

# **IFC STRATEGIC DIRECTIONS**

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## EXECUTIVE SUMMARY

1. IFC's external environment is becoming more complex, with clients requiring a broader array of responses to their development needs. Governments in both frontier and middle income countries have increasingly recognized the importance of supporting the growth of the private sector, creating a greater call for assistance from development institutions to help improve the investment climate and make financing accessible to businesses. More emphasis is being placed on developing domestic financial markets and encouraging small and medium business formation in order to fund the expansion of private enterprises and generate jobs.

2. In a number of middle incomes countries, regional and global private sector players are beginning to emerge which has positive implications for South-to-South partnerships and interregional trade. Many of these companies are seeking experienced global financial partners as they venture beyond their national borders. They will also need advisory support to meet the requirements of international markets such as complying with environmental and social standards and meeting the mandate for corporate social responsibility.

3. While developing countries on the whole have seen an increase in GDP growth, there has been a strong differentiation between various regions and countries. In some emerging markets there is more liquidity and the private sector is growing, while in others, especially in frontier markets, there is continuing difficulty in obtaining access to capital. This disparity in capital flows has also affected certain sectors such as infrastructure, where international capital investment is declining. As a result, financial institutions must develop a greater understanding of local needs in order to provide different services to different markets.

4. In frontier countries, the formation and growth of sustainable businesses continues to be a particular challenge. There remains a great need for long-term capital, improvements in the investment climate, stronger community and small business linkages with large corporates, and more private enterprise formation. Comprehensive solutions involving both the private and public sectors and pro-active business development are needed to meet this challenge.

5. International Financial Institutions (IFI) are increasing their lending to the private sector throughout the developing world. As a result, it is becoming more important for IFC to differentiate its products and services by providing added value through sustainability and other advisory services.

6. IFC has been responding to this complex environment with more focused and flexible initiatives. The Corporation has made significant strides in strengthening its client orientation, expanding its development impact, improving its technical assistance and advisory services, and extending its global leadership in sustainable private sector development. Recent achievements include the following:

- 68% of FY03 commitments in high impact sectors, 28% in frontier countries;
- Eight new Project Development Facilities (PDFs) created since 2000 geared to capacity building and Small and Medium Enterprise (SME) development;
- More senior staff located in the field to improve client responsiveness and provide the Corporation with greater access to market intelligence;
- A broader range of financial services offered to clients including corporate finance, structured finance and local currency products;

- Adoption of the Equator Principles based on IFC's Environmental and Social guidelines and policies, by 20 international banks representing more than 80% of the project finance market;
- Client satisfaction up 9% from the previous year across the departments;
- New incentive and performance management systems to help drive staff results on the ground;
- Strong growth in the portfolio, as new commitments in fiscal year 2003 increased by 24.7% to about \$3.9 billion;
- Improvement in the quality of the portfolio as a result of restructuring, provision reversal and unrealized capital gains; and
- Increased profitability in FY03 to \$528 million, driven by improvements in the quality of the long-term investment portfolio and above benchmark returns on liquid assets. FY04 net income likely to meet or exceed FY03 levels.

7. Despite these successes, IFC recognizes that private sector development in its developing member countries remains an unfinished agenda, and that the Corporation continues to have an important role to play in addressing the challenges at hand. This year's Strategic Direction Paper focuses on IFC's emerging business model to fully integrate and extend its financial, advisory and environmental and social capabilities to respond effectively to these external client demands. IFC has identified five strategic imperatives.

**7.1 Strengthen the Focus on Frontier Markets.** There continues to be a need for investment climate improvement and business capacity building in frontier countries in order to make private sector development effective and sustainable. There is also a significant need to take a more proactive approach to the development of good projects and overcome barriers to implementation. In response, IFC will increase its provision of diversified advisory services and will undertake proactive business development initiatives to meet these challenges.

**7.2 Build Long-term Partnerships with Emerging Global Businesses to Encourage Adoption of Sustainable Business Practices and Promote South-South Transactions.** As a global financial and sustainability leader, IFC is uniquely positioned to become the partner of choice of emerging global businesses from developing countries. By seeking to establish long-term relationships with such clients, instead of just engaging them in one-off transactions, IFC will have two main objectives, the pursuit of which should result in substantial development impact. First, IFC will strive to nurture the adoption by these companies of sustainable business practices, including good governance and high environmental and social standards. Second, IFC will seek to foster South-South partnerships as emerging global businesses become an important source of cross-border finance for other developing countries.

**7.3 Differentiate through Sustainability Competencies.** Among financial institutions, IFC has been able to lead with respect to sustainability issues by developing and implementing new metrics, enhancing reporting, and advising its clients on how to improve their environmental and social performance. IFC must now integrate these competencies throughout its operations and deepen its capability to deliver sustainable results on the ground.

**7.4 Address Constraints to Private Sector Growth in Infrastructure, Health and Education.** Over the past few years, there have been growing challenges for private sector involvement in the Infrastructure, Health and Education sectors. IFC will seek to address some of these problems by facilitating private-public partnerships (PPPs), developing cooperative programs with the World Bank and providing a number of innovative financing, advisory and project development activities to local private sector players and sub-sovereign public entities.

**7.5 Continue to Focus on Local Financial Markets Development through Institution Building and Use of Innovative Financial Products.** To better meet the needs of local businesses, IFC must continue to deepen the capacity of domestic financial institutions and expand access to financial markets for a broader range of clients such as microfinance lenders, and mortgage companies. IFC will continue expanding this work by providing technical assistance and advisory services as well as local currency financing, partial risk guarantees, securitization, and other new products.

8. To implement these strategic priorities, IFC must build up its capabilities to deliver high-quality services by:

- Making better use of its Project Development Facilities to help implement the World Bank Group private sector strategy in frontier countries, and expanding partnerships with IDA;
- Expanding its delivery capabilities to support SMEs through the Project Development Facilities and linkage programs, which will require creative solutions to Donor and IFC funding sources;
- Strengthening capabilities in the field that can nurture the growth of emerging global businesses, assist these clients in obtaining sustainability competencies and facilitate and promote regional projects as well as other South-to-South investments;
- Mainstreaming sustainability into IFC's operations and updating safeguard and disclosure policies to remain "ahead of the curve";
- Implementing new approaches to address infrastructure market constraints such as public private partnerships, IDA-IFC joint initiatives, local currency financing, and other innovative financing techniques;
- Scaling up IFC's activities in non-bank financial sectors (e.g. microfinance, mortgage finance, insurance) while extending use of new products in additional markets;
- Implementing a career management and accountability/incentive system to support a high-performance, merit-based organization, with a highly diversified workforce;

9. Above all, to support and sustain the implementation of these strategic priorities, IFC must continue to book high quality and profitable assets. Doing so provides the Corporation with a solid foundation to deliver on these priorities.

## IFC STRATEGIC DIRECTIONS

Over the past few years, IFC has made significant strides in strengthening its client-orientation and expanding its developmental reach through a targeted strategy which comprises the following components: investing in high-impact sectors (financial markets, infrastructure, health and education); encouraging the growth of small and medium enterprises (SMEs); expanding the Corporation's activities in frontier countries and providing an array of advisory and capacity building services to its clients particularly regarding sustainability and investment climate issues. IFC's external environment continues to become more complex, with clients requiring a broader array of responses to their development needs. While emerging economies on the whole have seen an increase in GDP growth, there have been strong disparities between various regions and countries. This requires financial institutions to develop a greater understanding of local needs in order to provide different services to different markets. This year's Strategic Directions Paper focuses on IFC's emerging new business model to respond to increasingly differentiated markets across client countries and maximize the Corporation's sustainable development impact. Section I provides an overview of the external context and IFC progress to date; Section II discusses the Corporation's strategic priorities; and Section III outlines the steps that will be taken to implement the strategy.

### SECTION I: THE CONTEXT

#### External Context

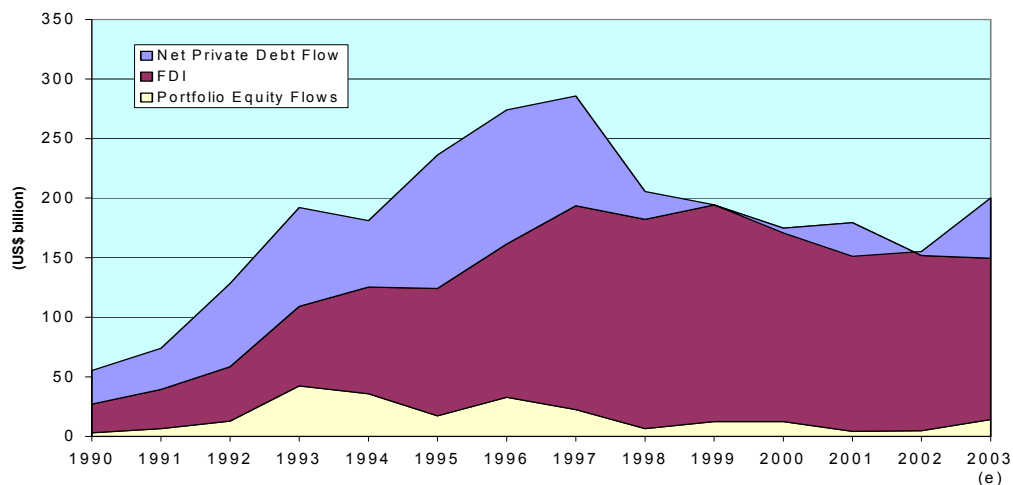
1.1 **Recovery in Developing Countries.** GDP in developing countries is projected to have grown by 4.6% in 2003 vs. 3.4% in 2002 (Table 1.1). This increase reflects a remarkable recovery in China and other East Asian economies from the SARS crisis, renewed growth in Latin America after a contraction in 2002, and a very strong performance in India. The engine of growth for the Asian region continues to be China through its own growth, its demand for commodities and via increasing integration with other regional economies. Expansion in Europe and Central Asia (ECA) was up to 5.3%, driven in part by broader integration with the European Union, and with Russia demonstrating substantial growth potential. The Middle East and North Africa regions grew by 5.1% with a sharp upturn in growth by the region's oil-exporting countries. Africa had only a modest growth rate of 2.5% although there was substantial variation among countries driven by many factors including oil and commodity revenues. Growth in emerging markets is expected to continue to be strong in 2004 although growth rates are predicted to moderate in Europe, Central Asia and the Middle East.

**Table 1.1: Real GDP Growth**

(%)	2000	2001	2002	2003 (e)	2004 (f)
World	4.0	1.4	1.8	2.4	3.5
High Income Countries	3.8	1.0	1.4	1.9	3.0
Developing Countries	5.2	2.9	3.4	4.6	5.3
East Asia & Pacific	7.2	5.6	6.4	7.4	7.3
Europe & Central Asia	6.8	2.4	4.6	5.3	4.9
Latin America & Caribbean	3.7	0.3	-0.6	1.1	3.8
Middle East & North Africa	4.4	3.5	3.3	5.1	3.7
South Asia	4.2	4.7	4.3	6.5	7.2
Sub-Saharan Africa	3.0	3.1	3.3	2.5	3.4

Source: Global Development Finance 2004, Executive Board draft

**1.2 Long-term Bank Debt Declines as Total Capital Flows Increase.** Reversing a trend over the past several years, net capital flows to developing countries increased in 2003 to reach a five-year high of \$200 billion, although flows are still down substantially from their peak of \$286 billion in 1997 (Chart 1.1). Stronger global growth and low interest rates in the industrial countries provided the positive external environment underlying the increase. Investors were also attracted by the efforts of some emerging market governments to improve economic policies. The growth in total net capital flows was driven by increased portfolio equity and debt flows, while net foreign direct investment continued to decline somewhat.

