

III. CHALLENGES

“Aid agencies should become increasingly concentrated in the most difficult environments. That means that they will need to accept more risk and so a higher rate of failure. They should compensate by increasing their project supervision, which means higher administrative overheads.”

*Paul Collier
The Struggle for the Bottom Billion, 2007*

INTRODUCTION

3.1 The need for IFC to play a significant role in promoting strong private sectors in developing countries is clear, and IFC’s achievements and financial strength place it in a strong position to meet the challenges. As IFC moves increasingly to frontier markets, reaching critical mass in capacity in these markets will be crucial to maximizing its impact there. IFC is also proposing to move forward on its climate change-related activities. However, these activities come at a cost, and it is clear that the key constraint for IFC to scale up its development impact continues to be the measured pace of resource expansion, which is outpaced by increases in demand. There are also other challenges which IFC will need to address for the next three-year planning period, such as human resource management, strengthening risk management and responding to counter-cyclical demand. However, IFC Management is confident that, with the Board’s guidance and support, it will be able to address these challenges and remain a leader in the delivery of development impact where it is most needed.

COUNTER-CYCLICAL PREPAREDNESS

3.2 The current uncertain global economic situation poses challenges and opportunities for IFC. While previous financial crises have been more at a country or regional level, it is possible that the next economic downturn will be more widespread across the globe. IFC has been preparing more concerted interventions than in the past and is potentially positioned to play a larger role as a result of the growth strategy of recent years. At the same time, as the prospect of a global slowdown becomes more prominent, IFC would have to balance competing demands in assuming its counter-cyclical role, depending on the timing and magnitude of the downturn, and its consequent effects on IFC’s portfolio and balance sheet. For instance, IFC’s efforts to increase activity in IDA countries and frontier regions might be compromised in the event of a rapid global financial sector meltdown. There would be scarcity of private sector investment in markets affected by a crisis and increases in demand for IFC’s liquidity support, while, at the same time, IFC’s portfolio could be impacted significantly.

3.3 **Past Experience.** IFC has faced several financial crises since the mid-1990s and has responded by providing liquidity and advisory services first to the financial sector and then others, and subsequently longer-term financing as the recovery took off. The most notable cases in the past were in Indonesia and Argentina, where IFC engaged closely with existing portfolio clients through a strong team of dedicated professionals in the field. In Brazil, when trade finance liquidity declined dramatically in 2002, IFC redeployed existing credit lines with clients from project finance uses to trade finance funding, and mobilized significant funding relative to IFC’s own direct credit exposure. Other examples have been in Korea, Lebanon and Mexico⁷.

⁷ See “IFC in a Counter-Cyclical Situation” in “IFC Strategic Directions: FY08-FY10 – Creating Opportunity, Additional Information”, IFC/R2007-0063/1.

3.4 **Recent Initiatives.** Learning from its past experience IFC has already strengthened its preparedness in a number of areas, including:

3.5 *Structured Approach in Portfolio Management.* In order to detect problems early, IFC has taken a more structured approach in the management of its portfolio. In addition to the quarterly project risk reviews, which set provisions, IFC changed the frequency of the comprehensive portfolio reviews from semi-annually to quarterly. Particular emphasis for these regional meetings is on projects that are facing problems.

3.6 *Equity Department.* In order to help guide IFC's equity investment decisions, in 2007, IFC set up a central Equity Department. This department provides analysis of market conditions and provides strategic portfolio recommendations for IFC's equity portfolio. It also proactively advises staff on global, country, and sector trends, and is working with investment departments to create asset allocation tools to help manage their exposure as well as identify new equity opportunities.

3.7 **Preparations Underway.** In addition to implementing the lessons learned from past crises, IFC has already put in place several measures, both defensive and pro-active, to prepare for economic downturns. In general, IFC's initial response to a crisis involves assisting existing clients by providing liquidity, both directly and through mobilization, often immediately or shortly after the start of the crisis. Such liquidity support in turn sends a strong signal to banks to keep their credit lines in place to help re-build the strength of the financial sector. Subsequently, as the market starts to recover, IFC would provide risk capital and longer-term funds to existing and new clients.

3.8 *Defensive Measures.* In light of the current deterioration in many markets, IFC has strengthened further its portfolio management at the department level, focusing on portfolio supervision of potentially vulnerable investments and identifying potential counter-cyclical roles to support existing clients. Decentralization has helped these efforts, as portfolio managers or client relationship managers in the field are able to monitor the situation and address any problems swiftly.

