

SECTION II. PROGRESS IN IMPLEMENTATION

2.1 Over the past few years, IFC has positioned itself well to respond to an increasingly dynamic and competitive external environment expanding beyond its traditional financing activities and its countercyclical role to address more complex needs. IFC has sought to move from a position of “lender of last resort” to that of “partner of choice,” providing products and services that not only differentiate IFC from other development institutions, but meet the changing and expanding needs of private sector clients and member countries. The latter are looking increasingly for partners that can share with them global experience, provide a stamp of approval and help them develop productive relationships with a broad range of stakeholders such as workers, suppliers and local communities.

2.2 Companies in middle income countries continue to come to IFC for long-term foreign currency financing and more recently, for the local currency products that the Corporation can offer. But what they value most is the Corporation’s ability to combine such financing with IFC’s advisory services and IFC’s commitment to a long-term relationship. These companies increasingly recognize the importance of good corporate governance and the need to meet international standards in order to develop stakeholder support and become competitive with global players at home or abroad. They also recognize the risk of a significant regional or global downturn and look to IFC as a long-term partner who will stand by them through the inevitable swings in the business cycle.

2.3 In frontier countries, clients are still challenged by a lack of access to long-term capital, compounded by limitations in private and public sector management capacity. They value IFC’s financing products, but also appreciate the Corporation as a partner in helping them address investment climate issues and sectoral constraints. They also value the role that the Corporation can play in developing partnerships with governments, particularly in the infrastructure area. In all the emerging market countries IFC serves, governments are facing considerable infrastructure needs, unevenly distributed growth and sustainable development challenges.

2.4 The Corporation has made significant progress over the past year in expanding its impact by implementing its corporate strategic priorities, sustaining its strong profitability, strengthening its financial position, increasing its risk management capabilities and improving its technical assistance. The following section details IFC’s key progress on its five strategic priorities, portfolio and financial performance, risk management, technical assistance, the management of human resources, and measurement and evaluation.

Strengthen the Focus on Frontier Markets

Table 2.1. IFC Commitments in Frontier Countries*

	FY02	FY03	FY04	Forecast FY05
Frontier Country* Investments (\$ millions)	\$619	\$874	\$1,032	\$1,320
IFC Frontier Commitments as a Percentage of Total IFC Commitments**	21%	28%	26%	28%
Frontier GDP as a Percent of Total Developing Country GDP	24%	24%	22%	22%

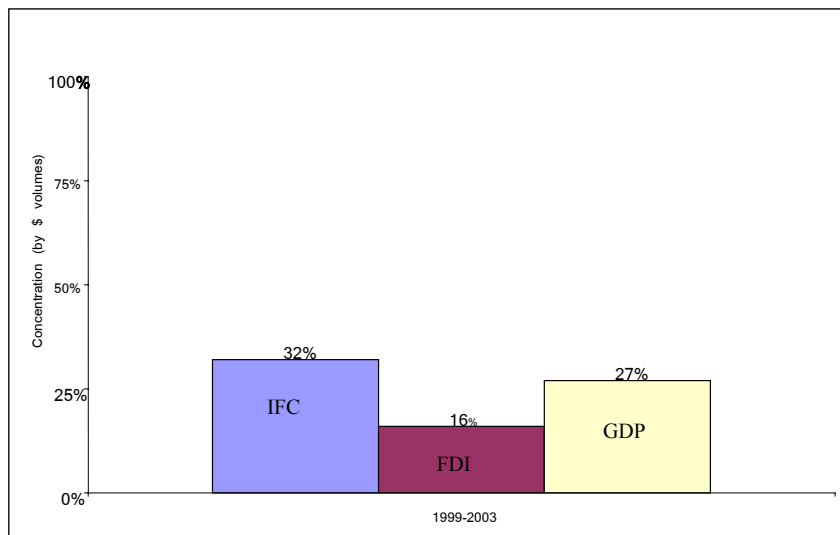
* Income category according to IBRD classification: IICR Risk Ratings are the Institutional Investor’s index, which has a scale from 0 (highest risk) to 100 (lowest risk). Frontier countries are defined as high risk (0-30) by Institutional Investor, or low income by IBRD classification.

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

2.5 **IFC Increased Investments In Frontier Countries.** IFC continues to put great emphasis on addressing the financing and investment climate needs of its frontier countries, particularly in Africa. IFC

commitments to the frontier have risen over the last two years to over \$1 billion. Frontier commitments in FY05 are forecasted at \$1.3 billion. The Operations Evaluation Group (OEG) noted in its *Annual Review of IFC's Evaluation Findings FY2004* (See Box 2.4 on page 19), that while the percentage of IFC's commitments in the frontier is fairly level, IFC has a higher concentration of commitments in frontier countries than the share of the gross domestic product (GDP) or foreign direct investment (FDI) of those countries. As the chart below from the OEG report indicates, over the period of 1999-2003, IFC's project approvals were twice as concentrated as FDI at the frontier and also relatively more concentrated than GDP. Rapidly increasing the investment volumes in frontier countries will remain a challenge given the absorptive capacity of the countries in the frontier and the limited levels of private investment, but a challenge that IFC is keen to address.

