term financing. In Africa, there are now very few private-sector driven big projects anymore, outside of South Africa. The widespread availability of alternative sources of finance for African banks, often at very low interest rates, as well as political crisis in Ivory Coast and Zimbabwe, limits IFC's opportunity for a substantial increase in volume in the short term. These issues however signal the substantial need and opportunity for scaling up our technical assistance and advisory services in the region (see Box 3.1 on IFC's new Africa strategy). A number of client countries in the Middle East and North Africa region continue to face a difficult geo-political situation.

1.5 **Increase in Activity of Other IFIs.** Over the past decade many IFIs have significantly increased financing support to the private sector (Chart 1.1). As a result, IFC's share, fell from about 40% in the early 1990s, to about 25% today.

1.6 Observing the decline in IFC's share of the market of private sector financing by IFIs, we note two areas in particular where many companies which were or might have been IFC clients have shifted to alternatives to IFC, both of which appear to be related to the adoption of different business models by other IFIs. One of them is Eastern and Central Europe, where the EBRD model includes putting much more extensive resources on the ground, having more flexibility in exposure and concentration limits and along the public-private spectrum, as well as being far more active in the better-developed accession countries than IFC is, and engaging extensively in the municipal finance business, which IFC is only now beginning to explore. The other area is the market segment where price and speed are the primary drivers of client choice, and where value-added is not sought after by clients: what can be called the "commodity" end of the market. Here, different business models incorporating lower return expectations, or a much more streamlined structure simply processing credit lines to banks, backed by AAA/AA

guarantees, or governments (like the European Investment Bank, which is expanding its geographic reach),<sup>6</sup> enable other institutions to price as much as 200 basis points below IFC or to process transactions more quickly with fewer requirements. For example, in Africa, where credit lines have previously been an important source of business, IFC is no longer competitive with the pricing and other terms offered by EIB. Going forward, there will likely be increasing competition among IFIs for the private sector in most regions, which is a good thing for the clients, perhaps leading to a layering of the participations of the various IFIs, according to product-type and risk. IFC believes its own business model, of having wide ranging capabilities and focusing on strengthening developmental outcomes, rather than competing on spreads, provides real value to clients, particularly in the area of environmental sustainability. Management feels that the extensive investments IFC has made in quality-enhancing functions (analysis of development impact, evaluation, environment and social, credit review) have helped IFC move up the “value-added” ladder, differentiating it positively with many clients, and yielding greater development impact, even if it does constrain its overall volume of lending (see Para 3.23 for further discussion). Where there is room for improved cooperation with institutions like EIB, their resources can be used to leverage the expertise and resources of IFC and commercial lenders.

**Chart 1.1: IFC's Financing Relative to the Total Private Sector  
Financing from Development Institutions (\$ billion)**



**1.7 Doha, Monterrey and Johannesburg.** The past year has seen a renewed emphasis on the issue of development from the international community. The major international conferences around Financing for Development, the World Summit on Sustainable Development, and the Doha round of trade negotiations, stressed the increasing role which the private sector in developing countries is expected to play in generating stronger economic growth, reducing

<sup>6</sup> In **Africa**, the EIB is soon likely to inaugurate its new 2.2 billion Euro investment facility under the Cotonou agreement, which should lead to significant increases in its activities in the private sector in the region. In **MENA**, EIB's resources are being significantly expanded. EIB launched its new Facility for Euro-Mediterranean Investment and Partnership (FEMIP). The new facility is supposed to increase EIB annual volume in the region from EUR 1.4 to 2 billion by 2006, and increase the private sector share to 40-50 percent from the current 25 percent. A Cairo office will be opened soon and a second office in the Maghreb will open later. The funding will include about EUR 200 million of EU funds.

poverty, contributing to global and local environmental goals, and strengthening the competitiveness of developing countries. IFC believes its capabilities and strategy position it well to be a significant contributor to the international community's goals. Box 1.1 illustrates the relationship between IFC's activities and the Millennium Development Goals.

### **Box 1.1: IFC and the Millennium Development Goals**

The international development community has articulated a consensus set of objectives for its efforts in achieving the Millennium Development Goals (MDGs). The World Bank Group plays an important role in these efforts. IFC's activities contribute both directly and indirectly to the development community's efforts to reach a number of the MDGs.

*Goal 1: Eradicate extreme poverty* (Target 1: halve the proportion of people whose income is less than a dollar a day). All of IFC's investment and advisory activities contribute indirectly to this MDG, as they seek to help developing member countries raise their levels of economic growth, which is a necessary ingredient for reaching this first of the MDGs. Aside from the economic value-added captured in Economic Rates of Return (ERRs) of IFC investments, IFC activities contributing to this objective include supporting the development of physical and financial infrastructure, which have spill-over effects both in terms of economic growth not captured by project ERRs, and broadening access to services and to the market economy. IFC's advisory activities, its demonstration impact, as well as its institution-building and infrastructure investments, all also contribute to improvements in the investment climate in its developing member countries.

*Goal 2: Achieve universal primary education.* IFC contributes indirectly to this MDG. When many IFC developing country members engage in sector reform, seeking to redirect public expenditures to primary education, IFC can support the process by investing in private secondary and tertiary institutions, reducing the impact of governments' reallocation of resources.

*Goal 6. Combat HIV/AIDS, malaria and other diseases.* IFC has begun to directly contribute to this MDG, with a small but increasingly visible and well-regarded program to highlight the "business case" for the private sector to address HIV/AIDS, and advice to clients on different options in awareness-building, prevention and treatment.

*Goal 8. A global Partnership for Development* (Target 18, in cooperation with the private sector, make available the benefits of new technologies, especially information and communications). IFC directly contributes to programs towards this target through its investments in Information and Communication Technologies, a priority sector. IFC also indirectly contributes in this area through its support for technology transfer through foreign direct investment – in its own projects and through FIAS.

### Internal Context

**1.8 IFC continues to maintain a strong balance sheet and credit rating.** As reported to the Board,<sup>7</sup> IFC continues to have adequate capital to maintain its AAA rating and current investment levels, in spite of the effect of the Argentina crisis and the generally difficult environment. New investment commitments grew strongly (10%) last year as IFC responded with new, and innovative products, and a more flexible approach, to address the urgent needs faced by many clients. IFC's continued financial strength has enabled it to continue to seek new business opportunities, despite the difficult markets and in contrast to the withdrawal of many private financial institutions, and to continue to strengthen its support of development.

<sup>7</sup> *Enhancing IFC's Capital Adequacy Framework*, (IFC/SecM2003-0009), February 18, 2003.

**1.9 FY03 Reorganization.** To respond to the challenges of the external environment, discussed above (paras. 1.1-1.7), IFC last year announced an internal reorganization,<sup>8</sup> designed to strengthen the Corporation's ability to book good quality assets, and so enable it to better deliver on its developmental mission. Main elements of the reorganization included:

- a more pro-active approach to business development and improving capacity building activities;
- consolidation of financial markets and manufacturing and services activities into two global departments;
- refocusing of IFC's regional departments on country/regional strategy, capacity- building work and business development;
- further strengthening of IFC's local presence through relocation of senior staff.

1.10 Six months after the implementation of this reorganization, several improvements can be noted. Responsibilities in financial markets and manufacturing were transferred to the new global departments without disruption of services to IFC's clients, and the new groups have begun the process of better integrating understanding of their sectors' global trends into investment plans. Regional departments are more focused on ensuring the right mix of IFC support to member countries and beginning to uncover new business opportunities. All seven Regional Directors are now field-based. Administrative cost growth has also been contained. Naturally, a number of challenges remain in continuing to implement the reorganization, principally in pushing business development forward, better integrating advisory and capacity-building into the package of development services provided by the Corporation to its developing member countries, and relocating or locally hiring more senior and experienced staff into regional hubs.

**1.11 Build up of advisory and capacity-building services.** IFC acts as both a commercial and a public entity. It invests principally on a commercial basis, and this remains at the core of the Corporation's approach. As a development institution, IFC also engages in a range of advisory and capacity-building services,<sup>9</sup> whose costs are not fully compensated for by clients or others, but where IFC's shareholders request IFC involvement in support of a wide range of public goods: (i) which they see as important to development, (ii) which they believe IFC is the right organization to undertake, and (iii) which involve costs that are not covered by end users (or by donor funding). Examples include:

- SME work (advice to governments, to firms, or to other practitioners);
- improving the environmental and social aspects of private investment, beyond essential risk mitigation;
- work to develop high impact small projects, whose costs exceed the potential returns (in, for example, financial institutions or small economies);
- technical assistance in a variety of other areas, including capacity building and institution-building in financial markets;
- evaluation and strategy work to improve development effectiveness;
- governance costs not incurred by private sector commercial enterprises.