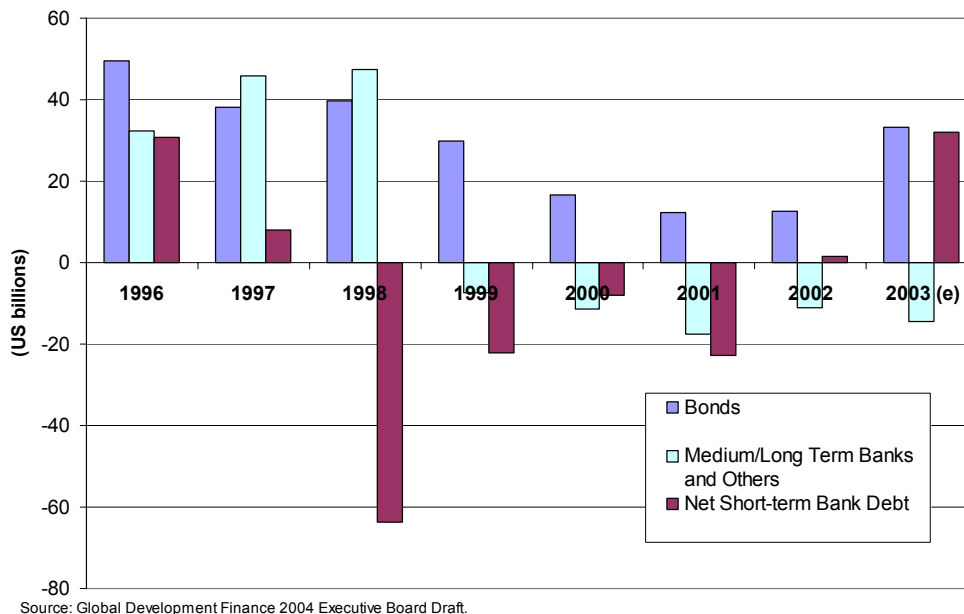
**Chart 1.1: Net Capital Flows to Developing Countries**

Source: Global Development Finance 2004 Executive Board Draft.

**1.3** Although total net debt flows to emerging markets increased, this increase has been driven by net bond flows (to both commercial and government borrowers) and short-term bank debt. Medium and long-term bank and other debt, on the other hand, has been declining over the last few years. (Chart 1.2) This trend in net medium/long term bank debt outflows reflects a continued retrenchment and refocusing of international banks away from developing country

cross-border finance. This has been driven by a number of factors including a reduction in demand for external finance by some corporates and governments unwilling to take on unhedged foreign currency exposure, growing opportunities for governments and large corporates to access the capital markets, and the strategic repositioning of certain international banks away from developing country risk and in general away from lending while moving more into fee-based services. Such withdrawal may also in part be due to considerations of the possible implications of Basel II, which might add extra capital requirements for developing country debt.

**Chart 1.2: Net Private Debt Flows to Developing Countries**



1.4 The composition of changes in capital flows in 2003 have varied widely across regions. In Asia, the increase was driven largely by short term debt increases, while in South Asia the rise in foreign finance came primarily in the form of FDI and portfolio equity. Transition countries in Europe had an increase in cross-border debt flows of all types, and Latin America had increases in short term debt and bond flows. Net private flows to Africa strengthened in 2003 due mainly to stronger commercial bond flows to South Africa.

1.5 In general, companies able to access the bond market or the syndicated bank debt market also tend to be the larger tier one companies. In most countries, smaller companies still have considerable difficulty obtaining long term financing.

**Table 1.2: Net Private Flows by Region**

(US\$ billion)	2000	2001	2002	2003 (e)
East Asia & Pacific	24.3	38.0	55.2	71.0
Europe & Central Asia	51.5	32.2	55.2	62.9
Latin America & Caribbean	78.0	58.1	25.6	47.3
Middle East & North Africa	-0.7	7.7	6.1	-3.8
South Asia	9.2	4.0	8.0	10.4
Sub-Saharan Africa	8.6	11.3	5.2	12.4
<b>All developing Countries</b>	<b>170.9</b>	<b>151.3</b>	<b>155.3</b>	<b>200.2</b>

Source: Global Development Finance 2004 Executive Board Draft

1.6 The greater appetite for emerging market bonds and the improvement over the last year in sovereign credit ratings resulted in a dramatic fall in sovereign bond interest rate spreads, with spreads hitting their lowest levels since 1997. While this is positive for developing countries in the short-term, the concern is that spreads may prove to be below what is warranted by country risk ratings and any changes in the factors underlying investor support (such as growth projections or government bond yields in industrialized countries) could lead to a reversal in the trend. If this were to occur, it is likely that credit spreads would rise quickly as liquidity in the market would tighten, strongly affecting countries or companies with high debt roll over needs.

1.7 In addition, the interest rates for international finance have shown a significant differentiation, as have other aspects of the international flows. New bonds issued by private sector borrowers have shown less spread compression than those for sovereign issuers, and spreads on syndicated loans have also not shown the same amount of decline. Spreads also have varied substantially by region.

1.8 **Greater Focus on Private Sector Development.** One very significant global trend is the increased importance that governments are placing on stimulating private sector development. While this has been an emerging trend for many years, the breadth of countries now committed to private sector development as the main engine of economic growth is unprecedented. In China, India and Russia, the transition to a private sector led model of economic growth is resulting in substantial improvements in the standards of living, even as these countries continue to be faced with the challenges of extending the benefits of growth to larger segments of their population and ensuring that growth is environmentally and socially sustainable. In frontier countries, the private sector is increasingly recognized for its potential, but the investment environment continues to be lacking in many dimensions – infrastructure, education, regulation, and business capacity. Governments in these countries are looking to IFIs to help them to improve the business environment for the private sector.

1.9 **Globalization and the Emergence of Global and Regional Players from Developing Countries.** In many cases, globalization is providing significant economic opportunities for developing countries, as demonstrated by the growth of trade and the emergence of global competitors. However, the benefits tend to go to those countries that have the strongest business enabling environments, including good infrastructure, health and education systems, again emphasizing the importance for private sector development of addressing these important investment climate issues. An increasing number of companies from developing countries such as China, Russia, India, Brazil, South Africa and Turkey are developing as global competitors,

and some have begun to look beyond their borders for growth opportunities. Corporations from many of these countries will play an increasingly larger role in interregional trade and “South to South” investment. They are becoming important partners in global supply chains and are likely to represent a fresh source of capital for less developed, frontier markets.

**1.10 Emphasis on Developing Local Financial Markets.** The development of local capital markets has been a high priority for country governments and development institutions for many years, as they are a critical element for enhancing local investment, growing the private sector and extending the benefits of growth to a larger segment of the population. The continuing withdrawal of international banks from emerging markets and the appropriate reluctance of governments and business to take the risks associated with unhedged foreign currency loans, are adding urgency to the need of making more progress in this area.

**1.11 The SME Challenge.** Governments have also been looking to the growth of small and medium businesses (SMEs) to provide jobs and develop the middle class. However, far too few economies are seeing sufficient SME growth. These enterprises continue to present unique challenges, as their need for access to capital and capacity building services is great, while they are disproportionately impacted by infrastructure and regulatory constraints. This will continue to be one of IFC’s major challenges.

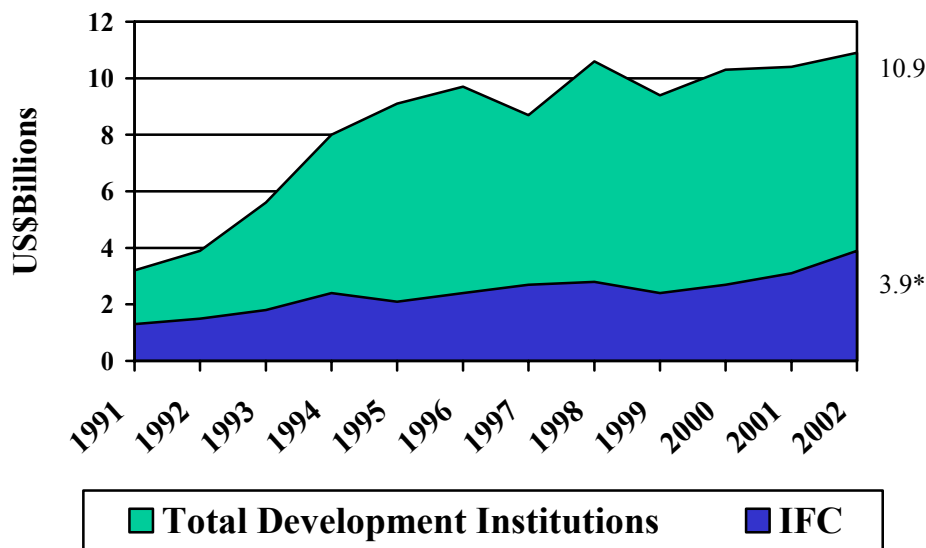
**1.12 Constraints to Private Sector Growth in Infrastructure, Health and Education.** Over the past few years, there have been growing challenges for private sector involvement in infrastructure (including communication and information technology), health and education. The infrastructure sector has continued to see declines in capital investment. Large private flows came into the infrastructure sector during the mid-late 90s, driven by the privatization programs of national utilities, the growth of independent power projects and the boom in telecommunications. The Enron scandal, the California power crisis and the adjustment in the telecommunication markets, affected many international sponsors, who withdrew from emerging markets. Furthermore, crisis related difficulties such as the default on IPP contracts in Indonesia, and the entangled issues in the utilities sector in Argentina after the devaluation, increased the reluctance of investors to re-enter the emerging markets. In the social sectors, the private sector is beginning to play a role in the expansion of services. Models for public-private partnerships in health and education have been developed, but adoption of these models is progressing slowly. Another important trend is the growth in the demand for local currency funding to meet infrastructure and social sector needs which are often being decentralized and financed at the municipal level.

**1.13 New Importance of Corporate Social Responsibility.** As the world economy becomes more integrated, there is a growing recognition by multi-nationals as well as companies in developing countries of the importance of addressing a range of corporate social responsibility issues and few financial institutions have succeeded in serving this need. Companies in countries such as India, China, Russia and in Latin America, are recognizing the benefits of good environmental and social performance for market and capital access, operational efficiency and better labor relations. This presents an important opportunity for institutions such as IFC that can provide advice in this area and whose presence signals high standards to the international community.

**1.14 Increased Lending to the Private Sector by International Financial Institutions.** Over the past several years, International Financial Institutions (IFIs) have increasingly

recognized the need to invest in the private sector of developing economies. In 2002 (the last year for data), the IFIs have continued to develop and strengthen their private sector financing activities, with the overall levels of commitments of IFIs somewhat higher than levels in earlier years. IFC's share of the commitments increased for the first time in many years, reaching about 35% (see Chart 1.3). Looking at preliminary results through calendar year 2003, we expect an overall increase in IFI volumes again this year.

**Chart 1.3: IFC's Financing Relative to the Total Private Sector Financing from Development Institutions**



\*FY03 Figure

1.15 IFIs are also expanding the product range they offer to include trade finance programs, guarantee products, equity funds, municipal finance and refinancing. They are using partnerships with major commercial banks to expand their coverage and capabilities, and for certain categories of investment, are offering subsidized financing, the impact of which might well be to distort capital markets. The trend of increased IFI activity is expected to continue and intensify. The net effect of these changes is that private sector clients will be offered a greater range of choices for finance from development-oriented institutions, in an increasingly competitive marketplace.