Chart 2.1: IFC Frontier Investment vs. Frontier GDP and FDI (1999-2003)



Source: OEG Report

2.6 In addition, the number of countries classified as frontier has been declining over the last several years. Large economies such as Russia and China have moved out of the frontier, taking large shares of the frontier's GDP and FDI with them. Since FY99 (when IFC began the classification) a net of nine countries graduated bringing the total of frontier countries to 94. Based on these observations, OEG has recommended that IFC consider broadening the definition of frontier in order to include more countries at the margin of the current definition, arguing that this would lead to a greater development impact. IFC is currently reviewing this recommendation, including the possibility of expanding the frontier definition to poor regions in some of the large, middle-income countries.

2.7 **Effective Technical Assistance.** IFC's effectiveness in the frontier is not measured by its direct investments alone. Another way in which IFC is working to broaden its impact in these markets is by increasing the impact of its technical assistance. IFC is integrating the work of all its technical assistance facilities with its regional strategies and is in the process of restructuring certain facilities in order to provide them with a broader mandate. IFC is also implementing a more comprehensive monitoring and evaluation system to measure development impact, and improve the design and execution of its technical assistance (See para. 2.50 on page 19).

2.8 **Collaboration with IDA.** IFC is also strengthening its impact in frontier markets through close collaboration with IDA, especially in the areas of infrastructure, micro and SME (MSME) finance and investment climate work. Lack of infrastructure is one of the leading impediments to private sector development in frontier countries and integrated solutions involving IDA can be an important success

factor for IFC in frontier regions. In some cases, IDA funds support the enabling environment or regulatory reform to develop an infrastructure sector while IFC helps finance a private infrastructure investment. In other cases, IDA helps finance a private sector infrastructure investment that is also supported by IFC. Examples of these types of collaboration can be found in the power sector in Nigeria, Ghana and Senegal. In the SME sector, IDA funds are used primarily to provide technical assistance on the enabling environment, capacity building for SME support services, and training of financial institutions that lend to SMEs or provide microfinance services. In parallel, IFC provides investments or guarantees without a sovereign counter guarantee. In the SME sector, joint IDA/IFC teams have completed the design and implementation of the IDA-IFC MSME programs in Nigeria, Kenya, Uganda, Burkina Faso and Mali.

2.9 Substantial Progress in Africa. IFC is growing its investment portfolio and restructuring its technical assistance facility for greater impact in Africa. In FY04, commitments in Sub-Saharan Africa totaled \$395 million, up from \$140 million in FY03. Over the past year, identification of new investment opportunities has been the focus of IFC's expanded business development efforts in the region. To this end, IFC has adopted a more systematic approach to client relationships by appointing sector leads, based in the Africa department's Johannesburg hub, who coordinate with the relevant industry departments in Washington, as needed. In addition IFC has increased its local presence in countries such as Mozambique, Ghana, Senegal, and Madagascar. IFC has also had several successes in its goal to increase MSME funding operations including new microfinance investments in Angola and the Democratic Republic of Congo (DRC).

2.10 To deliver more effective technical assistance, the Africa Project Development Facility (APDF), which focused on retail services to SMEs, is in the process of being restructured to pursue a broader private sector development mandate, and will be renamed PEP-Africa. PEP-Africa is being organized along sectors lines to mirror the structure of investment operations in the region. PEP-Africa programs will be designed to support the three pillars of IFC's regional strategy in Africa, which include providing project development assistance, enhancing support to SMEs and improving the investment climate. PEP-Africa will be used as a means for IFC to add value to its investments as well as a mechanism to tackle broader issues of SME development and constraints to private sector development.

Box 2.1. IFC and the Millennium Development Goals

The increased commitment of the international community to poverty reduction and sustainable development was evidenced by the adoption of the Millennium Development Goals (MDGs) in 2000 by the 189 UN member states. The MDGs for 2015 are to:

1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality and empower women
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, malaria, and other diseases
7. Ensure environmental sustainability
8. Develop a global partnership for development

IFC supports the MDGs by promoting private sector development and growth—the key engine for poverty reduction. A strong private sector also contributes to the government tax revenues essential to promote the MDGs. IFC's strategic pillars focus on a number of areas that are particularly important for the MDGs:

- By providing finance and advice to support development in frontier markets, IFC places a special emphasis on contributing to the private sector and growth in poorer countries and regions.
- IFC's work on overcoming barriers to private participation in infrastructure supports overall growth, and via public-private partnerships, greater access to infrastructure services by the poorer segment of the population. Certain infrastructure projects also improve critical areas related to health care (e.g. via water and sanitation projects). Overcoming barriers to private health and education supports health and education MDGs via direct impacts (e.g. through improved health clinics) and indirect impacts (e.g. via freeing up government resources in tertiary education to better support primary enrollment).
- IFC's key focus on sustainability contributes directly to MDG 7 on environmental sustainability through support of environmentally sound investments and finance and advisory work in areas such as energy efficiency and innovative environmental technologies. Sustainability work also contributes to MDG 8 on creating a global partnership for development, by helping businesses, communities, and others work together for development.
- Finally, projects such as those in community development, HIV/AIDS, or supporting the role of women in education and entrepreneurship, contribute to a number of the other MDGs such as those related to health, education and gender.