3.9 *Pro-Active Measures.* IFC has begun mapping priority companies for possible equity support in downturns. Some of these plans go beyond individual companies and are more programmatic. For instance, in response to the tightening of credit in the Russian banking system, IFC has developed a systemic and staged approach to assist and provide opportunities for existing clients to continue their businesses.

3.10 *Enhanced Human Resources Management and Policies.* IFC has also begun to implement human resources management practices to ensure the organization is able to move appropriate staff to where they are most needed, whether for short or longer term assignments. IFC is also examining how best and most flexibly to use the clusters of staff now decentralized in several regions, and who have particular sector expertise, such as infrastructure, to improve its response capability. Furthermore, IFC would be able to mobilize staff within each region who are well equipped to work with clients in difficulty and in markets suffering downturns, should the need arise.

3.11 *Corporate and Departmental Counter-Cyclical Plans.* As a part of the annual strategy exercise, investment departments were asked to draw up counter-cyclical plans. These plans include: (i) more proactive risk-taking, such as providing equity or quasi-equity instruments in order to continue to support existing clients; (ii) developing hedging strategies; and (iii) utilizing advisory services such as risk management and non-performing loans management for

financial sector clients, and receivables management for real sector clients. These departmental-level plans will be supplemented by a Corporate-level exercise, where a group of key individuals will monitor global economic developments and prepare a corporate-wide counter-cyclical plan.

3.12 *Regular Stress Tests*. IFC conducts regular high-level stress tests for its entire portfolio. The results indicate that IFC has sufficient capital to withstand downturn events similar to those experienced in the last decade, but it is unlikely to be adequate in the event of more extreme shocks⁸.

3.13 *Global Facilities*. IFC already has in place several global facilities that could directly support IFC's counter-cyclical role, with some modification, including its Global Trade Finance Program. In addition, clients are increasingly requesting IFC to provide stand-by facilities in anticipation of liquidity constraints.

3.14 **Factors Impacting IFC's Effectiveness**. Several factors may impact IFC's effectiveness in undertaking a counter-cyclical role on a greater scale.

3.15 *Flexibility*. Past crises have seen rapid deterioration in macroeconomic conditions as well as unexpected policy responses. Any detailed simulation exercise would not be able to cover such "blind spots". The key for IFC is to be prepared for the unexpected, with utmost flexibility in all aspects of operations, including resource allocation, staff, portfolio, and capital.

3.16 *Balancing Risks*. To provide clients with the assistance needed to weather economic downturns, IFC must continue with prudent balance sheet management in order to ensure that it has sufficient capacity to take additional risks for selected companies, even when the downturn has affected its financial position.

3.17 *Portfolio Exposure*. IFC has significant exposure in several countries. Should these markets be affected by an economic downturn and the need arises for IFC to provide liquidity support, IFC will need to reorient its strategy and rebalance its portfolio. IFC is currently undertaking an effort to manage exposures in these countries even more effectively, through mobilization at origination and a programmed divestment of loans and equity to create financial capacity to play its counter-cyclical role when the need arises.

RISK MANAGEMENT AND FINANCIAL CAPACITY

3.18 As IFC scales up its activities and decentralizes further, management of risk, including maintenance of a sound financial structure and appropriate risk management practices, will become an even more critical issue. IFC will need to focus considerably more resources on this area.

3.19 **Risk Management**. The Risk Management function is being upgraded to facilitate improved client service and efficiency while retaining appropriate checks and balances on decentralized decision-making. In addition, IFC's strategic response to global and macroeconomic volatility will involve: (i) more stringent portfolio risk management and supervision, as discussed above; (ii) planning to meet demand for IFC's traditional counter-cyclical role; and (iii) earlier engagement of the Special Operations Department⁹ to identify and

⁸ Use of IFC's FY07 Net Income: Retained Earnings and Designation of Retained Earnings (IFC/R2007-0275)