### **IFC Progress to-Date**

1.16 IFC has taken a great many steps in recent years to be responsive to an increasingly complex and dynamic external environment. Its key strategic priorities have been to invest in the development of domestic financial markets, infrastructure, health and education, as these sectors are critical for attracting and supporting the private sector, which has become the engine for growth in many developing countries. IFC has worked increasingly with the World Bank on improving the business climate in emerging economies and has focused on building the capacity of small and medium enterprises, in order to encourage job creation and empowerment of the

poor. IFC has placed special emphasis on investing in high-risk frontier countries, where the developmental impact could be the greatest.

1.17 To respond to the growing need for more differentiated services, IFC has also increased its client focus by greatly enhancing its presence in the field. In addition IFC has increased its technical assistance and advisory services, which are often needed to make investments successful and lasting. The Corporation has also led the way in making a business case for sustainability and has become recognized as a leader in environmental and social standards. IFC has weathered recent crises in emerging markets and has made steady progress in increasing its profitability and improving the quality and size of its portfolio.

1.18 **High Impact Sectors a Priority.** IFC continues to invest substantially in high impact sectors in order to strengthen the industries that contribute relatively more to development through “spill over” effects. These sectors represented 68% of IFC’s total commitments in FY2003, with commitments in the Financial Sector rising to 51% of total commitments, while Infrastructure and Information Technology made up 15% of commitments. The social sectors comprised only 1%, reflecting a highly selective approach in these challenging sectors. (See Table 1.3)

**Table 1.3: IFC Commitments in High Impact Sectors**

	FY01		FY02		FY03	
	US\$ mil.	%	US\$ mil.	%	US\$ mil.	%
Financial Sector	1,154	42	1,236	40	1,981	51
Infrastructure (excl. CIT)	321	12	445	14	465	12
Information Technology	297	11	295	10	132	3
Social Sectors	125	4	60	2	29	1
Total High Impact Sectors	1,897	69	2,035	66	2,607	68

- Financial Markets.** IFC investment in this sector now accounts for the largest share of its total committed portfolio at 29% in FY2003, up from 24% in FY2002. While providing investment capital, equity and Tier II funding to commercial banks continues to be an important part of IFC’s financial sector operations, the Corporation is also expanding into areas such as microfinance and housing finance and increasing its advisory activities. IFC SME investment finance for its own account (through financial intermediaries) was over US\$450 million in commitments in FY03 (about 12 percent of commitments), somewhat below the levels of recent years. However, there was a significant increase in commitments for microfinance projects, which reached US\$90 million in FY03 compared to US\$28 million in FY02. Technical assistance has been closely integrated with many of these microfinance projects to ensure the sufficient availability of knowledge and skills to create sustainable, commercially viable institutions.
- Infrastructure, Communication and Information Technology.** As the sector continued to witness the withdrawal of strategic investors, IFC has taken a counter-cyclical approach by proactively engaging in project development, acquisition financing, restructuring as well as refinancing of equity or loans. Where there are local currency markets, IFC has helped its clients access these markets and extend available maturities.

IFC's investment work continued to be complemented by its advisory services for governments in privatization and promoting public-private partnerships.

- **Health/Education.** IFC's committed health and education portfolio has grown to more than US\$230 million, nearly doubling since 2000, when the social sectors group was created in IFC. Health and education projects, while small in size relative to IFC averages, have generally had a strong developmental impact in delivering services that provide high private returns to users of those services, setting standards for best managerial, clinical and educational practices, and using innovative financing and delivery mechanisms. IFC's role in social sector projects has been equally strong, providing, in addition to finance, advice on corporate governance, financial management, and environmental and safety procedures. However, project risk management continues to be a challenge, due to the still nascent private sector role in these sectors. Here again, IFC's investment work is supported by advisory services.

**1.19 Increased Innovation in Financial Products.** To complement its work in promoting the development of domestic capital markets, IFC created the Structured Finance Group in 2000, to provide a broader range of financial products to its clients. The group provides clients with long-term local currency financing and partial credit guarantees, acts as a catalyst to mobilize additional financing for clients, and provides cross-border securitizations and credit derivatives. The group has mobilized a total of US\$1,952 million with IFC's credit exposure of US\$403 million through 26 transactions in 12 countries.

**1.20 Closer Collaboration with the World Bank on Investment Climate Work.** In the last two years, the World Bank and the IFC have significantly upgraded their work on investment climate issues in order to help client countries attract and grow their private sectors. The World Bank Group has expanded its work on investment climate surveys, the Doing Business indicator project, as well as on related operational work. To facilitate the flow of information regarding investment climate issues between the two organizations, the new Bank Group Private Sector Vice President has also been appointed as the IFC Chief Economist.

**1.21 New Focus for Technical Assistance Activities for SMEs.** IFC provides a broad range of technical assistance support to benefit SMEs, which is in large part delivered through its Project Development Facilities (PDFs) and the Private Enterprise Partnership (PEP). There are now 12 Facilities managed by IFC that support small business development including those in Latin America, North Africa, the Middle East, Sub-Saharan Africa, Indonesia, Bangladesh, Southeast Asia, China, South Pacific, the Former Soviet Union, and the Balkans. A major change over the last few years has been a re-orientation of SME support from providing direct assistance to individual firms for business plan development, capacity building or finance, to supporting institutions that service such businesses, including training firms, business associations, local consultants, and financial institutions. In addition, in the fall of 2003, the reporting lines for the various Project Development Facilities were changed, placing them under the responsibility of the IFC regional directors in order to strengthen the facilities' integration with regional strategy, products and services, with the SME Department continuing to provide expertise and dissemination of best practices. While these measures will improve IFC's delivery of services for SMEs, the Corporation is still identifying best practices for building capacity in this sector. It remains a challenge to persuade financial institutions to provide capital to SMEs, establish meaningful and lasting linkages between large companies and smaller ones and reach a

significant enough number of SMEs with technical assistance, to have a sufficient impact. Much has been accomplished, but there is great deal more to be done.

**1.22 Continued Emphasis on Investing in Frontier Countries.** IFC had a successful year in implementing its frontier strategy, as it increased its share of investment in high risk/low income countries in FY03. As Table 1.4 below indicates, the share of IFC investment fell below FY00 levels in FY02 then increased by one third to 28% in FY03. While progress has been made, increasing the percentage of new commitments in high risk/low income countries remains a challenge. Looking forward, this challenge is compounded by the graduation of a number of large economies from high-risk to medium or low-risk, leaving a set of smaller and more fragile countries as the focus for IFC's frontier strategy.

**Table 1.4: IFC Commitments by Country and Risk Rating\***

	<b>FY00</b> %	<b>FY01</b> %	<b>FY02</b> %	<b>FY03</b> %	<b>Forecast FY04</b> %
Frontier Country Projects	US\$M Total**	US\$M Total**	US\$M Total**	US\$M Total**	US\$M Total**
IICR Risk Rating Unrated and 0-30 or Low Income Countries	598 28%	1,003 41%	619 21%	874 28%	1,428 30%

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).

\*\*% Total Commitments excluding commitments to regional and global projects.

**1.23** As noted in OEG's Annual Review, poor results can occur when risks are "layered" in projects (e.g. poor investment climate and pioneering sector), while investment and development outcomes tend to improve when countries improve their business environment. Management has responded to this challenge by putting more emphasis on improving the investment climate in frontier countries and on capacity building for small businesses. In Africa, where IFC has started implementing its new strategy, an additional US\$15 million over 3 years has been dedicated to this effort, which has resulted in the launching of several initiatives including significantly enhanced and expanded SME programs, proactive upstream project development, more technical assistance and advisory services, and a focused engagement on investment climate issues by IFC.

### **Box 1.1: Learning from Operations Evaluation Group (OEG) Findings**

Lessons derived from experience are an essential element in performance improvement and strategy formulation. Among the various OEG reports in the last year, a number have had significant relevance to IFC strategy, including the Brazil and China Country Investment Reviews, the Extractive Industry and Power Sector Studies, and the Annual Review of IFC's Evaluation Results. Some of the key strategic points that emerge from these and other recent OEG reviews are the following:

**IFC's recent efforts are likely to lead to better project outcomes.** OEG expects recent IFC approvals to have better outcomes at evaluation than the recently evaluated sample of XPSRs (approvals '95-'97) as they should benefit from the steps taken to improve IFC's work quality.

**There is a strong link between IFC's investment and development outcomes.** There is not a trade-off between development outcomes and investment outcomes.

**IFC projects with extensive "risk-layering," or compounding of risk factors, have largely had poorer financial and developmental results.** IFC needs to carefully assess its projects to insure that focus on development does not lead to unwarranted compounding of risks. Particular attention needs to be made to working with second tier companies that may not have the management strength for difficult new projects.

**High risk or frontier countries and sectors do not necessarily mean low returns.** IFC projects in high-risk countries can have very good returns if the investment climate improves over the life of project. Similarly, projects where IFC has a strong role, such as in frontier provinces and sectors, tend to have better returns. IFC strategic sectors also tend to have better outcomes.

**In frontier countries, a focus on advisory work may be an appropriate precursor to investments.** IFC has had a good experience in a number of countries, such as Russia and Vietnam, where it has focused primarily on advisory work related to the investment climate and then moved to increase investment work.

**Equity investments are particularly vulnerable to investment climate issues.** A recurrent theme in OEG studies has been the difficulties of getting adequate straight equity returns due to poor investment regimes. Attention to these issues is particularly warranted in selecting investments and structuring appropriate equity instruments.

**The success of privatization and liberalization policies depend on country conditions.** In the power sector, (IPPs) have yielded good development outcomes under the right country, sector, and contractual conditions. However, there is no set solution regarding timing of investments and regulatory change. There are countries where "leapfrogging" to privatization has led to positive sector change, but there are others where this did not lead to sector improvements.

**1.24 Leadership in Sustainability.** An increasing number of IFC's clients, other financial institutions and investors are beginning to explicitly recognize IFC's leadership in the sustainability area and the value that its environmental and social standards and expertise provide. This is partly a result of a growing awareness among companies of the business case for sustainability. Among financial institutions, IFC has been able to get a first-mover advantage with respect to sustainability issues by developing and implementing new metrics, improving reporting, and advising its clients on how to improve their environmental and social performance. In June 2003, ten major international banks from seven countries adopted the Equator Principles, based on IFC's environmental and social safeguards and guidelines, as standards for their project finance activities. The Equator Principles are a major step forward for the industry, and an acknowledgement that IFC is becoming a standard setter in sustainability

work. Since June 2003, ten more banks, representing four more countries have joined, making the Equator Principles the new market standard, applicable to over 80% of the project finance market.<sup>1</sup>

1.25 Another important part of IFC's sustainability services includes assessing the corporate governance practices of its clients. IFC has a *Corporate Governance Unit* that provides assistance to investment officers in the evaluation of corporate governance issues at client companies, recommends improvement programs and benchmarks, and helps clients implement best practice. The quality of the approach has attracted the attention of other financial institutions, and recently FMO has asked to use IFC's appraisal methodology to train its own staff on best Corporate Governance practices. In addition, last year, IFC created an *Anti Money-Laundering/Combating the Financing of Terrorism (AML/CFT)* function to provide support for IFC staff and technical assistance for clients in identifying and combating money laundering.