Build Long-term Partnerships with Emerging Global Players in Developing Countries

2.11 Staying Close to the Market with a Strategic Focus. To be more responsive to client needs, IFC made the strategic decision to decentralize and place experienced staff and high-performing managers in field offices. Through a greater local presence, IFC is developing deeper relationships with domestic clients and expanding business opportunities and development impact as IFC's understanding of the clients' needs grows. As IFC becomes more field-based and less headquarter-centric, business with local clients is increasing. In FY04, 52 percent of the projects that IFC committed were done with domestic sponsors. Through the first half of FY05, that number is trending around 63 percent. IFC's strategic business development efforts along with the realignment of the project development facilities under regional management are deepening its local client base and helping to bring more value-added services to projects.

2.12 Building Long-Term Relationships Through Repeat Business. The client survey conducted in 2004 revealed that one of the top 2 reasons clients valued IFC was for its role as "a long-term partner." IFC is perceived as an institution that will stand by its clients through volatility in business cycles, as well

as political crisis or unrest. For IFC, long-term relationships allow the Corporation to provide a tailored financing package as the clients' needs evolve, and offer its clients an array of value-added services that broaden and increase a project's development impact. When IFC engages with existing sponsors, IFC has the opportunity to identify new projects that can benefit from the company's experience in applying IFC's standards on sustainable business practices. This leverages IFC's development impact from one project to another. Among the projects IFC committed in FY04 with existing sponsors, about half were for new projects, many of which were in different countries or regions.

Box 2.2. IFC Role and Development Impact with Large Companies

Large companies can deliver high development impacts because of their financial strength, the scope of their activities and their potential for innovation. As IFC seeks to promote South-South investments and extend project benefits to a broader range of stakeholders, the development impact that can be achieved from working with large companies is becoming clearer than ever:

- Large companies are the most important source of FDI investment in emerging markets;
- They have the potential of becoming champions for the Corporation's sustainability agenda, e.g. in environment, social, corporate governance aspects of projects, and community engagement;
- They play a critical role in the implementation of large/complex projects, including public-private partnerships to develop critical infrastructure;
- They provide a channel to support the development of SMEs, e.g. via banks, linkage programs;
- They are also excellent partners to pioneer new types of financial instruments, such as structured finance products.

Some recent examples of larger company investments with high development impact:

- IFC provided a US\$50 million credit line to one of the top five private banks in Brazil for funding environment-related projects and companies committed to high corporate governance standards. The Brazilian bank will be the first to use IFC's sustainability methodology to help make credit decisions and will aim to move beyond compliance with IFC's policies to maximize sustainability performance.
- IFC has helped finance the expansion of a major retailer into discount food stores and hypermarkets in Bulgaria, Poland, Romania and Croatia where it is difficult to obtain international finance for retail projects. The project provides expanded access by low income consumers in lesser developed regions to lower priced and more diverse products. The project will also improve the quality standards of local suppliers.
- In Colombia, IFC is supporting the efficiency improvements and expansion plans of a conglomerate with operations in 17 countries, and is engaged in the process of improving the group's legal structure and corporate governance policies. In addition, the investment will help support the group's extensive development initiatives in local communities with vocational training, housing, health and social programs.
- In Asia and Africa, IFC has a project with a trading group that will strengthen the capital structure of a fully integrated supplier of agro-industrial commodities in order to help it expand its operations in over 20 frontier countries including Indonesia, Vietnam, Cameroon, Cote d'Ivoire, Ghana and Nigeria. The project will promote sustainable forest management (with IFC technical support) and support the establishment of extensive local supplier networks.

2.13 Encouraging South-South Investments. Even though most foreign investment still originates in developed countries, companies in developing countries have become active investors in other developing countries. In FY04, IFC's South-South investments were estimated at \$514 million, or 20 percent of total foreign sponsored projects, up by 17 percent from FY03. Most South-South investments are made within the same region (intra-regional), but the number of inter-regional investments is growing. Examples of FY04 inter-regional South-South investments supported by IFC include: a large textile company from Sri Lanka investing in Madagascar, an established ceramic tile manufacturer from the

United Arab Emirates expanding operations to India, Iran and Bangladesh, South African and South Korean paper companies investing in China, and a Turkish glass producer expanding its production of beverage bottles to Russia. IFC plans to boost its efforts in assisting local clients looking for investment opportunities in other emerging countries. (See Annex 1 Box 1 page 31 for South–South investment – The Moatize Coal Project in Mozambique.)

Differentiate Through Sustainability

2.14 In the past year, IFC has advanced its sustainability agenda through: (i) improving policies and processes; (ii) bringing sustainability competencies to clients; and (iii) developing sustainability strategies in sectors which have large environmental, social and governance impacts.

Improving Policies and Process

2.15 ***IFC Safeguards.*** As IFC learns from its experience and faces new challenges, the Corporation is engaged in the process of revising its policies and internal review processes to deepen its sustainability capabilities, improve service to clients, and increase accountability to stakeholders. With current policies serving as a baseline, IFC is working to recast its safeguards as *IFC’s Policy and Performance Standards on Social and Environmental Sustainability*. The first round of consultations on the proposed new policy have been completed.

2.16 ***Disclosure policy.*** Since IFC last updated its *Policy on Disclosure of Information* in 1998, public expectations concerning the level of transparency of publicly owned institutions and the private sector have increased. Therefore, in January 2004, IFC launched a review of IFC’s disclosure policy in close consultation with clients, industry groups, civil society, and government. The draft disclosure policy will acknowledge the importance of financial and non-financial reporting in fostering a culture of transparency, while still respecting the legitimate business confidentiality of clients. It will also address how such reporting can be used to assess IFC’s development outcomes.

