

INTERNATIONAL FINANCE CORPORATION OPERATIONS EVALUATION GROUP

Instructions for preparing an Expanded Project Supervision Report (XPSR) Financial Markets Projects (revised 2004)

OEG encourages short and concise XPSRs with no more information than necessary to support evaluative judgments (ratings) and lessons. Five pages usually suffice, and bullet points are welcomed.

If you have any questions, please contact your OEG counterpart or the OEG Help Desk at (202) 458-2299.

In the XPSR:

- **operation** refers to IFC's objectives, activities and results in making and administering its investment;
- **financial intermediary (FI)** refers to the legal entity in which IFC is making its investment and that is undertaking the project and may be a bank, non-bank financial institution (NBFIs), investment fund or fund management company;
- **project** refers to the specific FI objectives and portfolio of projects that were partially (or wholly) financed by the IFC investment – as described in the Board report – it is not a legal entity; and
- **investment** refers to the specific IFC financing instrument (loan, equity, underwriting, etc.) that was selected for an XPSR.

The XPSR's Evaluation Findings, and each of its dimensions and indicators, address a project's contribution to IFC's purpose and mission: to promote sustainable private sector investment in developing countries, helping to reduce poverty and improve people's lives. They also evaluate the investment's impact on IFC's financial sustainability, and IFC's work quality in executing the operation. IFC uses XPSR findings to account for accomplishment of its purpose and mission, to learn from past operations, to identify needs for systemic improvements and to improve selection and execution of new operations and IFC's strategy.

The XPSR assesses performance of the project since its inception, i.e. what has happened until now, and what might happen in the future. Future prospects should be realistically assessed, taking into account past performance as well as any changes (including external factors) that have affected, or are likely to affect, the project and FI over the rest of the project's life.

There are many different types of financial markets projects. These instructions focus on operations implemented by FIs that ultimately finance real sector investment projects (sub-projects). If you have difficulties applying these instructions to other FI operations (e.g., NBFIs, private equity funds, credit rating agencies) please contact OEG.

Project Description, Objectives and Rationale

Start the Evaluation Findings with a brief description of the project, its objectives¹, its rationale and the “without project” counterfactual – a plausible paragraph on what you believe would have happened if the project had not proceeded.

¹ objectives can be prioritized into primary (the immediate purpose(s) of doing the project, e.g. creation of an FI or on-lending for SMEs, housing finance, etc.) and secondary (desirable but not vital for the project's existence, e.g. encouraging the client to list its shares when providing a credit line or equity for institution building)

For example, “without the project, leasing would probably not have been introduced in that country; there would have been less competition and higher interest rates; the FI would have had more (or less) significant asset-liability mismatches; lending volumes would have been (a lot or somewhat) lower; 25 private enterprises would probably not have had access to financing (or with shorter maturities); the FI would have put more or less money into government T-bills; etc.” A starting point may be the project documentation at approval, but usually more information about what would have happened without the project is available at the evaluation stage (e.g. knowledge about external factors, etc.). It is not always easy to assess what would have happened without the project, but this section should offer an educated and plausible guess.

DEVELOPMENT OUTCOME

A project's development outcome encompasses all effects on a country's economic and social development. Development impacts are evaluated on a “with versus without project” comparison, i.e. considering (i) what happened with the project and, (ii) counterfactually, what would have happened without it. Distinguish, to the extent possible, the project from the FI's performance. For example, when a project was to support SME lending which only constitutes a small portion of the FI's portfolio, the XPSR should focus on the SME-portfolio's performance more than the FI's overall performance, or when IFC invests in a fund management company that already has funds under management, the XPSR should focus on the incremental effect of IFC's investment on the fund manager's profitability.

Project Business Performance

Concept

Project business performance measures the project's long-term impact on the FI's profitability and viability. Investors have diverse goals, but ultimately there is only one bottom line: financial returns. Sufficient financial returns are necessary to attract and reward private investment.