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<sup>8</sup> *FY03 Business Plan and Budget* (IFC/R2002-0070.), May 10, 2002.

<sup>9</sup> Referred to as non-commercial activities in Technical Briefing : *IFC: Unbundling Commercial and Non-commercial Activities*, January 15, 2003.

1.12 IFC estimates the current cost of its advisory and capacity-building activities at about \$100 million in FY02,<sup>10</sup> of a total budget of \$367 million, including both operating expenses and other charges. In addition, donors contribute approximately \$120 million annually to IFC managed activities (e.g. the Project Development Facilities, the Private Enterprise Partnership (PEP) and the Technical Assistance Trust Funds (TATF)). Thus on an expenditure basis, the combined IFC-funded and donor-funded IFC managed advisory and capacity-building activities are almost as large as IFC's commercial investment operations. To some extent, this illustrates that an increasingly important part of the Corporation's effort and impact takes a form not unlike the "knowledge bank" part of the World Bank. Alternatively, this can be thought of as analogous to a private sector-oriented IDA, where donor resources and IFC's budget together enable development activities which would not happen if just left to market actors pursuing exclusively commercial returns, yet at the same time benefiting from the private sector discipline and orientation that IFC brings to the table. Paragraphs 3.24-3.26 discuss this issue in more detail.

1.13 **Slow growing investment portfolio, and volatile profitability.** Overall, IFC's investment portfolio is still growing slowly, although the pace of that growth is beginning to pick up as a result of the more innovative loan facilities that IFC introduced last year, and the greater flexibility shown in responding to clients' needs. Growing a quality portfolio is important to ensuring IFC's longer-term development impact, and to support the continued growth in IFC's broad range of technical assistance and other non-remunerated development activities. IFC is the only MDB that has no operations which have government guarantees, but takes pure commercial risk on its entire portfolio, and is therefore generally subject to higher risk. Portfolio vulnerabilities, particularly IFC's exposure in some key countries currently under strain, continue to expose IFC to the risk of volatility in the Corporation's profitability, despite the strong FY03 first half results.<sup>11</sup> Last year's *Strategic Directions* paper highlighted IFC's need to continue its efforts to improve asset quality and profitability, and to increase business generation in support of these objectives.

## SECTION II: IFC's STRATEGIC PRIORITIES

2.1 **IFC Management believes it to be appropriate to reaffirm the key priorities of IFC's strategy.** These priorities continue to address key development objectives and correspond to areas of comparative advantage of the IFC. As in the previous two fiscal years, IFC's developmental priorities will continue to be:

2.2 **A primary focus on frontier markets.** Previous *Strategic Directions* papers have noted that IFC maintains a clear focus on being "at the frontiers of the market." In practice, this has meant a focus on *countries*<sup>12</sup> where there is little or no foreign capital flow – especially debt capital – *or areas and sectors within a country* where there is very limited capital availability. As discussed in Section III, IFC will continue to help companies in frontier markets implement sound investment plans but, in line with World Bank's own strategic emphasis, is increasing its

<sup>10</sup> *Ibid.*

<sup>11</sup> FY03 Q1-Q2 operating income was \$213 million, compared with \$13 million for FY02 Q1-Q2, but may not be indicative of full year outcomes due to potential vulnerability in two major components of operating income – gains on the liquid asset portfolio are likely to be reversed if interest rates rise, and provisions could increase if there are negative developments in some of IFC's high exposure borrower countries.

<sup>12</sup> See Annex 1 for list of current frontier countries.

focus on strengthening investment climates and capacity building, through advisory work and know-how transfer. Over the longer-term, focusing in this area is expected to lead to a greater overall increase in private sector development.

2.3 In addition to IFC's focus on frontiers, including frontier sectors and areas within non-frontier countries, IFC also has an important counter-cyclical role to play in non-frontier markets when their access to alternative sources of financing dries up. IFC can help mitigate the effects of interruptions in market flows, particularly on larger corporates in middle-income countries which often rely on cross-border finance, helping support the continued growth and development of emerging market companies into global players, as well as strengthening flows of FDI (particularly south-south FDI). International financial flows to emerging markets are expected to continue to be volatile for the foreseeable future, and are unlikely to return to the peak levels seen in the mid-1990s. IFC's strategy in middle-income countries will therefore continue to include frontier sectors and products (especially strengthening of the financial sector), and stepping in when market participants withdraw.

2.4 **Emphasis on high-impact sectors.** Previous *Strategic Directions* papers have also noted that IFC seeks to emphasize sectors that contribute relatively more to development, i.e. where "spill-over" effects in addition to the economically productive use of capital are significant. These have included domestic financial markets, infrastructure, information and communications technology (ICT), and social sectors. IFC intends to continue with this approach.

2.5 *Financial sector* development is widely recognized as a critical pillar of economic growth and poverty reduction. Efficient intermediation of domestic savings facilitates investment and reduces dependence on external flows; sound financial institutions limit systemic risks; and a broad range of financial products – such as leasing, micro finance and SME lending – help broaden participation in the market economy. From experience we have learned that domestic financial markets must be built up to back non-export oriented investments. IFC was one of the first international institutions to develop financial sector expertise, which it has continued to broaden over the past two decades. IFC's internal capacity in this sector, experience in bringing technical partners, and ability to transfer best practices constitutes a key part of the Corporation's comparative advantage. Developing domestic financial markets will continue to be a core priority of the Corporation, and will involve both investment and advisory services activities (to strengthen balance sheets of financial institutions recovering from systemic crises; channel funds for SMEs; micro and small business finance; and housing finance).

2.6 *Infrastructure* has long been seen as a sector with high impact for development, given its impact on factor costs, market access and competitiveness for the entire economy, as well as health and environmental impacts in the case of water. This continues to be the case. A significant role for the private sector opened up from the early 1990s as many developing country governments turned to the private sector to help address capital expenditure, maintenance and management needs. IFC responded by developing specialized expertise in telecommunications, power, transport and utilities, and making this area a strategic priority for the Corporation. This sector will continue to be a priority, while rapidly changing conditions pose increasingly difficult implementation challenges, addressed in the next section.

2.7 The private sector's involvement in the *health and education sectors* is growing rapidly in many developing countries, as a result of several reinforcing trends: broad recognition of the importance of health and education for economic growth and poverty reduction; increasing

demand for quality services; and, in many countries, fiscal and administrative public sector constraints to meeting this demand. Many governments now view the private sector as a partner to the public sector, recognizing the potential of the private sector to promote efficiency and innovation, expand access to services, and improve quality. IFC's strategy reflects the response to demand for a greater private sector role in health and education by: (i) providing and mobilizing private resource flows to complement traditional public funding; (ii) enhancing bottom-line discipline and managerial efficiency in traditionally under-managed sectors; (iii) contributing to institutional and systemic capacity building; (iv) improving coverage to all population segments; and (v) supporting human capital formation, to improve skills in these sectors.

2.8 **SMEs** continue to be a high priority of many of IFC's member governments, and a difficult development challenge. While SMEs form the overwhelming majority of firms, and account for large shares of employment and GDP of all member countries, they are consistently underserved in terms of access to capital and know-how. Additionally, research undertaken by IFC and others clearly indicates that SMEs are more adversely impacted by poor business enabling environments than larger corporations. As countries reform, often shedding jobs in public sector enterprises, and seek to accelerate growth and broaden the base of beneficiaries of growth, the ability of SMEs to respond and expand becomes increasingly critical. IFC has made SMEs a corporate strategic priority for several years. This priority continues, while the way IFC addresses it has been evolving. From an approach first based on expansion of direct investment in SMEs, IFC has moved to a strategy of pursuing and bringing together several different approaches to help maximize success in this area – including helping local financial intermediaries better serve SMEs, providing extensive technical assistance through project development facilities, and creating linkages between large corporates and SMEs. IFC is refining the implementation of this SME strategy, as discussed in the next section.