2.17 ***Mainstreaming.*** During 2004, to meet the goal of differentiating IFC from other lending institutions through its sustainability services, IFC co-located over 60 percent of its environment and social specialists in industry or regional departments. The “mainstreaming” of these social and environmental staff allow specialists to engage in projects at an earlier stage, resulting in better integration of the financial and non-financial services that IFC offers clients. Mainstreaming has also resulted in social and environmental specialists playing a more active role in business development for IFC, particularly in regional offices.

2.18 ***Sustainability learning.*** The Sustainability Learning Program (SLP) is designed to educate investment staff about sustainable business approaches for clients and familiarize them with IFC’s many in-house resources which can add value to an investment. Practical exercises and case studies are used to highlight specific ways that IFC can build better business by helping clients invest in sustainable business opportunities. To date, approximately 400 transaction leaders, business developers, managers and support staff have been through this training.

Building Sustainable Businesses

2.19 ***Corporate governance.*** IFC incorporates governance analysis in its investment appraisals and helps lead global dialogue on corporate governance in emerging markets. The joint Bank-IFC Corporate Governance Department has developed a web-based methodology to provide investment staff with tools to evaluate the governance of potential clients and help improve their practices. The curriculum has also been used by the Netherlands Development Finance Company (FMO) and the Inter-American Investment

Corporation, among others. In addition, Corporate Governance staff provides guidance to regulators, stock markets, members of boards, and other corporate governance advocates, as well as to client companies. In FY04, IFC provided technical assistance to 50 companies and financial institutions to enhance their corporate governance practices.

2.20 **Linkages.** SME Linkages are programs that link SMEs to major IFC investments and bring additional economic benefits to the surrounding communities. Programs often focus on value chain development or income generating opportunities for local entrepreneurs. Typical components of linkages programs include training to improve SMEs' operational efficiencies, raising quality standards and structuring appropriate financial products. To date, about US\$20.4 million of technical assistance funding (\$5.4 million of which has come from IFC with various donors and private sector companies contributing the remainder) has been mobilized for 14 active linkages programs in 10 countries associated with IFC investments of over US\$1.3 billion. Currently 16 projects in various regions are in the pipeline. IFC is also developing monitoring and evaluation systems for all linkages programs including parameters for measuring SME performance.

2.21 **AIDS.** Businesses feel the impact of the AIDS epidemic most clearly through their workforce, with direct consequences for a company's bottom line. Since 2000, the Corporation's AIDS program—IFC Against AIDS—has worked to increase the private sector's role in fighting the epidemic. In FY05, IFC Against AIDS started to develop proactive technical assistance assignments, along the regional strategic priorities. For example, in cooperation with PEP-Africa, IFC is designing a three-year project "Managing HIV/AIDS in Small and Medium-Sized Enterprises" which will be initiated in FY06. The Project will aim at making the "business case" for action and developing the HIV/AIDS mitigation skills of SMEs.

Developing Sectoral Strategies

2.22 **Extractive industries.** A three-year independent review of the World Bank's role in the extractive industries recommended that the World Bank Group help to ensure that governments make the best energy choices and manage project revenues wisely, and that greater emphasis is placed on social/environmental safeguards and local community concerns. IFC's activities in extractive industries (EI) are now guided by the *Management Response to the Extractive Industries Review* and other independent internal evaluations. In close cooperation with the Bank and MIGA, IFC is in the process of actively implementing the *Management Response* proposals, which can be grouped around four key areas: (i) Greater focus on evaluating and mitigating the governance risks to project benefits including the promotion of greater transparency; (ii) Ensure that affected communities benefit from projects including prior informed consultation and broad community support of EI projects; (iii) Updating and effective implementation of relevant EI safeguard policies; and (iv) Commitment to increase funding for renewable energy and energy efficiency and gas development. IFC expects to report formally to the Board on implementation progress at the end of 2005.

2.23 **Sustainable energy and industrial efficiency.** IFC provides direct investments, co-finances programs with financial intermediaries, and leverages donor funds to support energy efficiency and renewable energy projects. In FY04, the active, mainstream investment portfolio in renewable energy and energy efficiency projects totaled US\$227 million, nearly 20 percent of IFC's electricity sector portfolio. IFC is also actively developing the carbon finance market for greenhouse gas emission reductions with companies in emerging markets and buyers in industrialized countries, now that the Kyoto protocol is in effect.

2.24 **Agribusiness.** IFC is proactively tackling sustainability issues in private sector agribusiness. In FY04, IFC launched two initiatives: "best management practices" for commodities and an "animal

welfare” program that addresses humane treatment of livestock. IFC is also active in advising agribusiness clients regarding food quality management systems required by world markets, the promotion of cleaner and more energy-efficient processes, renewable energy sources (ethanol, cogeneration), and “good practices” regarding the conservation of natural resources.

2.25 Ensuring sustainability in financial markets. IFC has also been engaging with the financial sector on sustainable lending and investment issues beyond corporate governance and anti-money laundering. The Sustainable Financial Markets Facility (SFMF) is an IFC and donor funded TA program established to provide training and best practice guidance to financial institutions on sustainable banking and finance, in partnership with local and regional organizations. SFMF’s programs include market studies, training workshops, and capacity building. Moving forward, IFC is implementing an integrated program to identify value-adding sustainability opportunities in private equity fund portfolios, as well as developing a program for sustainable portfolio investment.