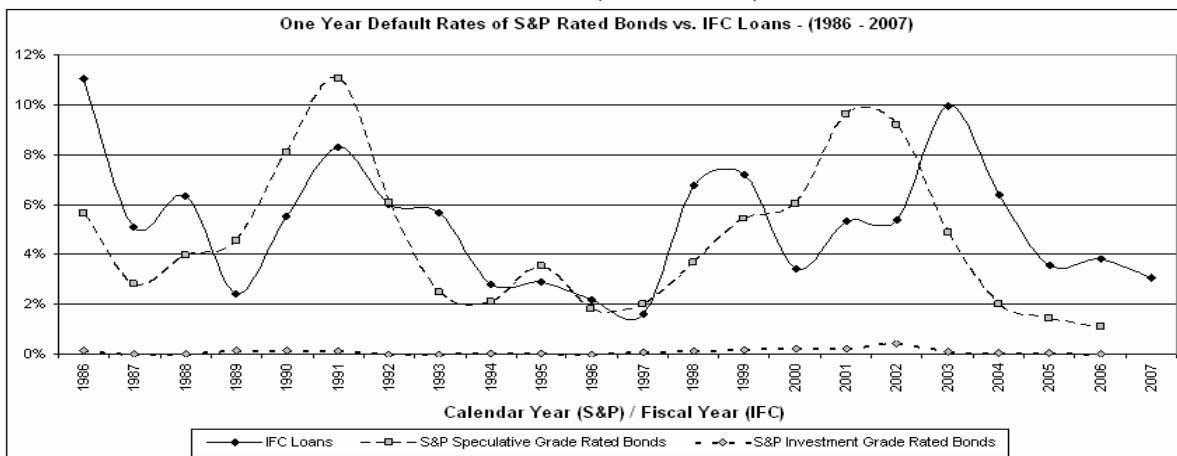
⁹ The department is comprised of a small number of workout professionals who have extensive experience in handling jeopardy projects.

address problem investments quickly. IFC is also enhancing Corporate Tools for Risk Management. These tools include economic capital allocation, early risk rating systems and higher portfolio supervision that allow for greater decentralization and enhanced accountability for pricing, performance measurement and portfolio management. Other steps to enhance risk management are described in the Background Paper.

3.20 International Financial Reporting Standards. As discussed with the Audit Committee on February 14, 2007, IFC has set a revised target date of FY10 to resume presentation of its financial statements using International Financial Reporting Standards (IFRS). In the interim, IFC's FY07-09 financial statements will be prepared using accounting principles generally accepted in the United States. Among other changes, this will require the Corporation to make expanded use of fair value accounting, principally in debt securities and equity investments, as well as derivatives associated with the loan, debt securities and equity portfolios. This will imply significantly greater volatility in net income reporting, including the possibility of sizeable net losses due to market downturns in any given quarter as well as greater volatility in IFC's capital position.

3.21 Financial Capacity. IFC is by its nature and mandate a risk-taking institution. Economic theory postulates that there is a direct link between risk and reward and IFC's experience bears out this relationship: it has traditionally made some of its largest returns in investments considered among the most risky at the onset. As an indication of the significant risks inherent in its portfolio, an analysis of IFC's one year default rates shows that they are comparable to Standard and Poor's speculative ("junk") grade default rates (Chart III-1).

Chart III-1: IFC and S&P One Year Default Rates (FY86 – FY07)