2.9 **Sustainability**, shorthand for a broad range of environmental, social and governance issues, has emerged as a new challenge for many businesses in developing countries. As public concerns grow over this range of issues, over climate change, over the benefits of globalization, over HIV-AIDS, and over corporate governance scandals, companies face new demands from consumers, investors, trading partners, regulators and policy-makers. New related opportunities also arise. Every day, more companies are affected in new ways. The emergence of sustainability as a business issue has found IFC extremely well-positioned to add value to its clients in reducing risks, and finding opportunities to reduce costs and gain competitive advantage. By finding new ways to increase convergence between the private interests of firms and the public goods deriving from good environmental, social and governance practices, IFC is able to both help clients and improve the quality of growth in our member countries. Expanding our support to clients in this area is a corporate strategic priority.

### SECTION III: IMPLEMENTING THE STRATEGY

3.1 **Frontier markets.** IFC has had some successes in the implementation of its frontier strategy, but is finding it difficult to significantly increase the share of investment in high risk/low income countries. As Table 3.1 below indicates, the share of IFC investment in these countries rose significantly in FY01, but then fell back to below FY00 levels in FY02. As discussed in previous *Strategic Directions* papers, IFC's frontier strategy encompasses not only frontier countries, but also frontier markets (high risk sectors, pioneering transactions, less

developed regions, and the introduction of new products). Last year's Corporate Scorecard<sup>13</sup> illustrated how many of IFC's investments in non-frontier countries are nevertheless in frontier markets. Nonetheless, a core element of IFC's strategy remains to increase investments in frontier countries, and growing the volume of IFC's investments in these countries is a key implementation challenge.

3.2 IFC's ability to rapidly increase its investments in frontier countries is constrained by several factors. This is a function of the small size of economies and projects, and their limited absorptive capacity, the withdrawal of strategic investors, and the costs of project development. Since the mid-1990s, a combination of emerging market crises and deteriorating economic conditions at home has increased the risk aversion of foreign investors, particularly for high risk countries, where net foreign direct investment has now virtually disappeared. This poses a challenge for IFC to fulfill its catalytic role in introducing lenders and investors to viable projects in these countries.

**Table 3.1: IFC Commitments by Country and Risk Rating\***

	FY99		FY00		FY01		FY02	
	US\$m	% Total**	US\$m	% Total**	US\$m	% Total**	US\$m	% Total**
Frontier Country Projects								
IICR Risk Rating Unrated and 0-30 or Low Income Countries	694	28	598	28	1003	41	619	21

\* Income category according to IBRD classification. IICR Risk Ratings are the Institutional Investor's index, which has a scale from 0 (highest risk) to 100 (lowest risk). Decline from 41% to 21% is due to several exceptional country programs in FY01 (e.g. combined program in Cameroon, India, Indonesia and Nigeria went from \$61m in FY00 to \$597m in FY01 to \$186m in FY02). \*\*% Total Commitments excluding commitments to regional and global projects.

3.3 In terms of performance, OEG's recent *Annual Review*<sup>14</sup> found that IFC operations in high-risk countries performed slightly better than average in terms of their evaluated development and investment outcomes, but not significantly so. The environmental effects of operations in high-risk countries were, however, significantly worse, reflecting the poor legal and regulatory environment in many high risk countries. OEG also found that the success of investments in high-risk countries is heavily influenced by whether or not these countries improve their investment climates. Development impacts and investment outcomes were significantly higher in countries that graduated from the high-risk group during the period between investment approval and the point of evaluation. Investments in countries where the investment climate improved from high risk to medium/low risk had a development outcomes success rate of 77% (compared to the overall average of 57%), and an investment outcomes success rate of 73% (overall average 50%). Conversely, development and investment outcomes for investments in countries where the investment climate deteriorated were significantly lower, at 36% and 9% respectively.

3.4 An important issue with IFC's frontier strategy was highlighted by OEG's *Annual Review* last year.<sup>15</sup> OEG found that the results of IFC's investments have been particularly unsatisfactory when risks are "layered" in projects: i.e., when IFC's investments have been in a high-risk country environment, and in a difficult or pioneering sector, and/or sponsored by groups with limited experience or financial capacity. As a result, OEG recommended a balanced

<sup>13</sup> Annex 2.

<sup>14</sup> *Annual Review of IFC's Evaluation Results: FY2002*, Operations Evaluation Group, February 2003.

<sup>15</sup> *Annual Review of IFC's Evaluation Findings: FY2001*, Operations Evaluation Group, February 2002.

approach in implementing IFC's frontier strategy. IFC will continue to focus carefully, in frontier countries, on finding investments with strong sponsors (including those IFC brings in pro-actively) and on medium, not high-risk sectors. This may require IFC to spend additional resources "scoping", to clarify before proceeding with a project that it is likely to be successful. Where risks cumulate, IFC will need to increase focus on proper compensation for the risk it is bearing. Thus IFC's frontier focus will not always be reflected in higher investment volumes in frontier countries. Similarly, IFC's investments in difficult sectors will, on balance, focus more on medium than high-risk countries. At the same time, the relative scarcity of good investment opportunities in many frontier markets requires IFC to complement its investment work with extensive technical assistance, and to transfer know-how and best practices from more developed areas.

### **Box 3.1: IFC's Africa Strategy**

Africa provides a good illustration of how IFC is seeking to shift and strengthen its approach to frontier countries. Africa remains a major priority for the development community, and a challenge in many areas. IFC has taken a number of steps over the years to strengthen its contribution to the development of our member countries in the region. These have included the creation of the Africa Project Development Facility (APDF), the Africa Enterprise Fund (AEF) and Africa Management Services Company (AMSCO), significant expansion of IFC staff in the field including relocation of the Regional Director and the creation of the Johannesburg hub, and a consistently larger budget for Africa than for any other region. There have been a number of notable successes, including the backing of several groundbreaking projects (e.g. Mozal, the Chad-Cameroon pipeline), and a large number of firms supported by advice. IFC has also advised on several landmark privatizations. However, there continue to be several areas where IFC's approach has proven less successful, or where challenges are growing. Asset quality has been unsatisfactory, and below that of other regions, especially in the small business portfolio and in countries where the investment climate has not improved. Lessons learned in newly developed project facilities (such as the Private Enterprise Partnership) need to be incorporated into the approach of African SME facilities. And IFC financing volumes have grown more volatile, falling in the last two years. This is due in part to the effect of very large projects (such as the Chad-Cameroon pipeline, which was part of the large volume 2 years ago, and Bujagali, which has not proceeded), greater selectivity for small investments, and the expansion of financing provided by others, in particular EIB. Much of IFC's historical volume of business in Africa has also been through credit lines, which are no longer competitive.

Going forward, IFC will be adjusting its approach to how it can best help its African member countries. A new Africa Strategy is in preparation and will be available soon. The new approach will include the following elements, consistent with IFC's overall shift in approach to frontier countries:

- More proactive efforts to support private investment, with a greater focus on non-investment activity.
- Scaled up SME programs and facilities, relying on mobilizing increased donor support, including IDA.
- New efforts with IDA to develop appropriate models for public funding of infrastructure developed and managed by the private sector.
- An expanded role in support of sustainable extractive industries, where we will pay particular attention to evolving best practices in revenue management and disclosure of revenues.
- A shift in financial sector focus on institutional development and expanding access to financing for SMEs.
- A focus on developing and deploying innovative financial products and services in the region.
- Expanded focus on IFC role in improving countries' investment climates.
- A focus on ensuring support for the implementation of HIV/AIDS and other health-related programs appropriate to our private sector projects.
- Efforts to support cross-border investments from South Africa to other countries of the region.

Doing this effectively means IFC will concentrate these proactive efforts on a small number of priority countries. In other countries which are promising, we would undertake a more limited range of proactive efforts, while continuing to be responsive to demand for financing.

### **Box 3.2: Learning from Operations Evaluation Group (OEG) Findings**

Lessons derived from experience are an essential element in performance improvement and strategy formulation. IFC's current strategy benefits from the studies prepared by the Operations Evaluation Group (OEG), including the recently issued *Annual Review of IFC's Evaluation Results*, which includes the following recommendations:

**There is a strong link between IFC's investment and development outcomes** – 80% of IFC's projects with good investment outcomes also had good development outcomes. IFC should therefore continue to sustain the momentum it has built up in strengthening work quality and addressing shortfalls in effectiveness, particularly where operations feature multiple risk factors.

**The strength of IFC's role is important** – where IFC has made a unique value-added contribution over a project's early life, outcomes have been better. In pursuit of its sustainability agenda, and in recognition of this strong link, IFC should ensure that it is always adding value in its operations beyond merely meeting a need for financing.