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

2.26 IFC has been able to grow its infrastructure business despite the withdrawal of many foreign strategic investors by adapting products to meet the evolving needs of the market. In addition to actively supporting those international strategic investors who have chosen to continue investing in these markets, IFC has also been developing new relationships with local and regional companies that are interested in entering the infrastructure business. However, in the face of the clear need for broader infrastructure solutions and a challenging external environment, IFC has been actively seeking new ways to support the scaling-up of infrastructure investments in its member countries.

2.27 Progress in Sub-National Lending. Seeking to utilize a variety of tools to address the need for infrastructure financing, the IFC has created a new group on a pilot basis, in conjunction with the World Bank, to focus specifically on sub-national financing. The Municipal Fund Department’s role is to fill a gap in the World Bank Group’s product line with regard to support for sub-national clients (local governments, public corporates and financial intermediaries), without sovereign guarantees. This support takes the form of loans or guarantees designed to invest in essential social, economic and environmental infrastructure as well as technical assistance to strengthen the managerial, financial and operational capacities of clients.

2.28 IFC has determined that the sub-national business line has the potential to be both profitable and have a high development impact based on lessons learned from the pilot phase of the Municipal Fund Department. Box 2.3 (*See page 14*) discusses in more detail these lessons and the activities of the pilot. IFC is now working with the IBRD to scale up its efforts in sub-national finance on a global basis and is proactively developing business.

2.29 Expand Project Development. The Corporation has also made a strategic decision to help develop infrastructure projects in a much more proactive manner, often with the World Bank, by pursuing attractive investment opportunities which require up-front project development and technical assistance as a precursor to investment. IFC is expanding this project development effort through three different mechanisms: intensive, up-front work by investment staff, primarily in Sub-Saharan Africa; growing the level of activity of advisory services, often as follow-on transactional advice following World Bank sectoral reform work; and putting in place dedicated infrastructure-related resources in field-based facilities in several regions. IFC expects that these efforts will increase the flow of well-structured and bankable projects which will attract private investment.

Box 2.3. Municipal Fund – Emerging Lessons from the Pilot

In addition to processing investments, the Municipal Fund team has been developing the various building blocks that are an integral part of establishing a new business. Specifically the team has:

- Committed two projects in Mexico and South Africa. An additional 2-3 transactions are expected to close in FY05, raising IFC's total exposure in the sector to about US\$100 million.
- Assessed markets for all regions. Municipal Fund staff have studied 18 countries and identified specific new business opportunities in several markets (e.g. Brazil, China, Colombia, India, Peru, Philippines, Russia and Thailand).
- Built external partnerships and alliances with a range of advisors, commercial and development banks, donors, multilaterals and a range of industry forums.
- Established internal ties with the World Bank's regional task managers and the various parts of the Infrastructure and PREM networks.
- Developed a risk analysis framework and credit model for sub-national finance based on market best practice.
- Established a market presence both through in-country marketing, presentations at conferences and consultations and partnerships with other market participants.

The key lessons learned during the pilot phase are:

- Sub-sovereign finance contributes strongly to IFC's strategic objectives. The market size is large, profitability is reasonable, development impact is strong, and IFC is well equipped from a skills and resources base to address the needs of the sector.
- Rapid growth is possible, however, there will remain some unevenness in the pace of growth because this remains a new business line, in a difficult market, with growing but still limited IFC brand recognition, price elastic demand and long origination and processing lead times.
- Technical assistance support to enhance capacity and creditworthiness of borrowers and assist in project implementation needs to be an integral part of the model. Existing IFC Municipal TA activities in the sector such as the pioneering work done in simplifying business regulations in Bolivia provide an excellent base to grow TA support.
- Competition exists and is growing from regional development banks and others.
- The market is highly differentiated – almost every country needs a tailored response and borrowers need to be viewed in their local context.
- Portfolio supervision needs are high.
- Local currency products are essential as are local partners and local presence.

2.30 As in the case of infrastructure, the Corporation has also adopted a proactive approach to promote health and education development in full coordination with the World Bank. Because both health and education sectors are mainly local and not yet fully mature, pursuing attractive investment opportunities will continue to call for technical assistance and heavy up-stream involvement. Major efforts have been deployed in East Asia as well as in Africa, where two dedicated health and education staff have been posted to the Johannesburg hub. These efforts will be expanded in the years to come in the Middle East and North Africa (MENA) and Southern Europe and Central Asia (SECA) regions.

2.31 **Develop Public-Private Partnerships (PPPs).** IFC has recently established a unit within the Infrastructure Department to help respond to the opportunities emerging in many member countries for PPPs in infrastructure. The identification and development of PPP-type projects will require a comprehensive approach and systematic engagement by IFC with various parts of the World Bank Group, including, for example: (i) concerted infrastructure sector approaches among IFC, the Bank and MIGA in target markets; (ii) collaboration on joint financings with IDA, IBRD, MIGA and other multilateral/bilateral agencies; (iii) the strategic use of IDA and donor funds to catalyze private and

market-based investments when needed; (iv) coordinated IFC and Bank advisory and financing activities; and (v) the need for IFC to be able to “go upstream” to develop projects from inception as appropriate.

2.32 In the Health and Education sector, IFC is also looking to expand its support of PPPs. IFC is actively engaged with the Government of Mexico to support the first hospital project under a newly developed PPP program. If successful, this program will facilitate genuine engagement of private sector expertise and resources in delivering public services, increase the quality and efficiency of healthcare provision targeted at lower income population groups, and introduce new sources of financing for the traditionally underfunded sector. IFC will continue to pursue other such opportunities in its member countries, with an initial emphasis on Europe and Latin America.