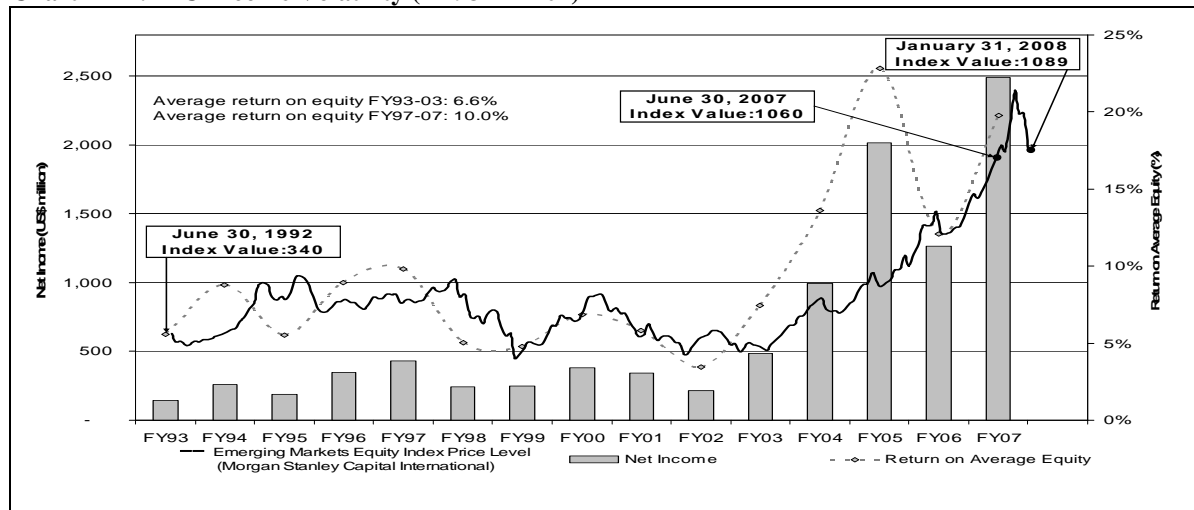


3.22 Likewise, while IFC has in recent years benefited from capital gains on equity, these should be recognized as the returns for the significant risks taken by IFC (as evident in the volatility of returns on equity shown in Chart III-2 comparable to the Morgan Stanley Capital International (MSCI) emerging market equity index) and the additionality it brings to its investments. The period from FY02 to FY07 has been characterized by an unusual "synchronized boom" in equity and commodity markets as well as global liquidity, all of which have been extremely favorable for IFC's investments. However, since May 2007, the market environment has deteriorated due to the U.S. sub-prime market and liquidity crises, the potential for a recession, and heightened investor risk aversion. The hypothesis of emerging markets having "decoupled" from the U.S. is now being questioned and there is fear that a serious U.S. downturn would in fact have strong negative implications for many of the markets

in which IFC operates. Indeed, notwithstanding positive long-term prospects, with increased globalization, a medium-term "synchronized bust" triggered by liquidity or other events cannot be ruled out. It should also be noted that there have been very large movements in the price level of the MSCI emerging market equity index during the first seven months of FY08 as depicted in Chart III-2.

3.23 Despite this inherent volatility, IFC maintains its AAA credit rating by: (i) diversifying its investments, giving it exposure to a range of risk profiles; (ii) maintaining a strong financial structure and capital base; (iii) being a long-term investor particularly for its equity investments; and (iv) engaging in rigorous due diligence, accumulated knowledge and experience in developing countries and sound risk management practices.

Chart III-2: IFC Income Volatility (FY93 – FY07)



3.24 Given the inherent risks and the volatility of its income, IFC requires a strong capital base to support its growth and frontier market focus. Furthermore, given IFC's need to play a countercyclical role in times of stress, it is necessary for IFC to maintain resources to preserve its AAA rating during and immediately after a stress event. This is a very high standard and not one followed by commercial institutions. As evident from current market events, commercial institutions typically scale back investments during times of crisis, sell assets and raise capital or accept a downgrade in ratings. Furthermore, unlike most other major multilateral development banks, including the European Bank of Reconstruction and Development, IFC does not have callable capital.

3.25 Accordingly, IFC assesses its capital adequacy by measuring growth needs and the risk profile of its current and projected investments and first establishing minimum capital adequacy for these needs. The minimum capital adequacy requirement is determined using the new CAPRI (or economic capital) framework which differentiates assets based on statistical measures of risk. Under this approach, equity is substantially more capital intensive than loans, for example. Likewise, the approach enables IFC to distinguish among countries and sectors in terms of capital intensity. In coming months, these tools will also be used to inform judgments on maximum exposures to equity, countries and sectors. In view of the uncertainty in markets and the potential for unanticipated or extreme events (as for example in the sub-prime and bond insurance market), IFC also augments these minimum capital requirements with stress tests. The stress tests are informed both by historical experience as well as judgmental assessments of potential scenarios. A preliminary analysis shows that IFC has adequate capacity to support the

proposed growth, subject to some limits on equity exposure and exposures in some countries and sectors where there is either actual or emerging concentration, or where the portfolio composition is such that it is more capital intensive. In light of the strategy to encourage diversification and increased focus on IDA countries, a limit on aggregate exposure to the top five exposure countries is also being considered. A more detailed analysis of financial capacity and stress tests will be presented in the Annual Report on Financial Risk Management.