IFC projects are normally one of two types, both of which can be structured as either loan or equity:

- **targeted funding**, usually either a loan (credit line) where IFC wishes to encourage the FI to develop business in specific sectors (SMEs, exporters, micro-finance etc.) and therefore the use of funds is expected to be limited to the identified sector rather than the FI's overall portfolio, or equity in an equity fund. In the case of targeted funding, it is possible to identify sub-projects funded by IFC's project;
- **general funding**, where the effect of the IFC project is spread over the whole portfolio of the FI, such as a corporate loan or an equity investment in an FI other than an equity fund. In the case of general funding it is not usually possible to identify sub-projects funded by the IFC project.

Either type of project can include “**institution-building**” components (possibly through technical assistance) which may not have a quantifiable financial return. These should be considered under this rating to the extent that they have affected the FI's profitability, or are likely to affect it in the future. An example of capacity building would be development of staff skills and procedures (such as credit skills and loan appraisal standards) that will allow profitable pursuit of operations beyond the IFC-financed project at reduced transaction costs.

Indicators

In **targeted funding** where IFC's funds were used to finance or co-finance identifiable sub-projects, the primary indicator is the sub-projects' profitability and credit quality, and therefore their long term financial impact on the FI. In the case of credit lines, compare the profitability of the sub-project portfolio

to the rest of the FI's portfolio (sub-project portfolio performance should demonstrate to the FI whether the targeted sector is worth developing into a sustainable business segment).

The XPSR should identify the sub-projects and attach brief descriptions of each including industry sector, purpose of loan, amount originally advanced and currently outstanding, date of advance, original term of loan, interest rate, credit quality (identifying overdue payments, amounts of provision).² Multiple loans made to the same client should be identified individually. A summary profile for a fund's investees should contain at a minimum: sub-project name, sector, time of first investment, amount of investment at cost (in US\$ and as relevant also in local currency), latest valuation (and basis thereof), and internal rate of return.

In general funding (without identifiable sub-projects), the primary indicator is to what extent the project has affected - positively or negatively - the FI's long-term profitability and viability or, in newly established institutions, the primary indicator is their overall profitability (actual and projected) and viability.³

Relevant profitability indicators may include: ROAE, ROAA, net interest margin, provisioning/default rates, operating expenses/total income, share of interest income (and more generally, income from stable sources) in total income (as opposed to accounting income such as foreign exchange gains or securities reclassification gains and volatile and one-off income such as securities trading gains and real estate sale proceeds). When an FI is listed, its stock price performance can give a good indication of the returns to the FI's shareholders, but this may be an unreliable indicator for IFC's project performance, particularly where the project constituted only a relatively small portion of the FI's operations, or when there are significant short-term fluctuations.

In order to evaluate the FI's viability, the XPSR should also discuss the main risk areas identified by analyzing the FI's financial statements, e.g. capital adequacy, asset quality and structure (including the comparative size of the government securities and loan portfolios), provisioning adequacy (indicated by the open loan exposure), extent of related party lending, industry sector concentrations (especially to high risk sectors, e.g. real estate development), individual borrower and group concentrations, asset and liability maturity profile and mismatches, foreign exchange exposures (including mismatches between sub-loan currency and the currency of sub-borrower revenues) and interest rate exposures, and funding concentrations⁴. Most of these can be expressed as a percentage of the loan portfolio or of the FI's risk-weighted capital. In this context the XPSR should assess the operating policies of the FI to ascertain whether the risks are being prudently managed.

Other issues discussed in detail under "Economic sustainability" and under "Private sector development – impact of the investment climate" below can be briefly addressed here to the extent that they materially affect the FI's profitability. Examples include macroeconomic conditions, the degree of dollarization in the economy, interest rate and exchange rate distortions and/or volatility, subsidies (direct or indirect) that may exist in the financial market, the depth and sophistication of financial markets (e.g. market

² See either an actual good practice example or another suggested format for sub-project reporting. Where the number of sub-projects or projects exceeds 20, a summary profile (for example by sector, by instrument, etc.) suffices. For a different type of FI-project, see the good practice example for a housing credit line.