2.33 **Provide Advisory Services to Governments.** IFC provides transactional advisory services to support governments in designing and executing sustainable privatizations of government-owned corporations and to help governments structure private participation in infrastructure. As many governments continue to face difficulties in raising infrastructure investment levels and improving the quality of service delivery, the demand for the advisory services has been increasing, particularly in frontier regions including Sub-Saharan Africa. IFC works closely with the World Bank to proactively engage in transactional assistance, for example, for privatization, and is increasingly in upstream project development for potential IFC clients. Recently, IFC provided advisory services to the Moroccan government on structuring and implementing the first PPP irrigation project in emerging markets as part of an agricultural sector reform process, which successfully obtained a private partner through a highly competitive and transparent process. IFC also provided advisory services to Polynesian Airlines of Samoa and Air Tanzania on their privatizations. Further, IFC aims to provide integrated packages of advice and financing to meet clients’ demand where appropriate. *(See also Annex 1 Box 1 on page 31, The Moatize Coal Project in Mozambique.)*

2.34 **Promote Local Currency Financing.** IFC has continued to innovate in providing local currency financing to its health and education clients. Most of IFC’s clients in health and education generate little foreign exchange. IFC is actively seeking to provide local currency financing for its health and education clients in India, Mexico, Russia, and Turkey. Through partial guarantees of bonds and bank loans, or by using the derivatives market when available, IFC can provide these clients with an option for local currency financing that is most suitable for their needs. In FY05, two such transactions were committed in Chile and Ghana.

2.35 **Find Ways of Reaching Small Clients.** As part of a major effort in Africa, the Corporation is investigating ways to provide financing to small health and education facilities, which comprise the bulk of private providers in the region. IFC is currently implementing a pilot in Ghana that, if successful, will allow IFC, working through a financial intermediary, to finance small primary and secondary schools. This pilot could generate a replicable model to be used in other low income countries and in other sectors.

Develop Local Capital Markets

2.36 **Focus on Priority Areas.** Financial institutions in many developing countries continue to suffer from insufficient capital, high non-performing loans, and ineffective regulatory systems. Within its broader objective of strengthening local capital markets and institutions and improving access to needed products and services, IFC is seeking to focus on specific priority sectors, including the financing of micro-enterprises, SMEs and housing finance. IFC’s commitments in the MSME sector increased 8 percent in FY04. Mortgage finance is also of particular importance, as it plays a major role in the growth of the housing and construction sectors and the expansion of financial markets, through the securitization of mortgages and other fixed income products. Total IFC commitments in housing finance has grown from \$28 million in FY02 to \$231million in FY04. Recently, IFC successfully supported a Mexican

peso-denominated revolving warehousing facility for the expansion of mortgage finance activities in the low to middle income housing segments in Mexico, and enabled the company to diversify its principal source of financing from the public sector. IFC is also about to launch a \$500 million Global Trade Finance Program which was approved in November 2004. This will provide IFC with a flexible platform to support the extension of trade finance to underserved clients globally.

2.37 Participating in Selective Bank Privatizations. In FY04, IFC supported four financial institution privatizations in Southern and Eastern Europe and East Asia. In addition to pre-privatization equity funding, IFC provided technical assistance throughout the privatization process. IFC's participation reinforced the credibility and transparency of the privatization process in these countries.

2.38 Introducing Innovative Products Using Risk Sharing, Credit Enhancement and Guarantee Facilities. IFC continues to develop new products customized to meet client needs depending on their asset size and the currency of their revenues. Use of local currency financing, partial credit guarantees, securitizations, swaps, and other structured finance and risk management products is expected to grow from \$702 million in FY04 to \$725 million in FY05. Local currency financing itself increased 134 percent from FY03 to FY04, from \$206 million to \$481 million, with the largest increase in Indian Rupee and Mexican Peso financing, followed by South African Rand. IFC plans on increasing and extending the diversity of its product offerings, and sees its ability to create new products as one of its main avenues of growth moving forward.

2.39 Developing Local Securities Markets. In many developing countries, the local financial markets are still dominated by the banking sector, and the lack of alternative financial intermediaries continues to present constraints to private sector development. IFC's assistance in developing local securities markets has become more important in order to improve access to long term local currency funding and diversify the funding sources for companies. In FY04, IFC combined technical assistance and investments to help build primary and secondary securities markets in several developing countries. Use of innovative financing such as securitizations and guarantees also helped deepen the local securities markets. For example, IFC provided advice on organizing a marketplace for trading bonds, and invested in the start-up of a local credit rating agency in Thailand. In Russia, IFC provided a partial guarantee for a local bond issue.

2.40 Providing Other Technical Assistance and Advisory Services. To help build capacity of financial institutions, IFC provides institution building assistance to banks, credit bureaus and securities markets. About 30 percent of IFC's financial markets technical assistance is linked to IFC's investment. IFC also provides corporate governance and anti-money laundering programs to financial institutions to support IFC's investment and portfolio operations. The Corporate Governance Department assists on average about 10 financial market investment projects per year (*See sustainability, para. 2.19 on page 11*) and IFC's Anti-money Laundering Group (AML) continues to support investment operations, and has undertaken special projects as well.