HUMAN RESOURCES

3.26 IFC's human resource (HR) strategy has evolved to support the decentralized business model with the objective of building IFC's impact on the ground. Since FY99, IFC's HR strategy has been centered on building a high-performance, merit-based organization that can effectively and efficiently help the Corporation achieve its business goals. There are three pillars to the HR strategy: (i) differentiation of staff based on performance; (ii) accountability of managers for people management and results; and (iii) recognition of behaviors that model excellence, teamwork, integrity and commitment to IFC's mandate. While the HR strategy remains consistent, operational emphasis is adjusted annually based on business needs. The 2008-2010 HR Strategy emphasizes managing growth and decentralization in support of a more client-centered IFC.

3.27 **Managing growth.** In response to client and business demands, IFC has grown and has expanded its reach globally. At the end of calendar year 2007, IFC's workforce totaled 3,196 staff, reflecting a 32% increase since FY05. The most significant increase in staff is in country offices. The total country-office based staff is 1,657 (52% of all IFC staff) compared to 1,082 (44% of all IFC staff) in FY05. While the majority of the growth in country staff has come in advisory services (which grew from 555 staff in FY05 to 904 staff today), staffing in investment operations has also grown in the field from 527 staff in FY05 to 753 staff today.

3.28 To meet the needs of a growing workforce, there is a renewed emphasis on the onboarding of new staff, which includes mentoring and training. It is critical for IFC's effectiveness to have new staff integrated quickly into regional departments, as applicable, and into sector groups, to sustain and enhance the Corporation's global knowledge management. More than 70% of the new staff orientation course offerings (six out of nine offerings in FY07 and seven out of nine offerings in FY08) are held in the field. Similarly, about 60% (five out of nine offerings in FY07 and four out of seven offerings in FY08) of the core credit training course offerings have been held in the field.

3.29 **Decentralization in Support of a More Client-centered IFC.** IFC's goal is to create critical mass of staff in the field to serve clients more efficiently. The Corporation strives towards this goal two ways: it is moving senior staff with global knowledge from Washington to the field and is recruiting highly skilled staff with deep understanding of local market conditions into the field. This two-pronged approach is designed to build both sector expertise in the regions and to build functional capacity in all aspects of the project cycle.

3.30 *Global Career Framework.* A key HR priority is the development and implementation of a new global career framework for client-facing investment and advisory services staff. The new framework supports a single corporate culture and provides clear guidance to staff on career paths and what is required to succeed and advance at IFC. It also clarifies the responsibilities for career management, for managers and staff alike, and provides departments increased flexibility in a decentralizing organization. The career framework outlines new corporate competencies for all IFC staff as well as job stream competencies that apply to all

staff in the investment and advisory streams. The new emphasis on role-specific competencies encourages specialization of skills as staff progress.

3.31 In the new framework, staff hired in any location are expected to be of the same caliber. They can then progress to senior jobs within their own region and/or may relocate to other regions. An important feature is that new managers in operations are required to have had a field assignment before taking on this leadership responsibility. Key aspects of the implementation include developing and enhancing tools to encourage mobility, providing staff better access to information about opportunities that are available, and enhancing the performance assessment process and the managers' role in providing staff career guidance.

3.32 *Mobility*. Moving senior staff from Washington to the field has been challenging in some regions. Although more staff have been relocating to the field since FY05 (an average of 40 staff per year compared to 27 in previous years), net transfers of senior staff to the field have remained steady (around 10 per year). Beginning with East Asia and South Asia, IFC has competitively selected vendors to provide relocation and destination services to IFC staff. Over the next two years, enhanced mobility support will be provided to the remaining regions.

3.33 *Recruitment*. As IFC's operations move closer to clients, it is critical that the right people be hired and placed in the right place to meet client needs. IFC recruited 1,981 new staff since July 2005, including 1,292 staff (or 65% of the total) in the field. Most recruitment in country offices occurred in Advisory Services (66% of field-based recruitment). While the recruitment strategy is clear, a major challenge facing IFC is the highly competitive employment market worldwide for finance and investment professionals. Turnover for Investment Officers has averaged around 7.5% over the last three years, compared to 3.6% for the period FY01-FY05. Turnover remains particularly high for those investment officers who have 5-9 years of experience, with 30% of those staff having left IFC. IFC is losing core staff just as they become more productive as team leaders. IFC is also experiencing a higher rate of offer rejections than in recent years: about 18% of the offers to finance/investment professionals were rejected in FY07 (excluding another 15% based on verbal offers) compared to less than 8% of offers rejected over the previous five years.