1.26 IFC also encourages sustainable development by helping our larger clients develop "Linkage Programs" with local SMEs and the local community. The IFC works with its investment clients to design and implement custom-made linkages programs that help local entrepreneurs by improving access to finance, building capacity, and increasing market access. The linkage programs add value to clients by mobilizing other areas of IFC's expertise (e.g. microfinance, supplier financing, etc), lowering costs through the local procurement of more goods and services, enhancing community programs, and improving relations with various local stakeholders. All these benefits help deepen the development impact of IFC's projects. Since its establishment in fiscal year 2003, the Linkages Unit has initiated about 49 linkages programs, with 14 active projects, and 35 programs in the pipeline.

1.27 *IFC Against AIDS* was initiated three years ago to work with IFC clients to: 1) identify and analyze the risks that the AIDS represents for their business, and 2) provide guidance to establishing programs of HIV/AIDS education, prevention and care for the workforce of those clients and/or neighboring communities. By December 2003, IFC Against AIDS had been asked to work on about 30 projects and had 10 active projects. Most are in Africa<sup>2</sup>, but an increasing number are in Asia (India, Bangladesh, Indonesia). Sectors involved include cellular telephony, agribusiness, manufacturing, infrastructure, and oil, gas, chemicals and mining.

1.28 To address global warming and climate change, IFC has partnered with the government of The Netherlands to establish the IFC-Netherlands Carbon Facility ("INCaF"). INCaF purchases greenhouse gas (GHG) emission reductions (or carbon credits) from projects using the Clean Development Mechanism (CFM) of the Kyoto Protocol. The Facility provides additional revenues to eligible projects that generate emission reductions in developing countries by purchasing these for the benefit of the Netherlands. IFC also acts as a private sector partner for the Global Development Facilities ("GEF"), the official financing mechanism for the U.N. Framework Convention on Climate Change. With the support of GEF funding, IFC also invests in renewable energy and energy efficiency projects.

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<sup>1</sup> Participating banks as of January 2004 are: ABN Amro, Barclays, CIBC, Citigroup, Credit Suisse Group, Credit Lyonnais, Dexia, Dresner Bank, HSBC, HVB Group, ING, Mediocredito Centrale, Mizuho Corporate Bank, Rabobank, Royal Bank of Canada, Royal Bank of Scotland, Standard Chartered, West LB, Westpac and KBC Bank.

<sup>2</sup> For example, the most advanced program, with a Brazilian company in Angola, has reached 100,000 company employees and their families.

1.29 **Greater Client Focus.** In order to be a provider of value-added services beyond financing, IFC needs to be more proactive to the changing imperatives of specific markets and more responsive to client needs. To accomplish this, IFC has increased its presence in the field. As a result of the FY03 Corporate reorganization, staff located in the field continues to grow, with currently 43% of the staff located in 55 field offices in FY03. It is expected that through a larger field presence, IFC's regional departments will increase their market understanding, and begin the process of enhancing long-term relationships with domestic clientele from both the private and public sectors. This should pay off in terms of an increased ability to engage companies in activities with broader development impact, such as sustainability and South-South investments, as they become regional and/or international players, and to assist governments in providing a better regulatory environment for businesses. However, attracting and retaining seasoned employees in the field will continue to be a challenge, especially as other institutions compete for these same valued resources.

1.30 Despite the challenges, it appears that the decentralization combined with a systematic approach to business development (as a result of the FY03 reorganization) as well as a more pragmatic application of IFC's investment policies, is beginning to show dividends, as evidenced by the increase in commitments and the improved client survey results. Client satisfaction in FY03 was up 9% from the previous year across departments. IFC's client service has been showing sustained improvements over the last three years, with client responses to the annual survey indicating that the Corporation's technical and industry expertise continues to be valued.

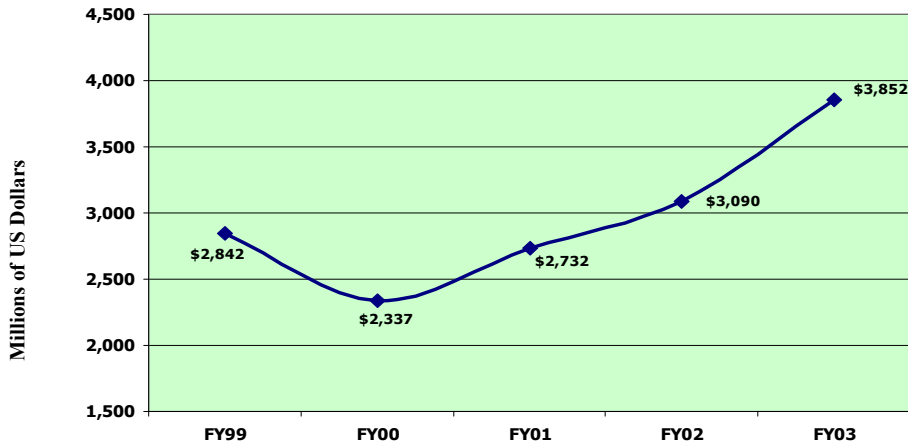
1.31 **Investment Commitments Grow and Profitability Increases.** IFC showed substantial portfolio growth, as new commitments in fiscal year 2003 increased 24.7% to about US\$3.9 billion (See Chart 1.4). At the end of December 2003, new commitments were US\$1.4 billion (about 38% of FY04 targets and ahead of the equivalent FY03 figure), indicating the potential for another strong performance in fiscal year 2004. The Corporation disbursed US\$3.0 billion for its own account in FY03 vs. US\$1.5 billion in each of FY02 and FY01.

1.32 IFC's financial performance has been steadily improving. In FY03, the Corporation's operating income rose significantly to US\$528 million. The main drivers of this strong financial performance were a stabilization of the loan/equity portfolio quality as provisions for losses declined to US\$98 million, from US\$657 million in 2002, and above-benchmark returns on all liquid asset portfolios, resulting in income from trading increasing by US\$126 million. On a three year average basis, operating income for FY03 was US\$355 million, demonstrating a gradual recovery to the mid-90s level. This upward trend in operating income is expected to continue. For FY04, based on current assumptions<sup>3</sup>, the Corporation is positioned to meet or surpass FY03's record operating income.

1.33 The Corporation's ROE was 8.2% or 8.7% when adjusted for specific contributions to technical assistance and advisory facilities. The methodology for calculating the adjusted return on equity calculation is discussed further under Measurement in paragraph 3.27, and in Annex 1.

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<sup>3</sup> Assumptions include (i) absence of negative developments in the Corporation's high exposure borrower countries, (ii) absence of any event that would negatively threaten global financial markets as a whole, (iii) completion of equity sales as anticipated, and (iv) absence of a significant rise in interest rates in the second half of FY04.

**Chart 1.4: IFC Annual Commitments**

**1.34 Greater Portfolio Diversification.** IFC has expanded the geographic breadth of its investment and advisory operations. Investments in Eastern Europe and Southern Europe have now become the second largest after Latin America in terms of new commitments. The portfolio has become more diversified, with top 10 country exposures accounting for a smaller share of the portfolio (46.5%) than five years ago (53.2%).

**1.35 Credit Quality is Slowly Improving.** The quality of IFC's portfolio is showing some signs of improvement. Provisions for losses in the equity portfolio declined from 29% of the total equity portfolio in June 2002 to 20% in December 2003 and loan provisions declined from 16.7% of the disbursed portfolio in FY02 to 13.0% in FY03. These improvements are the result primarily of a decided buoyancy in the equity markets and general improvement overall in IFC's principal exposure countries as well as large reversals of provisions taken on IFC's Argentina portfolio. However, it should be noted that these results also reflect a significant increase in investment write-offs. Thus, despite some progress being made in resolving a number of problem loans, non-performing loans (NPLs) rose from 11.7% in December 2001 to a peak of 18.3% in May 2003, mostly on account of the crisis in Argentina and its impact on IFC's portfolio. NPLs have since fallen to 16.5% as of December 2003, and are expected to continue to decline. The Corporation is making an increasing effort to book better performing assets to retain a strong portfolio, even while continuing to invest in high risk frontier countries. IFC recognizes that development does not need to come at the expense of profitability, and in fact, the two go hand-in-hand. IFC has taken a number of steps to improve credit quality over the past few years, including additional intensive credit training and development of enhanced approaches for risk assessment and pricing, such as the Capital Pricing and Risk (CAPRI) Project.

## SECTION II: IFC'S STRATEGIC PRIORITIES

2.1 Based on the changing external environment and the challenges facing IFC, the Corporation has identified five strategic priorities to increase its developmental impact, grow its portfolio, further strengthen its financial position and improve market responsiveness. They are as follows: 1) strengthen the focus on frontier markets with emphasis on the SME sector; 2) build long-term partnerships with emerging global players in developing countries; 3) differentiate through sustainability; 4) address constraints to private sector investment in infrastructure, health and education; and 5) continue to focus on the development of domestic financial markets through institution-building and the use of innovative financial products.

2.2 **Strengthen the Focus on Frontier Markets.** For many years, one of IFC's main strategic priorities has been to focus on frontier countries. While IFC has continued to make progress in this area, it is becoming increasingly clear that to meet the challenges in these markets, IFC will have to work on two fronts. First, it will need to scale up its provision of technical assistance and advisory services, and second, it must take a more proactive approach to project development. IFC's technical assistance and advisory services will continue to focus on both governments and private industry to improve the framework for investment and increase the capacity of businesses (mostly small and medium businesses) to thrive and grow.

- ***Advice to develop the support infrastructure for small and medium enterprises (SME).*** This includes the work of the Project Development Facilities and Private Enterprise Partnership facilities, the Global Business School Network, closer collaboration with the World Bank private sector development groups and enhanced partnerships with IDA. The focus of these efforts is in areas such as training advisors to small business, developing effective business associations and educational institutions, improving banks' lending practices for small business, developing linkage programs between large and small businesses and providing selective direct support to small businesses.
- ***Advice to governments – on general investment climate issues and privatization.*** The objective of such advice is to create an environment for successful private sector projects, including IFC investments. It includes the work of FIAS and the SME Project Development Facilities on investment climate issues, the work of the Advisory Services Department on privatization transactions, and Financial Markets Advisory services work on creating viable financial systems.

2.3 In addition to scaling up its technical assistance and advisory services, IFC will seek to take a more proactive approach to project development, including regional projects in collaboration with private sector partners, Governments, as well as the World Bank/IDA. This could take the form of advisory services or investments in project development companies, the purpose of which would be to bring projects to the stage where they can become bankable. By taking the initiative to bring potential partners from the private and public sectors to work in tandem, IFC would be aiming at helping realize more viable projects, with a large development impact.

### **Box 2.1: SME Initiative with IDA in Africa**

An example of a new initiative to enhance the range of opportunities for SMEs is a series of integrated IFC/IDA Micro, Small and Medium Enterprise (MSME) operations in Africa. The first of these joint operations was approved in December by the IDA Board for Nigeria. IDA funds will be used to support capacity building and technical assistance to firms and to financial institutions oriented to MSMEs, as well as initiatives to improve the business environment for small enterprises. IFC will target investments in SME financing institutions and microfinance, and use the experience gained via APDF and other IFC initiatives to expand successful capacity building programs with IDA funding. Similar programs are being developed for Madagascar, Kenya, Uganda, Tanzania, Ghana, Mozambique, Burkina Faso, Rwanda and Mali. The implementation of this initiative is proving somewhat more cumbersome than originally expected, as the management of both institutions work to put in place procedures and processes to address potential conflicts of interest by IFC as a lender to SME organizations which may also receive IDA funding under the joint program. Specific measures are being worked out with the IFC-Bank Conflict of Interest Office, which should enhance the chance of success of this initiative and the opportunities for its replication.