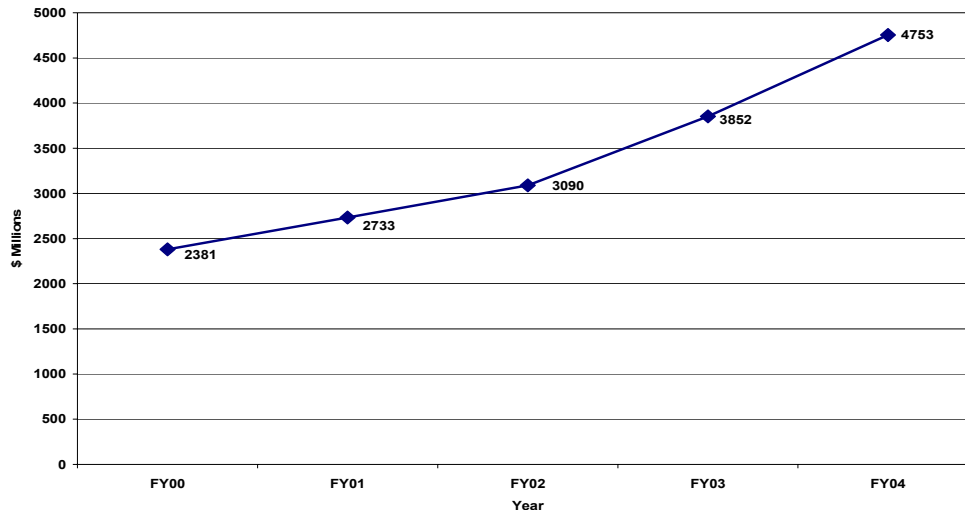
Portfolio and Financial Performance

2.41 Commitment Volumes Up. IFC experienced its second consecutive year of substantial portfolio growth, as new commitments in fiscal year 2004 increased to over US\$4.75 billion. New loan commitments grew 30.6 percent to \$3.4 billion while new equity and quasi-equity commitments increased 57.4 percent to \$1.1 billion. The Corporation disbursed US\$3.2 billion from its own account in FY04, a 7 percent increase over FY03. IFC's committed portfolio at the end of FY2004 increased by 6.5 percent to \$17.9 billion, from \$16.8 billion in FY03. Total commitments in FY04 showed a healthy sectoral and regional diversification. On a regional basis, commitments in Sub-Saharan Africa nearly tripled from \$140 million in FY03 to \$395 million in FY04. Sub-Saharan Africa's share of total IFC commitments increased from 4 percent in FY03 to 8 percent in FY04. The combined investments in Europe and

Central Asia also increased, making Europe and Central Asia the largest region in terms of new commitments. FY05 commitments for IFC's own account are expected to be in the mid to upper end of the plan range of \$3,800–\$4,800 million, although the final number remains subject to completion of a few large transactions by the end of the fiscal year.

Chart 2.2

Total IFC Commitments



2.42 Second Year of Record Profitability. IFC operating income for FY04 was \$982 million which represented an 86 percent increase over FY03, which had a then record operating income of \$528 million. The strong growth in profit on operations reflected significant realized gains on sales of equity investments, robust dividend income from the equity portfolio, stronger loan portfolio income, and the positive impact of a release of loss reserves in FY04. This high profitability led to IFC's FY04 Return on Net Worth of 13.7 percent, or 14.1 percent when adjusted for specific contributions to technical assistance and advisory facilities, up significantly from 8.2 percent in FY03. IFC is anticipating another year of strong profitability in FY05.

Risk Management

2.43 IFC also took several steps to address the increasing complexity of its business as its operations continue to grow. In FY05, IFC established the Business Risk Group to address both operational (people, systems and processes) and strategic risks (mainly reputation risk) systematically. IFC has also made progress in establishing a project risk management function to systematically capture and track all aspects of project administration. In addition, the Financial Risk Management Group is currently revising IFC's capital allocation, pricing and risk limit framework. This CAPRI project is to review and change IFC's policies in line with new business imperatives and best practice in risk management. The work is also related to other works on performance measurement and incentives.

Technical Assistance and Advisory Services

2.44 New Systems Will Strengthen Technical Assistance and Advisory Services. Following a strategic review of its Donor Funded Operations in FY04, and in view of the growing importance of technical assistance (TA) in the vision of the Corporation, IFC is currently engaged in a major effort to strengthen the systems underlying the design, delivery and monitoring of its TA programs. Several initiatives are being undertaken in order to ensure that TA programs are delivered to a consistently high

standard. *Focusing on key lines of business*—IFC is reviewing its experience with different TA products, with the aim of identifying several key lines of business, which would then be supported and replicated in other markets. *Strengthening TA staff capacity and improving flexibility*—IFC is undertaking several human resources initiatives for its TA staff, including developing a corporate cadre and reviewing TA competencies. Training programs for TA staff are also being strengthened. *Monitoring and evaluation*—M&E staff have been recruited in all facilities and a new project approval system for all TA projects, similar to that which exists for investment projects, is being rolled out. A major objective of this system is to measure development effectiveness on the ground. This requires specification of indicators of output, outcome and impact for each project. These indicators will be tracked during supervision and at closure.