**Loan pricing and equity selection should reflect the risks and transaction costs in high-risk operations** - the returns from successful investments in high-risk investments have not been sufficient to compensate IFC on a portfolio basis for the higher rate of losses. IFC should consider the case for sweeteners to increase the return on loans, and/or the use of a subordinated debt instrument in lieu of equity investments in cases where a country/project's upside reward prospects aren't likely to adequately compensate the downside risk of loss of an equity investment; where government regulation constrains IFC from charging a market rate of interest; and/or the availability of soft loans or aid money has created an artificial market for pricing.

**IFC's instrument choice should contribute to the enhancement of investment climates** - improvements in frontier countries' investment climates will be a key determinant both of the success of IFC's investments and of these countries' progress towards the Millennium Development Goals (MDGs). For example, in Russia and Vietnam, IFC recognized that investment climate conditions were initially too risky and adverse to allow realistically acceptable investment outcomes, and instead developed its country strategies mainly around technical assistance and advisory programs. Over time, IFC progressively complemented its technical assistance and advisory work with direct investments. IFC should continue to tailor its range of investment and non-investment instruments wisely in response to prevailing investment climate conditions and objectively-assessed prospects for successful investment outcomes.

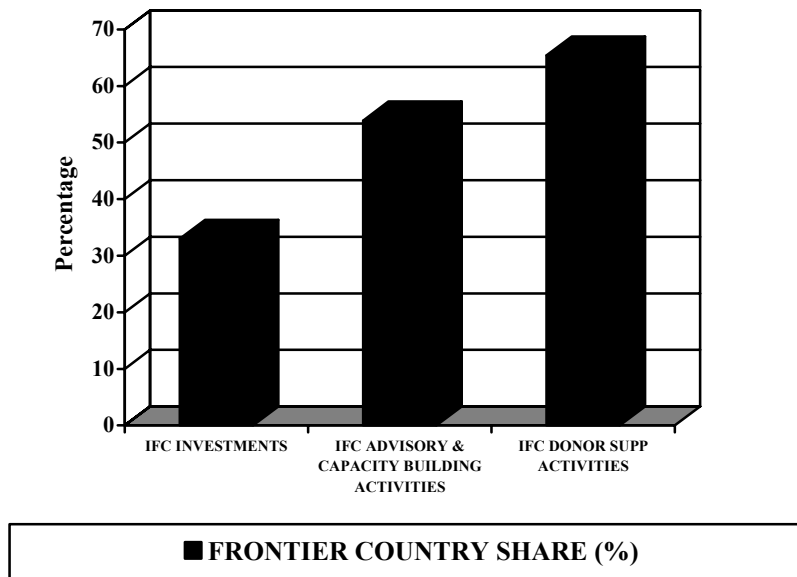
**IFC should establish self-evaluation systems for all of its non-investment operations** to ensure that its efforts to improve investment climates are informed by past experience, and that it rations resources to pursuits that have yielded good results.

3.5 The investment environment in frontier countries must meet minimum standards to be conducive to productive investment. Unfortunately, reform has bypassed many frontier countries, particularly in key sectors such as infrastructure and financial markets. Increasingly, therefore, improving the investment climate will be the key to strengthening private sector activity in these countries. We have learned that advisory services and technical assistance are absolutely essential as a complement to investment, and in frontier countries with weak investment climates are likely to be a better choice of activity for IFC.

3.6 Advisory work and know-how transfer has played an increasingly important role in IFC's frontier strategy in recent years (Chart 3.1). IFC supports governments' efforts on

privatization, on attracting foreign investment, and on improving the investment climate – especially for SMEs. Such advisory work is not intended to substitute for investment in these markets, but to make such investments happen, concomitantly or at a later stage, in a more effective and sustainable manner. IFC also works with firms to access other financing or to develop projects for IFC financing, and to make their investments more competitive and sustainable. All of this activity has the objective of increasing the level of bankable, sustainable investment.

**Chart 3.1: Frontier Country Share of IFC’s Investment and Advisory and Capacity-Building Activities**



**3.7 Non-Frontier markets:** In our *middle income country* (MIC) members, IFC’s role has also been shifting. After a trend of reduced demand for IFC from 1992 to 1998 (interrupted by the 1995 Tequila crisis), driven by sharply improved access to external financing, IFC’s capital is again in high demand. IFC’s recent *Strategic Directions* papers and the FY02 paper on demand for IFC’s services<sup>16</sup> have noted this evolution, with demand for IFC moving counter-cyclically to private financing flows. Looking at the adjustments IFC has made in response, IFC has been generally successful in re-engaging with large MIC corporates who have lost market access, particularly in Latin America, helping support their operations and continued growth into global players. IFC has also had success in helping mitigate the effects of interruptions in market flows to some large MIC countries through the aggressive and rapid implementation of trade facilities, which has been welcomed by several MIC member countries. At the same time, IFC has continued to pursue “frontier segment” investments within MICs, as documented in the FY02 Corporate Scorecard.<sup>17</sup> The challenges for the Corporation in these markets include the need to ensure a strong role, its mixed experience with moving down market to financing second-tier companies,<sup>18</sup> high costs of developing “frontier” transactions,<sup>19</sup> and difficulty in predicting when

<sup>16</sup> *The Demand for IFC’s Services and IFC’s Role and Additionality* (IFC/SecM2002-0015), February 14, 2002.

<sup>17</sup> Annex 2; also see *IFC’s FY03 Business Plan and Budget* (IFC/R2002-0070), May 10, 2002.

<sup>18</sup> OEG Country Impact Review for Brazil, forthcoming.

<sup>19</sup> *ibid.*

market flows return. Looking forward, we expect these countries to continue to account for the bulk of IFC's investment volume, but with increased volatility in volumes, and continued swings in portfolio quality depending on crises.

**3.8 Continuity of sectoral investment priorities, focused on high-impact sectors.** IFC continues to build knowledge and experience in high-impact sectors (Table 3.2). As a result, portfolio performance in these sectors has been generally above the IFC average. OEG's *FY02 Review* found that IFC investments in priority sectors have in aggregate yielded higher equity returns (real IRR of 4.2% v. 0.4% for non-priority sectors) and their loan performance has been better (74% with credit risk rating of 1 to 4, compared to 62% for non-priority sectors) than the rest of the portfolio.<sup>20</sup>

**Table 3.2: IFC Commitments in Priority Sectors**

	FY00		FY01		FY02	
	US\$m	%	US\$m	%	US\$m	%
Financial Sector	698	30	1154	42	1236	40
Infrastructure (excl. ICT)	460	20	321	12	445	14
Information & Communication Technologies (ICT)	90	4	297	11	295	10
Social Sectors	30	1	125	4	60	2
<b>Total Priority Sectors</b>	<b>1278</b>	<b>55</b>	<b>1897</b>	<b>69</b>	<b>2035</b>	<b>66</b>

**3.9 Infrastructure.** During the past decade, IFC has supported over \$53 billion in new infrastructure project assets (including net IFC investment of \$5.8 billion). The Corporation has backed a large number of groundbreaking transactions, in telecommunications, water, sanitation, rail, ports, toll roads, and rural electricity. It has been involved in some 20% of all projects in the more difficult sub-sectors, and is widely recognized as a leader. Infrastructure now accounts for a significant share (24% in FY02) of IFC investment. Infrastructure investments by IFC have also had superior performance, as noted by OEG in their *Annual Review*.

**3.10** Yet, with the exception of telecommunications,<sup>21</sup> there may have been an overestimation of how great a share of the infrastructure needs of developing countries would be served by private infrastructure. In the past 3 – 4 years, we have been observing an across-the-board reduction in the interest of key infrastructure players in developing countries. This appears to be driven by a number of factors:

- troubles in home markets for leading firms in the power and water businesses;
- continued regulatory uncertainty, and general concerns about risk and reward tradeoffs in developing countries, particularly in sectors where it is politically difficult to increase tariffs, exacerbated by investors' unmet expectations in several instances;
- turmoil in specific markets, like Argentina;
- lack of access to debt financing for investment programs.

<sup>20</sup> *Annual Review of IFC's Evaluation Results: FY 2002*. OEG's review of 194 investments evaluated from 1999 to 2001 found that IFC's investments in priority sectors also yielded better development and investment outcomes, though the difference was not significant.

<sup>21</sup> In the telecommunications sector, a large number of governments have successfully privatized their traditional fixed line networks and almost all have delegated operation of mobile service companies to private sector operators, usually in a multi-operator competitive environment.