³ The investment's profitability to IFC is separately addressed in section 2 and may differ. Project business performance addresses the intermediary's profitability from the point of view of all FI financiers. [The XPSR should not penalize FIs with lower profits than competitors because of more prudent operating policies, nor credit FIs with high short-term returns from highly risky or speculative investments. This discussion may also be referenced under "economic sustainability" as relevant.](#)

⁴ The list suggests possible focus areas. There is no need to discuss all of them in the XPSR; however, the accompanying PSR is expected to include a detailed analysis of financial statements and to cover all risk areas.

domination by state banks which influence domestic pricing), government pressure in such areas as financing state owned enterprises, and policies by domestic supervisory bodies that affect financial results (e.g. provisioning).

To evaluate the institution building aspects of the project, the XPSR should address to what extent the project has fulfilled its objectives as stated at project approval in the Board Report/original decision memorandum (for example, resource utilization; the project's success in reaching its targets – SMEs, start-up ventures, etc.; FI performance in applying agreed approval/supervision criteria). If applicable, the XPSR may assign a relatively greater weight to the fulfillment of primary objectives (see footnote #1) compared to the secondary ones but should nevertheless discuss both.

Where the project had a technical assistance component, the XPSR should assess its outcome, try to identify whether any of the TA needs were not addressed, and include comments from the FI's management as to the effectiveness of the TA. If applicable, TA provided by IFC should be compared to that provided by other IFIs, e.g. EBRD, EIB, EU, ADB.

Projects are owned by FIs, and successful FIs can have unsuccessful projects and vice versa. Comment on the FI's prospects as a viable, internationally competitive institution. Focus on any issues that might threaten the FI's survival and thus could endanger realization of the still-to-go IFC project benefits.

Evaluation standard

Rate the expected project business performance according to the project's expected (long-run) financial impact on the FI or, in the case of newly established FIs, according to their expected (long-run) profitability⁵ and viability. Where quantitative information is not available to separately address the project's financial impact, discuss with the main project sponsor(s) and the FI's management how they would rate the project's financial impact and provide a rationale for the rating. The front parts of the following evaluation standards refer to targeted funding, and the parenthetical standards refer to general funding.

- *Excellent*: Project substantially raised the FI's profitability and substantially improved its viability (or high overall profitability of the FI expected in the case of newly established FIs);
- *Satisfactory*: Project had a neutral to positive effect on profitability and improved viability (or adequate overall profitability expected);
- *Partly unsatisfactory*: Project returns were sufficient to cover cost of associated debt⁶, but did not provide adequate returns to equity holders or detracted from viability (or expected long-run returns to equity holders don't provide a risk premium over the cost of debt financing);
- *Unsatisfactory*: Project returns insufficient to cover cost of associated debt or harmed viability (or expected long-run returns to equity holders less than cost of debt financing).

Where the project is other than *satisfactory*, explain why, discussing the main drivers of the shortfalls or *excellent* performance, e.g. market and investment volume; interest rates, spreads and equity returns; resource utilization and portfolio size; resource allocation (sub-project/fund investee performance or overall portfolio quality, sector/geographical allocation); cost structure; execution schedule; contractual/management arrangements; technology, training and productivity; management quality; force majeure events.

⁵ Section 2 contains rating benchmarks for equity returns to IFC. While IFC might not have an equity investment or be a minority equity investor, these benchmarks can serve as an indicator in evaluating the adequacy of returns to equity holders.

⁶ Use actual or notional cost of debt, as provided in section 2.

Economic Sustainability

Note: This section of the XPSR should be cleared by the departmental economist. For projects with significant impacts on the local community, the social development specialist should also be consulted.

Concept

IFC's *purpose* is to “further economic development ... in its member countries” (encouraging private sector development is the means to achieving that purpose), and IFC's mission is ultimately to “help reduce poverty and improve people's lives”. Growth and development are not synonymous, but economic growth provides the resources necessary for development. Projects with high economic returns contribute to a country's economic growth, whereas those with low or negative economic returns detract from it.