**2.4 Build Long-term Partnerships with Emerging Global Players in Developing Countries.** Emerging global businesses can be an important engine of growth in developing countries. IFC is in the unique position to use its global reach and experience in markets around the world, combined with its sustainability expertise, to help these companies engage in sustainable projects beyond their national borders. This is becoming particularly important as domestic financial institutions do not yet have the financial, technical or environmental expertise needed to meet their needs and international banks have withdrawn from long-term cross-border finance. Facilitating South-South investments encourages efficient resource allocation within and between regions and can have a substantial developmental impact. Similarly, attracting, nurturing and retaining emerging global companies as clients will enable IFC to influence their adoption of good corporate governance and high environmental and social standards. IFC's ability to stand by its clients during times of growth as well as through periods of volatility or crisis will help it deepen long-term relationships with such clients. As a global leader in emerging market finance and sustainability expertise, IFC is positioning itself to become the "partner of choice" for these clients.

**2.5 Differentiate through Sustainability Competencies.** IFC invests on a commercial basis, and this remains at the core of the Corporation's approach. However, IFC has the ability to broaden this core competency by providing other value-added services to its clients. IFC is able to offer its clients a combination of diverse financial products, global knowledge in key industries, risk reduction as an affiliate of the World Bank Group, and a broad array of advisory services, particularly regarding sustainability. In a context where clients have an increased range of choices among IFIs, including some positioned as low interest rate lenders, IFC's comparative advantage is to provide these value added services along with funding to its clients, rather than just provide capital. By building on its sustainability competencies, the Corporation will be able to differentiate itself to its clients, while providing higher quality services and greater developmental impact.

**2.6** In order to pursue this strategy, IFC needs to develop capacity and proactively market its capabilities in environmental and social management, corporate governance as well as supplier and local community linkages. IFC has developed the tools to help its clients take advantage of

opportunities in these areas, which strengthen the long-term viability of their businesses. However, IFC will need to keep investing the resources to deepen its capability to deliver these services to clients and integrate its sustainability skills more thoroughly throughout its operations.

**2.7 Address Constraints to Private Sector Growth in Infrastructure, Health and Education.** IFC has a strong role to play in helping the infrastructure industry and social sectors overcome the regulatory, financing and implementation constraints facing this sector. It will focus on the following elements:

- Participate in the creation of new models of private-public partnerships;
- Provide input and advice on improvements to regulatory frameworks;
- Expand the use of local currency products and provide other innovative financial products, to encourage private sector investment in these sectors;
- Expand pioneering work in private sector financing for municipalities to develop infrastructure projects at the local level;
- Help foreign investors in these sectors to stay and keep investing in emerging markets;
- Address outstanding distressed asset issues, the resolution of which will be important to maintaining the credibility of the World Bank Group in this sector; and
- Form partnerships with the World Bank/IDA to address sector-wide constraints in a comprehensive manner.

**2.8 Continue to Emphasize Local Financial Market Development Through Institution Building and by Use of Innovative Financial Products.** IFC focuses on developing domestic financial markets that support the growth of the private sector through: (i) financial and capacity-building support to local financial institutions, and (ii) development of innovative financial products. IFC's support to building financial institutions aims at improving the efficiency of financial intermediation and the access to finance for the underserved. In this regard, special attention will continue to be given to providing advisory services and helping financial institutions address increasingly important environmental, social, and corporate governance issues. A growing emphasis is also being placed on housing finance as well as SME and microfinance activities and supporting the development of insurance and retail banking services in high-growth frontier and middle-income countries. IFC will also make use of its comparative advantage in developing innovative products through risk sharing, credit enhancement and guaranty facilities. By providing a broad range of financing structures, IFC will create capacity in the market for commercial investors to take emerging market risk. This will allow IFC to leverage its investments in the financial markets sector as well as provide a strong demonstration effect which would lead to greater local market development.

**2.9** The strategic priorities outlined above should enable IFC to strengthen its leadership as a global investor in emerging markets, and fulfill its mandate as a development institution in a changing and increasingly complex market environment. In pursuing these priorities, the Corporation recognizes the importance of maintaining a balanced regional and sectoral mix and a corresponding balance of investment and technical assistance activities. As importantly, IFC will continue to give great weight to booking good assets, being mindful that profitability is the foundation of development impact, and that solid financial health is required for IFC to continue to invest in and expand its value-adding noncommercial activities.

### SECTION III: NEXT STEPS IMPLEMENTING THE STRATEGY

3.1 To implement these strategic priorities, IFC must build up its capabilities to deliver high quality services. To support Frontier countries and SMEs, IFC will seek in particular to make better use of its Project Development Facilities and linkages programs. It will strengthen its investment climate work by fostering greater synergies with FIAS and the World Bank Private Sector Development (PSD) network and by creating partnerships with IDA in frontier countries. In addition, IFC will continue to strengthen its capabilities in the field with a focus on nurturing relationships with emerging global businesses, and assisting these clients in obtaining sustainability competencies and making South-to-South investments. By mainstreaming sustainability into its operations and updating safeguard and disclosure policies, IFC will also seek to remain “ahead of the curve”.

3.2 To help alleviate the constraints to infrastructure development, IFC will target in a more systematic manner, the creation of public-private partnerships, the use of local currency instruments and the development of appropriate financing structures. Regarding financial sectors, where, despite substantial progress, there continues to be significant need for instruction building and broadening access to finance, IFC will scale up its activities in non-bank financial sectors (e.g. microfinance, housing finance), while extending the use of new products in additional markets. To achieve these results, IFC must have a staff with the right skills mix and an appropriate incentive system. IFC will continue to implement a career management and accountability/incentive system that will create a high performance, merit-based organization, with a highly diversified workforce.

3.3 **Scaling up Technical Assistance and Advisory Services.** One of IFC’s priorities will continue to be the development of new investments in frontier markets. As discussed earlier, this will require strengthened advisory and capacity building services to create the environment conducive to new investment and to develop the capacity of local business. To implement this objective, IFC will also focus on more thoroughly integrating its Project Development Facilities (PDFs) and other advisory facilities with its regional strategies.

3.4 In addition, IFC will introduce a number of changes to its Project Development Facilities and SME related activities. They will include the following:

- In Africa, the Africa Project Development Facility is being restructured and re-oriented, broadening its mandate from SME business plan development to working on the enabling environment and delivering more effectively capacity building and advisory services for organizations and associations serving the SME sector. The new business model for APDF is being discussed with key donors in March 2004, with a final plan to be circulated in April. IFC is also piloting a new platform for delivering comprehensive support to SMES in a IFC-branded sites called *SME Solutions Centers (SSCs)*. The SSCs will combine existing programs of the SME facilities with other business services. These centers will have physical facilities and technology to provide SMEs with access to business information while also including financing vehicles managed by IFC partnerships. These centers will be rolled out over three years.
- In MENA, the Private Enterprise Partnership for the Middle East (ME-PEP) was approved by the Board in December 2003, and will set up advisory programs for SMEs in Afghanistan, Yemen, Iraq and the West Bank/Gaza (See Box 3.1 below). In the

meantime, the North Africa Enterprise Development Facility (NAED) in Algeria, Egypt and Morocco, is becoming quite active, working with banks on small business and microfinance, developing linkages programs, and helping strengthen the capacity of local consultants and business associations, and working with the World Bank on investment climate surveys and programs.

- In LAC, a new PDF facility was approved (LACP), initially targeting four core countries: Bolivia, Peru, Honduras, and Nicaragua. The facility will undertake some early, limited outreach activities in nearby countries, and will subsequently consider expansion into other countries in the region if the initial activities are successful.
- In Europe, the PEP for the former Soviet Union will continue to expand its services with programs being undertaken in Mongolia and Kazakhstan. As promised to its donors, SEED (Balkans facility) is exploring options to spin-off parts of its service to local providers, while leaving donors with the option of funding a second mandate for SEED as whole, or to fund a particular service, or project.
- In East Asia, the Program for Eastern Indonesia SME Assistance (“PENSA”) has become operational, and one of its early focuses will be to build supply chain linkages between local SMEs, local communities, and larger multinational enterprises based in Indonesia.
- IFC’s *SME Capacity Building Facility* (CBF) is another important component of IFC’s effort to increase the capacity of SMEs and organizations that serve the needs of the latter. CBF focuses on innovations and identifying partners that can work with IFC investment and technical assistance teams globally. Through CBF, IFC is broadening its impact on local businesses, fostering exchange of experience among key institutions on a global basis, and creating long-term sustainable impact on the business infrastructure for SMEs. CBF is also working to disseminate lessons learned in its SME initiatives and identifying opportunities to replicate previous successes in new regions or projects.
- IFC and the World Bank are supporting the development of the Global Business School Network (GBSN), which aims at increasing the supply of skilled local managers in emerging markets via strengthening the local business-training infrastructure. The project includes links between local and global business schools to develop initiatives in such areas as MBA programs and SME/entrepreneurship development. This public/private partnership will also include linkages to local governments, IFIs, foundations, trade groups and corporations. Pilot programs are being developed in Africa and Asia, with the goal of disseminating best practices to leverage results. The program supports the IFC’s work in SME capacity building, and also provides an important value-added component to IFC investment operations in the education sector.

### **Box 3.1: Middle East Private Enterprise Partnership (PEP-ME)**

IFC is in the process of implementing the Private Enterprise Partnership for the Middle East (PEP-ME), which was approved by the Board of Directors in December 2003. PEP-ME will cover four countries/territories: Afghanistan, Iraq, West Bank Gaza and Yemen. IFC will contribute \$10 million out of the expected total cost of \$40 million over the next four years. Overall, PEP-ME will focus on improving the business and regulatory environment,, strengthening financial institutions and markets, stimulating the growth of SMEs, and assisting in the restructuring and privatization of state-owned enterprises. The relative emphasis will vary according to the needs of the individual markets. The program was patterned after the Private Enterprise Partnership (PEP) in the Former Soviet Union, where a broad-based flexible approach to private sector development has yielded strong results. The new PEP-ME will be managed out of Cairo, and will have representation in each country/territory.

3.5 IFC's technical assistance and advisory services are financed by a combination of donor contributions (via Trust Funds and donor support to special facilities), direct IFC support through use of the administrative budget, and user fees. They are managed and implemented by IFC through a combination of in-house staff and hired consultants at headquarters and in the field. In FY03, the facilities spent approximately US\$76.4 million dollars on advisory work, of which approximately 35% came from IFC's own account and 65% was raised from Donors. IFC believes that donors will continue to fund a good part of its technical assistance and advisory services. However, it is also becoming clear that IFC must streamline and strengthen its sources of funding for technical assistance and advisory service.

3.6 In order to address the above issue, Management proposes that consideration be given to the creation of an IFC Technical Assistance and Advisory Fund, to which IFC would allocate a portion of its profits with the objective of ensuring the sustainability and predictability of its funding sources for technical assistance. The Fund would be used to finance: (i) technical assistance to Governments, public sector entities and private sector entities either in the context of a specific project or broader sectoral approaches; (ii) Project Development Facilities, which are focusing on SME development, capacity building and corporate governance initiatives; and (iii) project development costs in frontier markets. Every year, a portion of IFC net profit would be allocated to the Fund, when IFC's net profit is larger than US\$150 million. In this way, IFC believes its contributions to Technical Assistance and Advisory Services will be carried out in a more systematic and transparent way which will be tied to IFC's ability to allocate to the Fund from earnings, thus providing a stable core commitment to our donor partnerships.