3.11 At the same time, there has been considerable “pullback” by several developing country governments from private infrastructure. This pullback also stems from many sources, including unmet expectations and popular criticism of poorly-designed concessions, greater sensitivity surrounding rate increases (and the frequent timing mismatch between when costs rise and the benefits of investment become visible), and concerns over contingent public liabilities.

3.12 In response to this escalating challenge, IFC is exploring a range of new innovations and solutions. These include:

- joint financing with IDA (as in the case of Pamir Power,<sup>22</sup>) life-line tariff support funded by donors to cushion rate increases,<sup>23</sup>
- joint efforts with IDA and donors in early-stage project preparation (pilots underway in Africa);
- further piloting financing for municipalities’ infrastructure developments,<sup>24</sup> output-based aid pilots;
- increased business development efforts to encourage FDI in infrastructure;
- corporate lending; refinancing and acquisition financing to mitigate disruptions caused by the exit of key strategic investors;
- local currency financing and greater use of partial guarantees;
- using carbon credits as part of financing packages;
- exploring with MIGA additional ways to strengthen our support for the sector.

3.13 *Financial Markets.* IFC has over time built up world-class capacity in financial markets. In recent years, this build-up of capacity has enabled IFC to play an important role in creating and strengthening a range of financial institutions in member countries - from first private commercial banks in transition countries all the way to micro finance institutions, and in using domestic intermediaries as conduits for IFC financing - enabling more firms to access the kind of long-term funding essential for capital investments. This sector now accounts for the single largest share of IFC investment, at 40% in FY02. In addition to investment, IFC has provided advice to policy-makers, regulators, and institutions in many countries on market structure, institutional management and corporate governance. New innovations in this sector include stepping in to help mitigate the effects of market crises with trade finance facilities, micro finance, and housing, as well as helping more banks address increasingly important environmental and social issues.

3.14 Key challenges in this area for IFC have included better bringing to bear our global expertise across different parts of the world, strengthening our advisory work, and scaling-up the creation of specialized institutions for serving smaller firms. In part to address this, IFC’s FY02 reorganization centralized IFC’s financial markets activity, which had previously been undertaken through IFC’s Regional Departments. We expect that this new structure will lead to improved asset quality and to improved ability to transfer best practices from one region to another. The latter will be reinforced by greater focus on our advisory activities in a new unit within the Global Financial Markets department.

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<sup>22</sup> *Tajikistan: Pamir Private Power Project*, (IFC/R2002-0121), June 10, 2002.

<sup>23</sup> *Ibid*

<sup>24</sup> *Technical Briefing on Mexico-Tlalnepantla Municipal Water Conservation Project*, IFC/SecM2003-0007, January 28, 2003.

3.15 *Social Sectors.* In FY00, IFC created the Global Practice Group for Social Sectors to focus on its growing work in health and education. The Group then graduated to become an independent department in FY02, reflecting IFC's further commitment to the social sectors. Here again, IFC has built up considerable expertise in the financing of private health and education. After undertaking several small projects in Africa, carried out through the Africa Enterprise Fund, IFC focused on a few Latin American markets, where governments with IBRD assistance were engaged in structural reform of the sector. A number of pioneering transactions resulted. In the last two years, despite its geographical diversification, IFC's investments in these sectors decreased from the levels of FY00 for several reasons: new investments shrunk significantly in two big markets, Argentina and Brazil, one because of the country crisis and the other because of country exposure constraints; some early projects have required intensive portfolio effort, in particular projects funded through the Africa Enterprise Fund; and building-up expertise in a broader number of countries and subsectors has required significant new promotional and preparation work. Going forward, the Millennium Development Goal of education for all is expected to lead governments to focus their budgetary education spending on strengthening their primary and secondary education services. IFC's focus on tertiary education and technical training will help free up government funds for those priority areas. IFC will continue to apply lessons learned from its early investments in the sectors; further diversify both geographically through posting specialized staff in regions and within sectors; develop instruments to support small projects; and continue strengthening collaborative efforts across the World Bank Group (such as the *World Development Report 2004*) and with other development institutions, in particular to explore systematically public-private partnership opportunities

3.16 *Small and Medium-Scale Enterprises.* Support to SMEs has now been a priority for IFC for some time. Here too, there have been both successes and reverses, and the Corporation's approach to the challenge has evolved considerably. Earlier approaches have included ramping up direct investment processed from IFC's headquarters, and then subsequently through an expanded field presence, notably through the Africa Enterprise Fund (AEF) and Small Enterprise Fund (SEF) and the Extending IFC's Reach initiative. These approaches were marked by extremely poor asset quality, in part because they were done without sufficiently effective technical assistance, but demonstrated that direct investments in SMEs were not an efficient use of IFC's budgetary resources.<sup>25</sup> In contrast, the asset quality of financing SMEs through financial intermediaries was notably better. This second pillar of IFC's early approach continues to be very important. However, many banks remain reticent about significantly expanding their reach to smaller firms, and IFC contractual requirements that funds be on-lent to SMEs have not generally been very productive.

3.17 IFC's revised SME strategy focuses on (a) continued efforts to create specialized financial intermediaries or extend the services of existing domestic institutions to serve SMEs, and (b) significantly expanded non-investment support to build and effectively utilize domestic capacity and improve the enabling environment for SMEs. In the two years of implementing this new approach, there are already many visible successes:

- creation of a focus of expertise in the WBG's SME Department;
- development of multiple partnerships with donors and executing agencies;

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<sup>25</sup> See *An Evaluation of IFC's Investments through the Africa Enterprise Fund* (CODE2000-5), February 8, 2000; and *Extending IFC's Reach: Program Completion Report* (IFC/R2000-33), March 8, 2000.

- a major build-up in micro-lending;
- several high-profile demonstration projects.

3.18 As a result, IFC has developed the skills and capacity to be a major contributor in the development community's efforts to broaden the base and benefits of growth. This has in large part been made possible by a major expansion of donor support for SME-related advisory and capacity-building activities. At the same time, major challenges remain in terms of scaling up our impact, upgrading assessment of results, finding effective business models for financing small (as distinct from micro) enterprises, and rationalizing the funding of these activities. Much more could be done if additional resources were available.

3.19 Going forward, we will maintain the two basic pillars of our approach to SMEs. A number of steps will be taken to make headway on the key challenges cited above. In particular, IFC is discussing with IDA and donors some significant initiatives to scale-up its impact on SMEs, which will be brought to IFC's Board of Directors when sufficient progress on structures have been made. Also, a lot of work has already been done in developing evaluation methodologies,<sup>26</sup> which will be further progressed in the next year (see paras 3.24 - 3.26 below).

3.20 *Sustainability.* IFC's sustainability initiative, now two years old, represents the second phase of IFC's approach to environmental and social issues. From 1990 onwards, the Corporation has implemented a standards-based approach, grounded in its environmental and social procedures and safeguard policies. The 1998 adoption of IFC's own standards, derived from but distinct from the World Bank's, was an important milestone in implementing this approach. This has led to IFC's approach being recognized as "the gold standard" for private sector oriented financial institutions, and IFC has built up unmatched experience in making the, at times difficult, judgments involved in applying these standards. The Corporation is clearly seen as a leader in this area, even by critics of some investments, and a growing number of private financial institutions are recognizing the value of this approach and adopting the IFC's procedures and policies.

3.21 Since FY01, the Corporation has worked to complement this standards-based approach with one which can recognize not only acceptable but superior performance in managing environmental and social issues, and in identifying areas of convergence between the financial interests of sponsors and investors and the environmental and social objectives. IFC's new results framework, developed in FY02, for recognizing different levels of development impact<sup>27</sup> is the first for any financial intermediary to be able to incorporate the positive effects of reduced resource use and waste, improved corporate governance, and broader sharing of the benefits of economic activity. These are widely recognized as important facets to sustainable and quality growth, but rarely captured. At the same time, IFC has been successfully developing a unique ability to identify where firms can benefit financially from the taking of environmental and social steps that yield these developmental benefits. IFC's publication of this know-how,<sup>28</sup> in advance of the Johannesburg Summit, has been widely publicized and referenced. By helping firms recognize and manage environmental and social issues appropriately, IFC helps reduce their project and reputational risks, increasing investors' willingness to proceed with complex developments. Especially in natural resources, in oil and gas,<sup>29</sup> in mining,<sup>30</sup> and in

<sup>26</sup> See, for example, *Proposed Continued IFC Participation in the Private Enterprise Partnership* (IFC/R2002-0191), September 26, 2002

<sup>27</sup> This framework is consistent with and complements the methodology used by the Operations Evaluation Group in assessing development impact.