3.34 Recruitment of diverse talent has been a key factor in growing IFC's business. Despite market pressures, since FY05 the Corporation increased its representation of professional level women from 38.2% to 43.4% and developing (Part II) country staff from 45.7% to 49.4%. In addition, the number of Sub-Saharan Africa and Caribbean region staff on international appointments has increased from 7.0% to 9.0% in the same time period. Nationalities of Focus (NOF) are also now part of IFC's recruitment efforts and there are plans to increase NOF representation over the next few years through targeted recruitment efforts.

3.35 *Compensation*. The comprehensive review of the World Bank Group's compensation framework provides an opportunity to implement a more performance-based and market-based approach, which could help IFC mitigate its staffing challenges. Within a decentralized business model, IFC has a business imperative to ensure that its core talent pool is deployed effectively across regions, with equal standards for staff quality regardless of location. As a result, IFC endorses the elimination of the current distinction between international and local staff in the World Bank Group employment framework. The compensation framework should reflect the market, and annual increases should be performance-driven. IFC has already implemented a number of initiatives that differentiate staff based on market and performance (such as the Long Term Performance Awards program) and experience shows that such tools can be effective when managed systematically and with discipline. The use of such approaches

is driven by business imperatives – for example, the market for investment/ finance professionals with African experience/backgrounds in particular is at a premium, and constraints to hire and retain such talent continue to limit IFC’s ability to operate and deliver effectively in Africa.

3.36 IFC also endorses the implementation of differentiated functional pay among distinct career streams for The World Bank Group, an approach already used by organizations such as EBRD and critical to recruit and retain top talent. Today, a market-based “pay-line” for experienced finance/investment professionals has emerged, with salaries closely within range in cities such as Moscow, Delhi, Johannesburg and Sao Paolo – all key areas for IFC’s business. Given the existing World Bank Group compensation framework, IFC is severely limited in its ability to attract and retain these core professionals. Based on current reality, IFC is therefore supporting the implementation of a global pay-line for seasoned finance/investment professionals (including Treasury) for the World Bank Group overall, while other professionals should have a different pay line, to reflect the external market.

3.37 *Aligning Incentives to Reward Superior Performance.* IFC currently has in place four programs to measure and reward performance, which together, provide incentives to staff: (i) an annual performance, evaluation, and planning process linked to annual salary increases; (ii) a competency-based career framework that provides staff with clear guidelines on what it takes to progress at IFC; (iii) a Performance Awards program to reward and recognize annual results at the corporate, departmental and staff level; and (iv) a Long Term Performance Awards program to reward staff for actual, long-term results. All programs reward both team and individual performance. IFC continues to enhance these programs annually, and this year will further strengthen rewards and incentives for team and individual performance based on development impact metrics.

MANAGING GLOBAL KNOWLEDGE

3.38 As IFC becomes more decentralized and client-focused, maintaining and growing its global knowledge becomes a critical challenge. Local clients in particular are keenly interested in learning from IFC’s global experience to improve their own businesses. Global clients value IFC’s knowledge of countries and regions that may be new to them. And both local and global clients value IFC’s ability to apply the lessons of its past experiences to replicate and innovate new products and services in their markets. As more staff are located outside of Washington, often in frontier offices, it becomes more important to connect them to the global knowledge that can help them serve their clients. IFC has undertaken many *ad hoc* knowledge management initiatives in the past, but now looks to ensure staff can more systematically tap into the knowledge base that exists.

3.39 Much of the knowledge management work underway focuses on ensuring client-facing staff have access to core sector and product knowledge regardless of where they sit. Practice groups are being created to provide a channel for ensuring staff can access and contribute to IFC’s specialized knowledge, and develop their career as part of a specialized global community. To supplement IFC’s corporate on-boarding program, IFC is developing industry-specific on-boarding programs to ensure that new staff, especially those hired in the field, can get up to speed quickly on IFC’s global experience. Efforts are also underway to improve codification of lessons of experience and disseminate them in a way that people can easily access the information when they need it. Finally, job descriptions are being re-worked for most operational streams to highlight the importance of individual staff contributing to, and using, IFC’s global knowledge. A robust knowledge management process, coupled with

appropriate tools to attract and retain high performing talent, will substantially help IFC deliver its development mandate more effectively.