3.7 A working group has also been tasked with clarifying the strategic role of Donor Funded advisory services and capacity building activities and to make recommendations on how to enhance their effectiveness and efficiency. Specifically, the working group is examining reporting and monitoring systems, stability and management of sources of funds, donor relationships, personnel management. The goal is to ensure best practice development and knowledge sharing among the various work units, and organizational arrangements that maximize effectiveness in service delivery. Through a detailed program-by-program review, the plan is to develop a strategy, which contemplates the needs of each of the advisory operations managed by IFC and finds a balance between IFC's and donors' needs. The working group is expected to present its recommendations to Management by end of FY04.

3.8 **Strengthening Client Focus.** To position itself as a catalyst of cross regional investment and trade and broaden the impact of its sustainability work, IFC must move to become the

“partner of choice” of emerging global businesses from developing countries. No other institution is better positioned to do so than the IFC with its worldwide private sector experience and its access to governments as part of the World Bank Group, its ability to bring additional thought leadership in the sustainability area, and its ability to cross-fertilize its relationships across regions. To deliver in this area, however, IFC will need to leverage the Corporation’s core competencies with a more field-based and client-oriented approach built along the following principles:

- ***Staying close to the market with a strategic focus.*** IFC is becoming less head quarters centric and more field-based, and as a result is improving of its understanding of local markets and becoming more effective in developing business. IFC must build on this trend, placing more experienced staff in the field with the objective of keeping the corporation “ahead of the curve” as an innovator and influencer of the external environment instead of being merely reactive;
- ***Building long-term relationships through repeat business.*** IFC is pursuing long-lasting relations with its clients with a view to better understanding client needs, promoting sustainable business practices and influencing corporate strategies; and
- ***Broadening the scope of its engagement with clients by providing sustainable practices and corporate governance advice and Encouraging South-South investments.*** IFC is uniquely positioned to provide additional value to its clients by sharing with them the tools it has developed to help establish world-class environmental and social policies and corporate governance practices, and nurturing a client’s growth and expansion.

**3.9 Delivering on Sustainability.** IFC’s efforts to integrate sustainability into its operations have broadened and accelerated, increasing the Corporation’s capability to help clients identify opportunities to add value to their operations, in addition to mitigating risks associated with environmental and social issues. This capability has provided IFC with the ability to offer products and services that are currently “cutting edge” in the market and add value to its clients. The challenge for IFC is to continue to innovate in the area of sustainability and to instill this expertise throughout the Corporation. IFC is taking the following steps to achieve this objective:

**3.10 Incorporating sustainability into operations through mainstreaming:** Delivering value to its clients and better project results for its member countries requires improving the delivery and efficiency of its work on Environmental and Social issues even further. Therefore, IFC has embarked on a program to fully integrate sustainability issues into its core business, by integrating them more closely with investment work. Environment and Social staff, located in the investment departments will work closely with investment staff to improve the environmental and social aspects of projects by early engagement on business promotion, sponsor selection, and supervision that fully integrates environmental and social considerations into the review process. The mainstreaming process has been piloted in three departments: Oil, Gas, Mining and Chemicals; Global Manufacturing; and Infrastructure and will be rolled out to the rest of the departments by FY05. Several tools are available or under development to help investment officers and business developers move beyond a general discussion of sustainability with clients and actively seek ways to add value to project outcomes and sponsor capabilities. Mainstreaming also significantly improves IFC’s ability to find convergence between financial and environmental and social objectives.

3.11 ***Increasing sustainability training:*** In the same vein, differentiating IFC and adding value in the sustainability area requires investment staff to have understanding and skills well beyond what is currently available in business schools. Therefore, IFC has begun to improve the capabilities of its investment officers and managers to deliver value-added services. Many industry and regional departments have received sustainability training on a pilot basis specifically tailored to the business environment or region in which they work. This training effort has been complemented in FY04 by Corporate-wide *Sustainability Learning Program* pilots, which provide more in depth training into approaches that integrate sustainability into the IFC business model, including hands-on training for sector teams using actual business opportunities. Given the early success of these pilots, it is expected that such programs will continue in FY05.

3.12 ***Increasing capacity to deliver other value-added services.*** In addition to integrating environmental and social issues into the Corporation's core business processes, Management is focusing on increasing the Corporation's ability to add value in the areas of corporate governance, linkages programs, HIV/AIDS, and entrepreneurship for women. The challenge for IFC is to develop sufficient expertise throughout the Corporation in these areas in order to be able to consistently deliver meaningful services to its clients in a timely and efficient manner. The Corporate Governance group has provided training for all of the Corporation's industry departments and a number of field offices and is examining ways in which it can increase the capability of IFC to provide corporate governance advice in a more systematic fashion.

3.13 In the Linkages area, the focus is on strengthening and deepening IFC's expertise in order to deliver world-class programs to its clients. Client surveys and measurement systems are being put in place that will help the Corporation increase its understanding of the quality of its existing programs and determine where there are gaps to be filled or services to be expanded. IFC Against AIDS is launching a training program to enable SMEs to tackle the challenge that HIV/AIDS poses to their business. This training will be delivered in association with other IFC SME-support programs such as APDF and the Linkages Program and will include participants from various companies and local NGOs. A series of internal IFC training programs are also beginning, in order to help build investment staff capabilities in identifying and responding to potential client needs in this area.

3.14 As part of its drive to provide new value-added services to client companies, while furthering its development impact, IFC is also developing a practical approach to encouraging the participation of women in the private sector. Women entrepreneurs represent a large percentage of the work force, and entrepreneurship is a key to the way out of poverty for women in developing countries. Women also have a higher loan payback ratio than men, therefore creating a commercial opportunity. As one of the first steps, IFC will build best practice models for the economic participation of women in the private sector, and will explore potential opportunities to implement them through existing mechanisms such as the SME linkages program.

3.15 ***Expanding the reach of the Equator Principles.*** IFC will continue to strengthen the impact of its Safeguard policies and principles by developing training and support for the Equator banks as they begin to implement the principles. IFC will also explore expanding the Equator principles to other players in the financial markets such as insurance, housing finance and leasing companies.

3.16 ***Implementing the recommendations from the CAO reviews.*** The Compliance Advisor/Ombudsman released in April 2003 a review of IFC's Safeguard Policies which assessed the effectiveness and impact of the safeguard policies and identified emerging gaps in their implementation. Management has responded to the CAO review by launching a process to update IFC's safeguard and disclosure policies to be consistent with the conclusions and recommendations of the CAO report, including improvements in areas such as human rights, core labor standards, and financial markets clients. The review of the disclosure policy is likely to recommend ways to strengthen and enhance IFC's disclosure policy in order to provide better communication with the Corporation's stakeholders on its projects. Following the internal update process, there will be wide-ranging public consultations with stakeholders by the end of FY04/early FY05 on the suggested framework and details of the policies. These initiatives will ensure that IFC remains a standard-bearer in the area of environmental and social policy.

3.17 **Building New Financing Models in Infrastructure, Health and Education.** As noted in Section II, private investors in infrastructure projects in developing countries have continued to withdraw as a result of the impact of crises at home and in emerging markets, not the least with regard to socially sensitive sectors, such as electricity distribution, and water sanitation. Greenfield private infrastructure investment activity has substantially slowed in most of Latin America, but is continuing to grow in South Asia (particularly India), East Asia, and to some extent in Eastern and Southern Europe, and has come to a virtual standstill in Africa across a broad range of sectors. In the Social Sectors, private sector participation remains low and identifying sustainable, quality projects remains a challenge.

3.18 IFC is responding to changes in the marketplace by modifying its approaches when appropriate and targeting in a more focused manner the constraints affecting these sectors. First, IFC is working on creating new models of public-private partnership. Several experiments are underway to leverage IFC's investment and advisory capabilities with the World Bank's policy reform expertise and IDA funding, as well as MIGA risk mitigation services, to create new solutions for governments looking for private participation in infrastructure beyond the traditional privatization and concessions models. In the health sector, IFC is looking to expand its support of public-private partnerships that reach people from all income groups. It is currently financing a private group that provides publicly funded services throughout Central and Eastern Europe.

3.19 Second, as much of the responsibility for providing many infrastructure and other services has been passed to sub-sovereign entities, there is a need for the Bank Group to become involved in this area without recourse to national government guarantees which are increasingly unavailable. The municipal fund is a special unit that has been created to gain market knowledge by making selective direct investments in municipal projects, without sovereign guarantees. Currently, the fund's investments are made using IFC's balance sheet but its investment committee includes representatives of the World Bank. Based on its experience today, the municipal fund team, in cooperation with other parts of the Bank Group, will develop ideas for the Bank Group to scale up its activity in this area.

3.20 Third, IFC is adopting a comprehensive approach to developing infrastructure projects in close collaboration with the Bank. This involves intensive efforts on early project preparation and development. In Africa, IFC and IDA financing is being leveraged with donor funds and co-financing from AFDB, EIB and Proparco. (See discussion in Box "Infrastructure Partnership with IDA" below).

### **Box 3.2: Infrastructure Partnership with IDA.**

In order to expand the number of viable infrastructure projects developed in Africa, IFC has created a set of unique partnerships with IDA. Africa has largely failed to benefit from the expansion of private investment in public services, which has been seen in many parts of the developing world. Given the current depressed state of the global infrastructure market, Africa may continue to be left behind unless new models of public-private cooperation can be developed in order to help overcome the many challenges governments and private investors face in this area. In this regard, on a pilot basis, IFC and IDA have teamed-up with the governments of several African countries in order to help them to create the conditions under which private investment in the power sector can take place.

Two notable examples where IFC has played a key catalytic role along with IDA are the power sectors in Senegal and Ghana. In each of these countries, a joint IFC-IDA team has been working closely with the Government and private industry to provide a program, which comprehensively addresses the issues facing the power industry. For example, in Senegal, IFC organized trust funds and commissioned a study to assess the investment requirements of the electricity sector. Based on the results of this study and preliminary market soundings, IFC and IDA advised the Government to invite the private sector to develop an Independent Power Project (IPP). IFC contacted a number of international companies who could be potential bidders for the IPP, while IDA arranged trust funds for advisors to help the Government with the bidding process, and supported the Government in assessing and monitoring private sector participation in the sector. Two international companies have submitted bids for the project and the winning bidder should be selected by the end of March 2004. It is expected that a combination of IFC, IDA and MIGA will provide financing support for the once the winning bidder has been selected.

In Ghana, IDA is coordinating with donors to complete with economic analysis of the sector, while IFC has prepared a sector model to provide the Government a powerful planning tool that captures the cash flow impact of all the various parts of the sector. IFC is looking to finance a crude-oil fired IPP (Takoradi II) that is majority owned by a U.S. company, to help to convert the plant to a combined-cycle operation, thereby increasing electricity supply without additional fuel consumption, which will help reduce tariffs in Ghana. The joint IDA-IFC team is helping the Government to implement a private management contract for the state-owned electricity distribution company and IDA will make available financing for much needed capital investments in the distribution network. This is expected to result in reduced losses, higher collections and efficiency improvements, which should help the overall sector become self-sustaining.

3.21 Fourth, IFC will continue on a selective basis, to provide re-financing of sponsor equity or bridge loans (see “take-out financing” box below) and acquisition financing in situations where alternative commercial financing is not available due to political or sector uncertainty and where adequate returns could be captured by the Corporation.