<sup>28</sup> *Developing Value: the business case for sustainability in emerging markets*, SustainAbility, IFC and Ethos Institute, 2002.

<sup>29</sup> For example, the Chad-Cameroon Pipeline.

<sup>30</sup> For example, in helping address environmental and social issues during project implementation in the case of Minera Yanacocha, in Peru.

agribusiness,<sup>31</sup> the Corporation's ability to increase convergence between growth and sustainability objectives, along with its existing standards and expertise, will provide valuable support to member countries' development.

3.22 Going forward, key challenges in this area include better integrating this area of comparative advantage into IFC's business development efforts, developing mechanisms for IFC to be better compensated for the value it adds to clients in this area, and continuing to adapt internal procedures to more consistently identify opportunities for clients, and not just compliance risks.

### **Cross-cutting challenges**

3.23 **The need to increase business development.** The current very limited interest in emerging market investment, especially in frontier countries, threatens the medium-term and long-term prospects for economic growth and poverty reduction in IFC's member countries. The slow growth of IFC's investment portfolio also weakens its profitability at a time when expenditures on non-compensated activities (for example advisory work, development evaluation) are increasing. We also observe that, while some other private sector IFIs are being even more adversely affected than IFC by current market conditions, over time IFC has lost considerable "share of market" to regional MDBs (Chart 1.1). We believe that multiple institutions offering choices to clients are a good thing. However, we also believe that—as a result of the extensive investments made in quality-enhancing functions (analysis of development impact, evaluation, environment and social, credit review) by the Corporation, and IFC's ability to transfer lessons across regions—it is able on average to deliver better development impact than many others. For these reasons, improving our ability to develop new business and to help the markets recognize how IFC is different are an important challenge. The reorganization of July 2002 was a response to this challenge, creating a new regional structure with senior staff focused exclusively on business development and ensuring IFC has the best approach in its developing member countries. While the new structure is now in place and largely staffed, we recognize that successful business development continues to be a major challenge.

3.24 **Advisory and capacity-building activities** have become a significant portion of IFC's activities over the past four years, enhancing IFC's development impact. Many of these activities are central to building the private sector in developing countries, beyond what IFC can do through its commercial investing. However, because their costs are generally not fully compensated for by clients or others, they also increase IFC's costs and lower the Corporation's reported profitability.<sup>32</sup> Going forward, IFC intends to take several steps to improve the transparency and development effectiveness of its advisory and capacity-building activities, including:

- Moving toward separation of commercial investment and advisory and capacity-building activities in budgeting, to enable a more informed discussion about the mix between

<sup>31</sup> For example, Conaprole, where IFC is supporting the efforts of Uruguay's leading dairy co-operative to improve its corporate governance practices, and Favorita, where IFC is assisting a leading Ecuadorian banana grower and exporter in moving supplier farms to international labor and environmental certification standards.

<sup>32</sup> IFC currently estimates that adjusting IFC's returns for expenditures incurred in developmental but non-remunerated activities, and to a lesser extent for the effect of pricing caps, would raise IFC's reported return by about 2% of net worth (*Technical Briefing, IFC: Unbundling Commercial and Non-commercial Activities*, January 15, 2003).

IFC's commercial and advisory and capacity-building activities, and the mix within advisory and capacity-building activities;

- Focusing on getting more robust indicators of the development impact of advisory and capacity-building activities, both at the individual and aggregate level; and
- In frontier countries, clarifying how this set of activities, rather than investment activities, now represent the bulk of IFC's work, and is central to our role. We will be seeking to better leverage this set of activities in order to increase investment levels in our member countries, and IFC's own commercial investment activity.

3.25 **Results measurement.** The development community is putting increasing emphasis on the results achieved by institutions. IFC welcomes this, and is continuing its efforts of the past several years to upgrade the measurement and reporting of its development impact. Key elements of this results framework include:

- the work and reports of IFC's independent Operations Evaluation Group (see Box 3.2;)
- an Annual Portfolio Performance Review;
- the introduction of a Corporate Scorecard in FY99 (see Annex 2 for FY02 Scorecard);
- a revamped approach to articulating expected development impacts of investments, and the introduction of a development impact monitoring system;
- the introduction in FY02 of Departmental Scorecards for investment departments;
- the adoption in FY02 of a new framework for assessing the economic, environmental and social impacts of IFC investments ("high impact framework"); the framework incorporates IFC's historical economic rate of return (ERR)-based methodology, but also for the first time seeks to systematically capture non-quantifiable development impacts.

3.26 This framework provides a strong basis for assessing the development results of IFC's investment operations at a project, country and corporate level. The different elements will of course continue to need optimizing. IFC now needs to develop a good framework for assessment of its non-investment activities, as indicated above. In doing so, the key challenge for the Corporation will be to design and implement a system which is both high quality and whose costs are manageable. This will be particularly important as most of IFC's non-investment activities are not revenue generating, so that assessment costs either have to be cross-subsidized by IFC's commercial operations, or structured as part of donor contributions. In addition, Management is considering proposing a set of future performance targets for the Corporation, for discussion with the Board. We presently expect to address this issue in the next Business Plan and Budget paper to the Board.

3.27 **Incentives and Human Resources Issues.** IFC will introduce a long-term incentive program for investment staff this year, as a key element of the results measurement framework. This program will enable IFC to build managerial and staff accountability for results and reward staff who make measurable contributions to the long-term development impact and profitability of the Corporation.

3.28 In the last four years, IFC has been implementing a focused Human Resource (HR) strategy designed to build a high performance organization (refer to Annex 3, Update on IFC's Human Resource Strategy). The initial HR strategic priority, implemented in 2001, was to develop a foundation for measuring and rewarding the achievement of short-term results. A performance evaluation process that links staff assessment to delivery against annual business objectives was developed. In addition, the performance awards program was redirected to be

more closely aligned with performance evaluation. IFC is now in the system implementation phase, which includes a learning curriculum, to train managers and staff on how to use performance management systems to attain optimal organizational results.

3.29 The next HR strategic priority is to balance short term incentives with long-term incentives, in recognition of the long-term nature of IFC's business and career system. Two years ago, as a first step, IFC implemented a new career management framework for investment officers that defines competencies required for progression within the career stream. The competency framework is designed to develop core skills that are required for developing, executing, and supervising complex financial transactions in developing countries, which increasingly require the integration of sustainability and SME development components in the investment program. The competency framework guides the career development of investment officers (IOs), and assures that IFC is developing the knowledge and skills set needed in an increasingly difficult business environment.

3.30 The career management framework for IOs has been operating successfully for almost two years, and IFC has begun to develop this approach for other career streams, including: technical assistance staff working in SME development; resource management staff; and attorneys.

3.31 In 2003, IFC will take an important step in a continuing effort to align incentives, by introducing a long-term incentive program for investment staff. The program will:

- **Increase accountability** for development results and profitability throughout IFC. It will be an integral component of IFC's results measurement framework, and will link strategy, budget, operations, and evaluation with results measurement at both the organizational and individual levels.
- **Balance incentives** by assuring that rewards and career assessment of investment staff are based on development results achieved over a career, as well as mastery of professional competencies and delivery against annual performance objectives. As of July 1, 2003, individual "investment portfolios" will be developed for investment staff, and the track record of project results over time will be used as a factor in assessing staff development, including promotion.
- **Establish a long-term incentive plan** which will reward staff for achieving development impact and profitability targets.

3.32 Results measurement for development organizations is a complex endeavor. Tying it to staff development and accountability is even more complex. However, it is important to begin the process of aligning results measurement at every level in the organization. IFC believes it has made significant progress in the last several years to upgrade the measurement and reporting of its development impact. We believe it is time to take the next step of linking staff incentives to organizational performance measurement.

3.33 IFC will use the same methodology used two years ago to implement the career management framework for investment officers - define the program for investment officers first; implement the program; learn from experience and improve the program; customize the implementation for other career streams, only if initial results are successful. This disciplined approach of limiting the initial implementation to a well-defined subset of the workforce, enables IFC to introduce and learn from innovative approaches to human resource management, before it is implemented throughout the Corporation. Implementation of the long-term incentive plan will

be guided by the IFC Management Group, with advice and assistance provided by a working group of department directors from across IFC.