2.45 Funding Mechanism for Technical Assistance and Advisory Services (FMTAAS). The Funding Mechanism for Technical Assistance and Advisory Services (FMTAAS) was established under a Board Resolution in June 2004 and noted with approval by the Board of Governors at the Annual Meetings on October 3, 2004. IFC designated \$225 million from its FY04 profits for FMTAAS. After careful analysis of past profitability trends and in order to ensure even distribution of expenditures under this mechanism, IFC management decided currently to limit annual expenditure allocations under FMTAAS to about \$65 million for FY06 onward. About \$68 million has been allocated for FY05. Existing IFC Facilities and other donor funded operations have been allocated about 75 percent of the designated amount, while the balance has been allocated to various projects for capacity building and other technical assistance needs.

Human Resources

2.46 IFC has strengthened its operational capacity and core expertise by implementing a human resource (HR) strategy founded on the principles of results measurement and performance differentiation. Since the late 1990's, IFC has successfully introduced a number of HR innovations that are closely linked with its business goals. These initiatives reflect IFC Management's view that the Corporation needs well-skilled, high-performing staff, deployed globally, to drive the business and meet changing market needs. Coupled with disciplined implementation, these innovations have enabled IFC to build a performance-driven culture. As a result, IFC's internal culture has become much more client-based and results-oriented and today, proactive people management is recognized as an essential element of IFC's business strategy.

2.47 IFC has historically faced a challenge in growing its core expertise and hiring top talent, particularly since the Corporation competes for human capital with private sector entities. This challenge is becoming more acute in an environment marked by increasingly competitive labor markets. To address this challenge, IFC has implemented a number of programs to attract and retain high quality staff and reward superior performance. IFC has adopted a competency-based career progression framework to accelerate the mastery and learning of core skills. IFC has also adopted a number of incentive programs to reward performance in the short and long term. In this regard, IFC has led the World Bank Group in the implementation of innovative and cutting-edge HR programs, all focused on driving and sustaining a high performance organization, where staff are differentiated based on performance, skills and behaviors. IFC has also overhauled its recruitment strategy and now recruits its core staff globally, including targeting universities and mid-career professionals in Part II countries.

Measurement

2.48 IFC is continuing to improve its evaluation and measurement systems for the Corporation's investment and advisory activities. Scorecards have been developed that measure performance with respect to development impact, profitability and client service, and also focus on the "value-added" and high impact dimensions of IFC's work. The Corporate Scorecard (*See Annex 2 on pages 44-45*) reports

on these dimensions, and this year also includes a number of measures for progress in the “five pillars” of IFC’s strategy. A set of Department Scorecards is used to measure department performance and is tied to department incentives. This year the Corporation introduced individual investment officer scorecards that track performance of individuals over time and are the basis for the long-term performance award program.

Box 2.4. Learning from Operations Evaluation Group (OEG) Findings

Among the various OEG reports in the last year, a number have had significant relevance to IFC strategy, including the Evaluation of Four IFC-Supported Small and Medium Enterprise Facilities, the Evaluation of IFC’s Investment Climate Activities, 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 ‘96-‘98) based on a finding of likely continuing improvement in IFC’s additionality and work quality and a better risk profile of recently committed projects.

IFC may benefit from expanding the frontier country group. Since 1998 several countries have graduated from the frontier group. The size of the frontier group could be restored towards previous levels by expanding it to include more countries with relatively low shares of foreign investment. OEG found that IFC’s investment outcomes have been broadly similar in frontier and non-frontier countries.

IFC’s technical assistance work can be effective and may help improve IFC investment and development results. This year’s OEG Annual Review has confirmed, as have previous reports, the strong link between the quality of a country’s business climate and the development and investment impacts of projects supported by IFC. IFC’s results are best when investment climate improves over the life of a project. This year’s SME study and the Investment Climate study also suggested that IFC’s advisory services were effective in business climate enhancement and wholesale SME support activities. The China study and previous country studies have also found that IFC investment results could be strengthened through improvements in the investment climate and corporate governance, and recommended the application of IFC advisory services in these areas.

Improved strategic focus in IFC’s TA work is important. Both the Investment Climate study and the SME study emphasized the importance of a strategic approach to technical assistance, finding areas where IFC has a comparative advantage, and finding TA activities with the highest demonstration effect, broadest impact, and scalability. The reports have also emphasized the importance of knowledge management in improving the impact of IFC advisory activities.

IFC can benefit from increased focus on tracking development impact and IFC contribution to projects. Recent Annual Reviews have focused on the importance of tracking development impacts of projects during regular supervision and on tracking IFC’s success in providing the contributions to projects envisioned at the time of approval.

2.49 Current efforts focus on improving the processes for identifying and tracking the expected impacts of projects. The new format of IFC Board documents will provide for explicit indicators of development outcomes. The information systems at IFC are being modified to capture these monitorable outcomes and to track them on a regular basis. Public reporting of the development impacts of projects will also be improved. Information made available prior to project approval will include expected development impacts, and IFC will improve its reporting of its aggregate results on development outcome.

2.50 IFC has also started to establish a similarly comprehensive system for monitoring and evaluating the development impacts of all its technical assistance activities. A new review process for all technical assistance projects entering the pipeline should improve their design and facilitate increased use of best practice. In addition, a results assessment framework is being launched that will capture outputs,

outcomes, and impacts, as well as lessons learned and good practice examples for these projects. The new system will also provide important results information for IFC's reporting on development effectiveness, thus helping facilitate comprehensive reporting on IFC's development impact through both its financial and technical assistance activities.