### Box 3.3: “Take-out” Financing

#### Take-out Financing vs. Refinancing

Recently, the Board requested the clarification of IFC’s policy on “refinancing”. The most common form of IFC refinancing replaces short or medium term debt of a company with long term debt, or foreign debt with local currency debt. These refinancings usually provide support for the restructuring efforts of the company, and there is general agreement on the benefits and IFC’s role on these types of refinancing. On occasion, however, IFC is requested by the sponsor of a project to get involved in “Take-out financing”, whereby IFC financing replaces some of the sponsor’s capital, during the operational phase of the project. In FY03, IFC only agreed to undertake four such take-out financings out of 189 approved projects and only three so far in FY04 out of 73 approved projects. However, this type of refinancing is of particular concern to some Board members, since it usually involves foreign sponsors and a reduction in the sponsor’s equity or bridge loan exposure to the project.

#### Why Take-out Financing?

While take-out financing is relatively rare and IFC is very selective in engaging in this type of financing, the Corporation believes that, in markets where commercial financing is not available, and investors are withdrawing from the market, as is the case in the infrastructure sector today, IFC has a role in providing the assistance companies need to make their investments sustainable and competitive. This is not to bail out project sponsors, and take-out financing would only be considered when IFC’s involvement would help achieve a normal project finance structure, allowing project costs to stay within the industry norm and providing IFC with an commensurate return. Take-out financing would also not be a method for Sponsors to circumvent IFC’s appraisal and due diligence standards, including environmental and social guidelines. An overall review of the project’s compliance from inception with IFC’s environmental and social practices would be conducted and, if appropriate, IFC would utilize the opportunity to strengthen and expand good environmental and social practices.

3.22 Fifth, IFC will use innovative structures and products for infrastructure and social sector financing. Local currency financing can be very attractive in projects where the revenues are earned in local currency, and allows IFC to more effectively address the needs of its clients. Where there are currency swap markets, IFC will seek to finance projects with long-term, local currency debt. In South Asia, for example, IFC recently structured and financed an electricity transmission project in India with long-term Rupee-denominated financing, the first private transmission project in a developing country in Asia. Where IFC cannot have direct access to local currency funds, it will seek to provide wherever possible partial credit guarantees to achieve similar results.

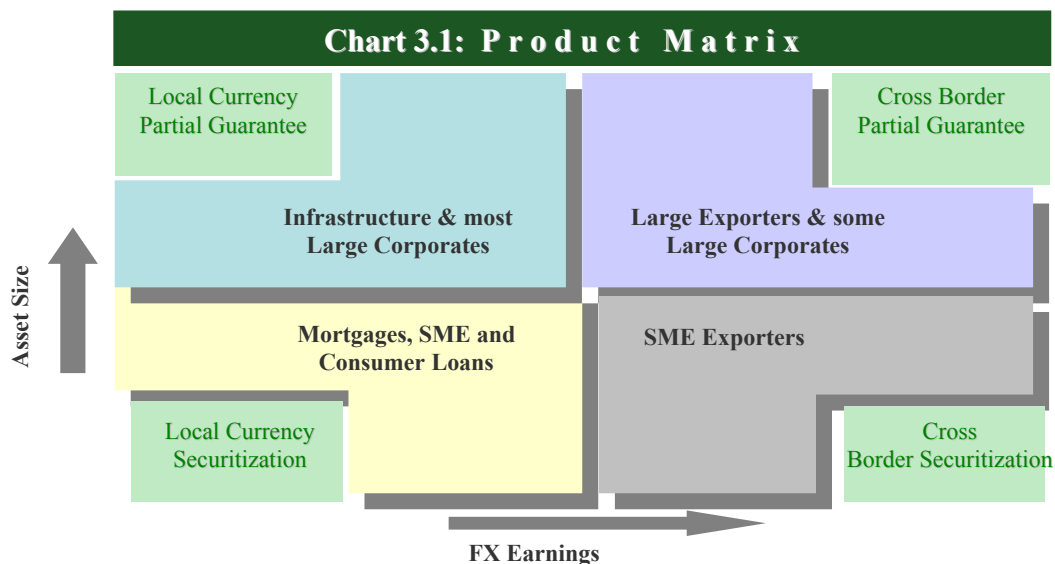
3.23 Sixth, IFC is investigating ways to provide financing to small health and education facilities, which comprise the bulk of private providers in the Africa region. IFC is currently developing a pilot that will allow it, working through a financial intermediary, to finance small primary and secondary schools. If successful, this pilot could generate a replicable model to be used in other African countries. However, it should be recognized that finding ways to support these providers on a sustainable basis continues to be a challenge.

3.24 **Developing Domestic Capital Markets.** IFC’s strategic objective in the financial markets sector is to strengthen domestic capital markets and institutions while broadening local businesses’ and individuals’ access to needed products and services. IFC will focus on the following steps:

- ***Strengthen the capacity of local institutions to provide financing for microenterprises and SMEs.*** The combination of IFC investment and capacity building assistance is being

used to increase access to micro and SME finance, including building new microfinance institutions, helping banks downscale into SME lending, creating credit bureaus that provide information on small-scale borrowers, and expanding the use of leasing as an SME financing tool. This work will be expanded, particularly in Sub-Saharan Africa which has the lowest level of financial penetration and credit to the private sector of any region.

- **Prioritize lending to non-banking institutions such as housing finance companies.** Fostering the development of non-bank financial institutions will continue to be a priority. Housing finance in particular will be a focus in high-growth frontier and middle-income countries.
- **Participate in selective bank privatizations.** Pre-privatization funding is important in certain markets to increase the likelihood of broader private sector ownership of financial institutions. For example in East Asia, especially in China, IFC will continue to support privatization efforts as well as in the Southern and Eastern Europe area, where there is much accession-related reform, including bank privatizations.
- **Provide other technical assistance and advisory services.** IFC will also provide technical assistance and advisory services to financial institutions with an emphasis on housing finance and leasing companies, corporate governance for banks, and environmental training for all financial institutions. IFC will also assist its clients with anti-money laundering programs.
- **Provide innovative products using risk sharing, credit enhancement and guaranty facilities.** IFC will continue providing a matrix of products customized to meet client needs depending on their asset size and the currency of their revenues. For example, IFC can help its clients access local currency financing using partial guarantees for infrastructure projects and large corporate borrowers with local currency revenues. On the other side of the continuum, cross border securitization might be a more appropriate product for exporters whose revenues are in hard currency. Chart 3.1 illustrates this approach to product customization.



3.25 **Measurement:** IFC has been engaged in a number of initiatives to improve the evaluation and measurement of the Corporation's investment and advisory activities. The goal has been to ensure that these activities are assessed against IFC's corporate objectives of development impact, profitability and client responsiveness and to introduce frameworks that emphasize the "value-added" and high impact dimensions of IFC's work. The Corporate Scorecard provides a comprehensive measure of the performance of the Corporation by reporting development impact results, including OEG's XPSR project reviews, client survey results and profitability measures (See Annex 2). Department scorecards have been prepared for each investment department on a yearly basis for the last three years and contain information at the department level. The effectiveness of the scorecard system has been enhanced by tying the results of department scorecards to incentives provided to departments and staff. An individual investment officer scorecard is being developed to track the performance of individuals over time in the context of the long-term performance award program.

3.26 To strengthen the measurement of IFC's technical assistance and advisory services, a uniform project completion measurement system, applicable to all technical assistance and advisory services activities in the Corporation is also being developed. The system will address both the effectiveness of the advisory work from an output perspective and the expected development impact, and will also include a corresponding system of evaluation. This will allow the effectiveness of the IFC advisory activities to become an important element in the assessment of the overall results of the Corporation.

3.27 **IFC ROE Benchmark.** Over the last year, IFC presented two Technical Briefings to the Board related to its rate of return, one on "Unbundling Commercial and Non-Commercial Activities" in January 2003 and another on "Benchmarking IFC's Profitability" in November 2003. In these discussions, IFC indicated it would move ahead to establish a return on equity target consistent with the recommendation of the WBG private sector strategy and with appropriate adjustments for non-commercial activities.

3.28 To implement the use of an ROE target, IFC will include in the Corporate Scorecard a new line showing IFC adjusted ROE versus a long-term target. The ROE target is adjusted only for specific IFC contributions to donor-funded programs (e.g. contributions to FIAS, IFC Trust Fund program, Private Enterprise Partnership, the Project Development Facilities, SME Capacity Building Fund and the IFC Environmental facilities). This maintains objectivity and clarity in figures presented for IFC, while still providing adjustments for a number of stand-alone non-commercial activities.

3.29 The long-term target for this adjusted ROE is recommended to be 6 percent. This target is based roughly on large international commercial bank returns (average of 8.1 percent pretax ROE over the last five years when adjusted to IFC leverage) lowered by about 2 percent to account for IFC non-commercial activities other than the specific contributions to special programs<sup>4</sup>. (Additional information underlying the determination of this long-term target can be found in Annex 1). Over the last eight years IFC would have exceeded the 6 percent level about

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<sup>4</sup> The January 2003 Board Technical Briefing on "Unbundling Commercial and Non-Commercial Activities" identified costs equal to about 1.5 percent of equity related to IFC non-commercial activities other than "contributions to special programs." These included uncompensated advisory work, work on small projects, non-commercial activities related to IFC's development mandate, and opportunity costs related to selective pricing restraint. The pre-tax ROE for a group of major private sector-oriented IFIs was 2.7 percent when averaged over the last five years.

half the time. With changes in market conditions, year-to-year deviations from a long run target could be very significant, and benchmarks will need to be periodically reviewed.

**3.30 Human Resources Challenges** Aligned closely with the overall strategy, the principal goal of IFC's human resource ("HR") strategy is to develop a high-performance, merit-based organization, with a highly diversified workforce, which can effectively achieve the Corporation's business goals. Over the past five years, IFC has implemented a wide range of HR tools and systems, outlined below:

- **Career management.** IFC has a comprehensive performance management system, focused on enabling feedback and strengthening staff development. The framework includes (i) a web-based annual performance evaluation system, with multi-source feedback, (ii) a competency-based career development system, and (iii) a dual career path for senior staff, along technical and managerial paths.
- **Leadership development and succession planning.** IFC has implemented new programs to select, assess and develop existing managers and high potential staff. This includes a succession planning system to identify high-performing staff before they are ready to take on managerial assignments and programs to develop existing and future leaders, such as leadership training, development assignments and executive coaching.
- **Staff development.** In support of key strategic priorities, IFC has substantially increased its investment in staff training and development. Among key priorities, IFC has implemented (i) an intensive credit training program to improve project quality, (ii) business development training for regional offices, (iii) SME training to support the Project Development Facilities, and (iv) new programs in Business Ethics and Sustainability.
- **Accountability and incentives.** To motivate its high-performing staff, IFC has developed new rewards and recognition programs. The existing Performance Awards program for teams and individuals has helped to align short-term incentives with annual corporate objectives. To balance the existing incentives for productivity with an emphasis on long-term project quality, we will implement the enhanced Performance Awards Program (IFC/R2004-007). This program will enable us to strengthen staff accountability for results by measuring and tracking project performance in terms of development impact and profitability.