3.34 Once the long-term incentive program is in place, IFC will have a comprehensive staff incentive and learning program that:

- i. nurtures the intellectual capital and skill sets necessary for IFC investment staff to remain a strategic asset for IFC;
- ii. aligns staff effort with short and long-term corporate objectives for operational effectiveness and efficiency; and
- iii. establishes organizational, management, team, and staff accountability for results.

3.35 **FY04 Budget.** In line with the continued focus on efficiency, IFC intends to present a FY04 administrative budget with no increase in real terms above the level authorized by the Directors for FY03.

## ANNEX 1 – FRONTIER AND NON-FRONTIER COUNTRIES BY REGION

CENTRAL & EASTERN EUROPE	SOUTHERN EUROPE & CENTRAL ASIA	MIDDLE EAST & NORTH AFRICA	
<b>Frontier Countries:</b> Armenia* Belarus Georgia* Ukraine  <b>Non-Frontier Countries:</b> Czech Republic Estonia Hungary Latvia Lithuania Poland Russian Federation Slovak Republic Slovenia	<b>Frontier Countries:</b> Albania* Azerbaijan* Bosnia Herzegovina* Kyrgyz Republic* Macedonia, Republic of Moldova* Tajikistan* Turkmenistan Uzbekistan* Yugoslavia*  <b>Non-Frontier Countries:</b> Bulgaria Croatia Cyprus Kazakhstan Romania Turkey	<b>Frontier Countries:</b> Afghanistan* Iraq Lebanon Pakistan* Syrian Arab Rep. West Bank & Gaza Strip Yemen, Republic of*  <b>Non-Frontier Countries:</b> Algeria Bahrain Egypt, Republic of Iran, Islam Republic of Jordan Kuwait Libya Morocco Oman Qatar Saudi Arabia Tunisia United Arab Emirates	
EAST ASIA & PACIFIC	LATIN AMERICA & THE CARIBBEAN	SUB-SAHARAN AFRICA	
<b>Frontier Countries:</b> Cambodia* Fiji Indonesia* Kiribati* Lao PDR* Marshall Islands Micronesia Mongolia Myanmar* Palau Papua New Guinea* Samoa* Solomon Islands* Tonga* Vanuatu* Vietnam*  <b>Non-Frontier Countries:</b> China Korea, Republic (South) Malaysia Philippines Thailand	<b>Frontier Countries:</b> Argentina Guyana* Haiti* Honduras* Jamaica Nicaragua* Dominica* Ecuador Paraguay St. Kitts & Nevis St. Lucia*  <b>Non-Frontier Countries:</b> Bahamas Barbados Belize Bolivia* Brazil Chile Colombia Costa Rica Dominican Republic El Salvador Guatemala Mexico Panama Peru Trinidad & Tobago Uruguay Venezuela  <b>OECS States:</b> Antigua & Barbuda Grenada* Montserrat St. Vincent & the Grenadine	<b>Frontier Countries:</b> Angola* Benin* Burkina Faso* Burundi* Cameroon* Cape Verde* Central Africa Republic* Chad* Comoros* Congo, Rep. Of* Cote D'Ivoire* Djibouti* Equatorial Guinea Eritrea* Ethiopia* Gabon Gambia* Ghana Guinea* Guinea Bissau* Kenya* Lesotho* Liberia* Madagascar* Malawi* Mali* Mauritania* Mozambique* Niger* Nigeria* Rwanda* Senegal*	Seychelles Sierra Leone* Somalia* Sudan Swaziland* Tanzania* Togo* Uganda* Zambia* Zimbabwe*  <b>Non-Frontier            Countries:</b> Botswana Mauritius Namibia Sao Tome & Principe South Africa
SOUTH & SOUTHEAST ASIA			
<b>Frontier Countries:</b> Bangladesh* India* Maldives* Nepal*  <b>Non-Frontier Countries:</b> Sri Lanka*			

\*IDA Countries; Frontier countries defined as low income (World Bank *World Development Indicators 2002*) or highest risk (Institutional Investor rating of 30 or less as of September 2002) countries.

## ANNEX 2 - CORPORATE SCORECARD FY02

*Mission: To promote sustainable private sector investment in developing countries, as a way to reduce poverty and improve people's lives.*

DEVELOPMENT IMPACT MEASURES	PERFORMANCE FY02	BENCHMARK/ TARGET FY02	BENCHMARK / TARGET
<b>Volume of impact</b>			
IFC net commitments	US\$3,092m	US\$3,000-3,400m	Plan Forecast
IFC net approvals	US\$4,006m	US\$3,600-4,000m	Plan Forecast
IFC committed syndications	US\$512m	US\$1,199 m	Previous year
IFC approved syndications	US\$1,829 m	US\$1,615 m	Previous year
<b>Quality of Impact</b>			
Financial quality: Loans (Non-performing loans)	15.2%	12.9%	Previous year
Equity (Specific Reserves as % of disbursed portfolio)	29.4%	25.3%	Previous year
Economic impact:			
– % satisfactory or better ex-post development outcomes (XPSRs)	56%	61%	Previous year
Environmental and Social:			
– % of low risk projects (rated "average" or "good" in ESRR)	79%	NA	Previous year
<b>Strength of Role</b>			
Frontier positioning:			
– Frontier countries (narrow definition), % of IFC total commitments in low-income countries or highest-risk countries*	21.0%	41.0%	Previous year
– Frontier countries (broader definition), % of IFC total commitments in low/lower-middle-income countries or in higher-risk/highest-risk countries*	90.0%	85.0%	Previous year
– Frontier investments within non-frontier countries*	36.3%	NA	Previous year
Priority sectors:			
– Financial sector, % of total commitments	40.0%	42.4%	Previous year
– Infrastructure, % of total commitments	14.0%	12.3%	Previous year
– ICT, % of total commitments	10.0%	10.8%	Previous year
– Social Sectors, % of total commitments	2.0%	3.9%	Previous year
Total Priority Sectors:	66.0%	69.6%	Previous year
SME- Related Activities, % of total commitments	17.0%	19.2%	Previous year
IFC's Additionality			
– High impact transactions	47%	NA	Previous year
– Projects with high financial/economic impact	32%	NA	Previous year
– Projects with high environmental or social impact	19%	NA	Previous year
– Advisory/ technical assistance engagements, # of assignments	177	190	Previous year
<b>CORPORATE STRENGTH MEASURES</b>	<b>PERFORMANCE FY02</b>	<b>BENCHMARK/ TARGET FY02</b>	<b>BENCHMARK/ TARGET</b>
Maintenance of AAA Rating	Yes	Yes	Yes
<b>Resource Utilization</b>			
Profitability			
– Net income, \$	US\$215m	US\$221 m	Plan Forecast
– Return on Net Worth	2.7%	3.6%	Plan Forecast
Productivity: # Commitments/Investment staff	0.34	.35	Previous year
Staff Engagement (% of satisfied respondents, Annual Staff Survey)	60.0%**	NA	Previous year
Client Satisfaction			
– % of satisfied respondents in the Annual Client Survey	73%	71%	Previous year

NA Not Available.

\*Frontier countries (narrow definition) are low income (World Bank income category) or highest risk (Institutional Investor rating of 30 or less) countries. Decline from 41% to 21% is due to several exceptional country programs in FY01 (e.g. combined program in Cameroon, India, Indonesia and Nigeria went from \$61m in FY00 to \$597m in FY01 to \$186m in FY02). Frontier countries (broader definition) are low income/lower-middle-income (World Bank income categories) or higher-risk/highest-risk (Institutional Investor rating of 30.1- 45, or of 30 or less). Frontier investments in non-frontier countries are investments in countries that are not defined as frontier, using the narrow definition.

\*\*Annual Staff Survey 2002, Percentage of Favorable Respondents on "My Job" Section of Survey.

## ANNEX 3 – Human Resource Strategy

### An Update – February 2003

1. IFC's human resource management is directly linked to its business strategy. Our primary objective is to develop a high-performance, merit-based organization, which can efficiently deliver IFC's business goals. To achieve this goal, we have successfully implemented a wide range of new HR tools and systems over the last three years:
2. *Career and performance management.* We have implemented a career management system where performance is the basis for staff development and progression. A new web-based annual performance evaluation system, including multi-rater feedback, has now been operational for three years. This new system has helped to substantially improve the attention given by managers and staff to performance assessments, as evidenced by a substantial increase in the completion of staff performance evaluations, from about 37% in FY99 to about 96% last year. A new competency-based career development system has also been implemented for our core career stream of Investment Officers (IOs), whose skills are now assessed on an annual basis to determine opportunities and potential for advancement. This tool helps IOs to know "where they stand" and "what it takes" to progress, and helps management to identify the top performing staff. In light of the current, competitive external business environment, performance management is a critical tool for motivating staff and focusing on individual results and accountability.
3. *Leadership development.* The selection, assessment and development of strong managers continues to be a top corporate priority. Two years ago, we established a new corporate assessment process of all our directors. We have now established a similar process for all IFC managers and high potential senior staff. Through our succession planning process, we now have a system to identify and develop managers and staff who possess the leadership potential to meet future business needs. This year we also launched, jointly with the World Bank, a new leadership development curriculum for all new managers.
4. *Staff development.* Since 2000, we have substantially increased our investment in staff training and development to create an environment where learning is valued throughout IFC. We have upgraded IFC's core training programs, such as induction and new staff orientation. We have also expanded our base curriculum, highlighted by the launch of an extended credit program for staff at entry and senior levels. New courses also include corporate governance, executive communications, negotiations and ethics. This year, in support of the reorganization, we launched a series of business development sessions held at our regional hubs to strengthen our ability to generate new, high quality business and to improve the working relationships of staff working across our new matrix organization.
5. *Staffing and diversity.* Since FY00, we have overhauled our recruitment and staffing process to improve our competitiveness for high talent, increase diversity and create more organizational flexibility. The Global Transaction Team (GTT) for IOs, created three years ago, is our core recruitment program, which has helped us to improve the flexible deployment of our staff and to accelerate staff development by assigning new officers to challenging assignments worldwide. We also continue to make progress toward increasing diversity: for instance, 60% of all new IOs hired since 2000 are from Part II countries; about 52% are women; and 18% are of Sub-Saharan

African descent. Our next challenge in diversity is to improve the recruitment of a few under-represented Part I nationals, and this is a key staffing priority for the coming months.

6. *Compensation and incentives.* Two years ago, IFC piloted a performance-based tool to adjust the in-grade salaries of high-performing IOs using a rigorous and systematic assessment process, based on the mastery of clearly defined competencies. (This program was first presented to the Board in IFC Strategic Directions 2001, Board -- Committee of the Whole: IFC/R2001-0035). At that time, IFC management had the option to implement a market-based premium for IOs, essentially comprising salary adjustments to all relevant staff based on market comparators; IFC management decided instead to implement a performance-based approach. After two years, this program has exceeded our expectations and has been very well received by staff at all levels. Given its success, we intend to implement this program on an annual basis and extend its scope from the current program (which includes Grades GF and GG) to include Grade H Principal Investment Officers. Our reorganization, which has resulted in the relocation of senior resources to several regional locations, has highlighted the need to extend this tool to recognize our highest-performing staff for their contributions to IFC's bottom line.

7. IFC has also successfully continued the implementation of the performance and spot awards program as a means of rewarding excellent performance for results achieved within the year. Last year, we made some modifications and improvements to the program to more closely align these incentives with the departmental scorecards, thereby linking the measures of annual corporate and individual performance along the parameters of profitability, development impact and client satisfaction.

### **The Reorganization And Work Force Trends**

8. Last year's reorganization resulted in a reduction of our staff, a necessary response to the challenges of our business environment. As of December 31, 2002, the end of the six-month internal job search period for all redundant staff, there were 26 voluntary ACS redundancies and 60 involuntary redundancies, of which 39 were staff based in headquarters and 10 were ACS staff. Of the total redundancies, 21 staff were able to find job placements in other parts of the World Bank Group. Overall, the redundancies did not result in a deterioration of our diversity ratios.

9. The IFC work force, which grew by 62% from FY95 to FY00, has now stabilized in response to our business environment. Since FY00, our work force has essentially remained the same: we currently have 2,053 regular staff, compared to 2,068 in June 2002 and 1,957 in June 2001. Today, our staffing strategy has focused on moving senior staff, including Directors, to our field offices. Since July 2002, 18 senior investment officers have relocated from headquarters to the field, and more are in the process of moving. We also now have all seven regional directors based in the field. This strategy is allowing us to be much more efficient and quicker in responding to our clients' needs.

### **Major Challenges Ahead**

10. This year, our primary focus is to implement the objective of last year's reorganization: an efficient IFC that is more responsive to our client needs, while growing and improving the quality of our portfolio and development work. Looking forward, our major challenges and priorities are outlined below:

11. *Leadership Development.* Our cadre of current and future managers is a corporate asset and critical to IFC's long-term success. As such, the objective of our leadership development program is to ensure that we have the best possible talent in place to lead IFC's current and long-term business needs. We recognize that our existing managers can benefit from a targeted development program to improve our organizational capacity to manage our staff. Our intent is to also develop a strong bench of future leaders. This year, we are therefore providing many in our top current and potential leadership with both internal and external training opportunities, job rotations, special assignments, mentoring and coaching. We are also considering an accelerated development program for high performing and high potential staff on a pilot basis.

12. *Comprehensive Career Management Framework.* This year's major priority is to complete the implementation of a comprehensive, global career management framework for IO development, with the objective of making our investment staff accountable for performance and results. The career management framework has three main components: (i) performance management; (ii) career development; and (iii) incentives.

13. Currently, we have the following elements in place:

- A state-of-the-art annual performance management system, which allows managers and staff to focus on annual performance objectives and results;
- A competency-based career system for IOs, which allows them to know where they stand vis-à-vis their peers and what it takes to progress; and
- A performance awards program which allows management to recognize outstanding individual or team performance with prompt recognition.

14. We are also currently developing a new career development system to clarify the expectations and opportunities for investment staff under the new organizational model. The IFC reorganization has resulted in a substantial increase in the number of IOs based in field offices to support business development and portfolio work. We are therefore moving away from a Washington-centered career path to a more expanded career model, where IOs will be called upon to work both in headquarters and in the field. The objective of this new career system is to ensure that all IO's worldwide, who are working on business development, project processing or portfolio, are equally valued and have equivalent opportunities for growth and development. Staff will thus be expected to move internationally and across regions more frequently to develop their skills and to meet IFC's business needs.

15. *Accountability and incentives.* An element clearly missing from our existing career framework is a tool to measure and reward outstanding results over time. The nature of IFC's business is long-term: the profitability and developmental impact of projects is not known until three to five years after a project's initial commitment. To make both our organization and our staff truly accountable for results, we are developing an incentives system which would: (i) measure and evaluate individual performance on projects over time, and (ii) compensate individuals that have demonstrated outstanding long-term performance and results.

16. To ensure both corporate and individual accountability for results, we believe our compensation and rewards systems must be closely aligned with IFC's business goals. Our existing compensation tools are limited when it comes to recognizing and rewarding true high performance over time. As a result, our ability to create a culture of accountability is limited. A priority for 2003 is to develop a long-term incentives scheme tied to IFC's bottom line, thereby linking corporate and individual performance.

17. We are currently examining a number of options for a long-term incentives program. All options take into account the three existing measures of our corporate and departmental scorecards: the achievement of corporate profitability, development impact, and client satisfaction. In a long-term incentives program, we would extend these measures from the corporate to the individual level. The performance of both IFC as a whole and individuals would be assessed along parallel measures. Individual staff would thus be held accountable for directly contributing to IFC's results.

18. Long-term incentives would only be awarded when both corporate and individual performance is exceptional. As noted in para 3.26, we are considering a number of parameters to evaluate our corporate performance. Once we establish a target, the long-term incentives program would be executed annually only if IFC meets or exceeds the corporate target. In parallel, individual performance and results would be assessed by a number of profitability and portfolio measures, currently being developed. Long-term incentives would be rewarded only to individual staff who demonstrate outstanding results after a period of three to five years. The incentives program would likely apply initially to staff in Investment Operations, who are responsible for the success of our commercial activities. Over time, we would analyze the success of the program and consider a potential expansion to staff in IFC's non-commercial activities.

19. A long-term incentives scheme would ensure that both IFC and individuals are held accountable for the success of our commercial activities, which directly drive IFC's bottom line and determine our portfolio quality. In addition, the measures of individual performance would take into consideration the achievement of outstanding development impact, including work in frontier countries or sectors. As a whole, we would therefore create a system of motivation and accountability that fully incorporates a central business objective of IFC: to grow our business with high quality assets which create genuine developmental impact.

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