**3.31** Looking forward, IFC's major challenge is to implement and consolidate this agenda, with a focus on the following themes:

- **Decentralization.** Over the last five years, IFC has moved from a Washington-centric organization to a global organization. Since FY99, IFC's total workforce increased by about 20%, from 1,856 to 2,230 staff. Most of this growth has been driven by a substantial increase in country offices, from 663 staff (about 36%) in FY99 to 951 staff (or 43%) today. The largest portion of this increase is linked with the growth of the Project Development Facilities, which have experienced a four-fold increase (from 106 to 489) in staff dedicated to technical assistance and work with small and medium-sized companies. A particular challenge going forward will be to define and clarify the career management and employment framework for this group of staff, most of whom are fully donor-funded. During this same period, IFC's investment staff, responsible for our commercial activities, has remained relatively stable at around 380 staff. This is a

significant statistic considering the substantive growth in investment commitments over the last four years. Since the FY02 reorganization, over 45 senior staff have moved from Washington to the field, including all regional directors. The focus on staff dedicated to business development activities has contributed to the growth of IFC's business. Moving forward, IFC will focus on ensuring and fostering staff mobility across boundaries, with a continuing trend of expanding its presence in country offices.

- **Leadership development.** In FY05, IFC will continue to strengthen the leadership bench at IFC by accelerating leadership, alongside technical, capability of high potential staff, at earlier stages in their careers. As part of these efforts we are implementing the new Global Business Leadership Program ("GBLP"), designed to develop a cohort of individuals acting corporately and collaboratively with a broad business perspective for future leadership positions.
- **Diversity.** A truly diverse workforce is required to be able to create new products, solve the most challenging and complex business problems, and to reflect the diverse backgrounds of IFC shareholders and clients. Therefore, IFC's strategy is to mainstream diversity in all of its HR processes and programs, with a particular emphasis in recruitment, career management and staff development. For instance, this year's Global Transaction Team recruitment (IFC's core recruitment program) includes 5 Sub-Saharan staff, 6 women and 9 Part II nationals (out of 17) and, as agreed with the Board, IFC has begun to recruit in Part II Universities. In addition, the new GBLP also includes 6 Sub-Saharan staff, 12 women and 10 staff from country offices, out of 21 staff in the cohort.

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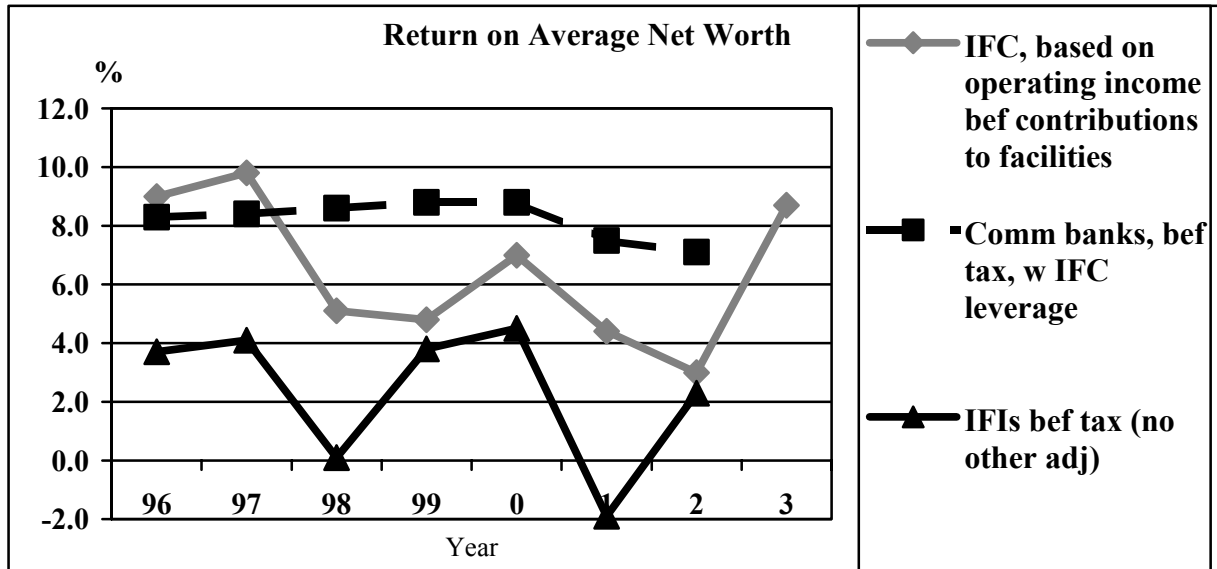
## ANNEX 1: IFC ROE Target

1. The Bank Group's Private Sector Development Strategy discussed by the Board in February 2002 the subject of IFC should have in particular an appropriate rate of return. It is recommended that IFC should not use subsidized finance, should in general earn a commercial rate of return, and any non-commercial costs should be made transparent and the effectiveness of these expenditures measured.
2. Since that report, IFC presented two Technical Briefings to the Board related to this topic, one on "Unbundling Commercial and Non-Commercial Activities" in January 2003 and another on "Benchmarking IFC's Profitability" in November 2003. The unbundling presentation identified about \$120 million dollars of non-commercial activities in IFC's costs (uncompensated advisory work, contributions to facilities, work on small projects, non-commercial activities related to IFC's development mandate such as OEG work and extra work with the Board, and opportunity costs related to selective pricing restraint) that resulted in a reduction in IFC return on equity of about 2 percent. The profitability briefing presented benchmark pretax return on equity data, adjusted for IFC leverage, for the largest 20 commercial banks in the U.S. and Europe (8.1 percent average over the last five years), and benchmark pretax return on equity data for major private sector-oriented IFIs (2.7 percent average over the last five years). In these discussions IFC indicated it would move ahead to establish a return on equity target, and discussed a range of 6 to 8 percent as potential targets for IFC's returns when adjusted for non-commercial operations.
3. In considering how to implement this approach IFC is proposing to show IFC return on equity results and a target in the Corporate Scorecard. An additional line is being added to the Corporate Scorecard which shows IFC adjusted ROE (adjusted for "contributions to special programs") versus a long-term target of 6 percent (see below).
4. **IFC ROE (adjusted for "contributions to special programs"):** The adjusted ROE in the Scorecard will exclude expenses identified as "contributions to special programs" which includes contributions to FIAS, TATF, PEP, PDFs, CBF and Environmental facilities. This will maintain objectivity and clarity in figures we present for IFC, while still providing for adjustments for a number of important non-commercial activities. The approach provides an automatic annual adjustment to the calculated IFC ROE for any change in contributions to special facilities, and thus meets a key goal of separating the expenses for major non-commercial activities.
5. **A long term target for adjusted ROE of 6 percent:** The recommended target level is based on the target range for IFC returns of 6 to 8 percent discussed at the Board Technical Briefing, but modified to correspond to the proposed adjusted ROE approach. The range discussed at the Technical Briefing was based on IFC returns excluding expenses related to all non-commercial operations, yielding an ROE about 2 percentage points higher than the IFC reported ROE. However adjustments for "contributions to special programs" are estimated to increase reported ROE only by about 0.5 percentage points. Therefore for comparability to this ROE, the long-term target needs to be adjusted down by the remaining 1.5 percent points of non-commercial activities. The equivalent long-term target will be in the range of 4.5 to 6.5 percent and IFC is recommending a target of 6 percent. As shown in Figure A1-1, over the last eight years IFC would have exceeded the 6 percent level about half the time. It should also be noted that with changes in market conditions (including risk free rates and risk premium) as well as

## ANNEX 1 (Cont'd)

potential changes in accounting standards, year to year deviations from a long run target could be very significant, and benchmarks will need to be periodically reviewed.

Figure A1-1



## ANNEX 2. CORPORATE SCORECARD FY03

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

CLIENT SATISFACTION MEASURES	PERFORMANCE FY03	BENCHMARK/ TARGET FY03	BENCHMARK/ TARGET
External: % of satisfied respondents in the Annual Client Survey	84.0%	73.0%	Previous year
Internal: % of satisfied respondents, Annual Staff Survey*	71.0%	60.0%	Previous year
DEVELOPMENT IMPACT MEASURES	PERFORMANCE FY03	BENCHMARK/ TARGET FY03	BENCHMARK / TARGET
Total Priority Sectors:	67.7%	66.0%	Previous year
– Financial sector, % of total commitments	51.4%	40.0%	Previous year
– Infrastructure, % of total commitments	12.1%	14.0%	Previous year
– ICT, % of total commitments	3.4%	10.0%	Previous year
– Social Sectors, % of total commitments	0.8%	2.0%	Previous year
% satisfactory or better ex-post development outcomes (XPSRs)	58.0%	56.0%	Previous year
Total High Impact transactions:	58.0%	47.0%	Previous year
– Projects with high financial/economic impact	48.0%	32.0%	Previous year
– Projects with high environmental/social/governance impact	29.0%	19.0%	Previous year
Frontier countries (narrow definition), % of IFC total commitments in low-income countries or highest-risk countries**	27.9%	21.0%	Previous year
Frontier countries (broader definition), % of IFC total commitments in low/lower-middle-income countries or in higher-risk/highest-risk countries**	88.1%	90.0%	Previous year
Technical Assistance/Advisory Services, DFO expenditures ***	US\$65 m	US\$53 m	Previous year
SME-Related Investments, % of total commitments	12.0%	17.0%	Previous year
% of low risk projects (rated "average" or "good" in ESRR)****	53%	57%	Previous year
PROFITABILITY MEASURES	PERFORMANCE FY03	BENCHMARK/ TARGET FY03	BENCHMARK / TARGET
IFC net commitments	US\$3,852 m	US\$3565 m	Plan Forecast
IFC net approvals	US\$3,991 m	US\$3987 m	Plan Forecast
IFC committed syndications	US\$1,181 m	US\$512 m	Previous year
IFC approved syndications	US\$1,458 m	US\$1,829 m	Previous year
Operating income, \$	US\$528 m	US\$128 m	Plan Forecast
Return on Net Worth	8.2%	2.1%	Plan Forecast
Return on Net Worth, Adjusted for TAAS *****	8.7%	6%	Plan Target
Loans (Non-performing loans)	16.7%	15.2%	Previous year
Equity (Specific Reserves as % of disbursed portfolio)	25.8%	29.4%	Previous year
Productivity: # Commitments/Investment staff	0.36	0.34	Previous year
Maintenance of AAA Rating	Yes	Yes	Yes

\* Annual Staff Survey 2003, Percentage of Favorable Respondents on "Overall Satisfaction" Section of Survey (My morale at work is high.)

\*\* Frontier countries (narrow definition) are low income (World Bank income category) or highest risk (Institutional Investor rating of 30 or less) countries. 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.

\*\*\* Donor-funded Operations (DFO) expenditures includes general administrative cost and cost incurred to deliver the following: the Trust Fund program, FIAS, PEP, Project Development Facilities, SME Capacity Building Fund, and special Environmental Facilities. Does not include cost incurred by AMSCO, GEF, LACP, PENSA. Most of the cost covered by the in-kind contributions from IFC and third-parties is also not captured.

\*\*\*\*The Environmental and Social Risk Rating ("ESRR") system rates environmental and social risks of portfolio projects.

\*\*\*\*\* IFC Return on Net Worth based on operating income adjusted for "contributions to special programs." This subtracts from IFC expenses contributions to the Trust Fund program, FIAS, PEP, Project Development Facilities, SME Capacity Building Fund, and special Environmental Facilities. The target ROE of 6 percent is based on 1) a potential range of 6-8 percent for a commercial benchmark, based on returns of commercial banks and other IFIs, (Board technical briefing on "Benchmarking IFC's Profitability," November 2003), 2) reduced by 1.5 percent to account for IFC non-commercial activities other than the "contributions to special programs" (Board Technical briefing on "Unbundling Non-Commercial Activities," January 2003).