This section evaluates the project's and sub-projects' effects on the local economy and the associated benefits and costs. Address to what extent, as a result of the project, resources are being allocated more efficiently and in particular to what extent the FI's portfolio or the sub-projects are providing a net economic benefit. Use the financial performance as baseline, but assess also any systemic (e.g. interest or exchange rate controls, crowding out by state-owned banks) or portfolio-specific (e.g. concentration in protected sectors) distortions. Discuss whether and to what extent the FI considers economic (in addition to financial) viability criteria in its financing decisions – for example, do the FI's credit decisions take market distortions such as trade barriers into account?

To the extent possible, also try to assess the project's impact on people other than the investors in the FI: owners of FI client companies and their customers and employees, government, competitors, local residents, etc. Examples of economic benefits and costs accruing to them are:

- benefits or costs for FI clients associated with cost of, or ease of access to, financial services, indicating increased or decreased financial market efficiency;
- contribution to government revenues, for example resulting from taxes paid by the FI or by sub-projects;
- contribution to widely-held development objectives such as poverty alleviation, social or gender equality, concern for child labor, or regional development;
- community services such as supporting local industry groups, education programs, community facilities;
- employment generated/preserved, training, real wages, quality of the workplace, non-wage employee benefits (e.g. provision of a crèche, medical treatment, education of dependents). However, please note that in financial intermediary operations the direct employment effects are often insignificant and, for example, a large workforce in the FI might be a sign of an inefficient institution;
- negative effects: government subsidies that reduce the resources available to other programs in order to benefit the project's owners; interest rate or exchange rate distortions exploited by the project which reduce the efficiency of the financial system; reliance on collateral or government/third-party guarantees to pay for loans which supported bad projects; support of inefficient projects benefiting from protection which raises prices for local consumers; providing foreign exchange financing to sub-projects that are unable to bear currency risk and suffer from a devaluation.

Indicators

The economic impact of a financial market project can be gauged by:

- assessing the project's financial impact on the FI;
- assessing the sub-projects' financial performance, economic benefits and costs; and
- determining to what extent the financial performance of the FI and the sub-projects is influenced by economic distortions.

For example, an FI's portfolio might be concentrated in a highly protected sector, and therefore the contribution to economic growth might be less than the portfolio profitability would indicate. (Going forward, this would also constitute a risk for the FI.) On the other hand, due to poor structuring, lacking protection for minority investors, or lacking ability to enforce contracts, an FI's portfolio might be performing poorly, even though the economic impact of the sub-projects it finances is positive.

Evaluation standard

The project's contribution to economic sustainability should be rated:

- *Excellent*: when the vast majority of sub-projects are economically viable, the project has made a substantial and widespread contribution to improving living standards or the project has substantially increased the efficiency of financial markets;
- *Satisfactory*: when most of the sub-projects are economically viable (sub-borrower portfolio quality is better than, or equal to, the higher of (1) the rest of the FI's loan portfolio or (2) the market average; or the aggregate equity fund portfolio return before management fees is satisfactory⁷, or more than half of equity fund investees have positive equity returns while aggregate portfolio return before management fees is less than satisfactory but no less than zero), or the project has positively influenced the efficiency of financial markets;
- *Partly unsatisfactory*: when a large portion of the sub-projects is not economically viable (sub-borrower portfolio quality is worse than the higher of (1) the rest of the FI's loan portfolio or (2) the market average, or more than half of equity fund investees have zero or negative equity returns while aggregate portfolio return before management fees is less than satisfactory but no less than zero) or the project has made no positive contribution to the efficiency of financial markets;
- *Unsatisfactory*: when the majority of sub-projects is not economically viable (sub-borrower portfolio quality is worse than both the rest of the FI's loan portfolio and the market average, or the aggregate equity fund portfolio return before management fees is negative), the project has negatively affected living standards or the project negatively affected the efficiency of financial markets.

If the rating is other than *satisfactory*, the XPSR should explain the reasons.

Environmental Effects

Note: This section of the XPSR must be cleared by the environmental specialist. For projects with significant social safeguard policy issues (e.g. resettlement), the social development specialist should also be consulted.

Concept

⁷ Using the investment outcome equity benchmark for active investments. If the project had substantial non-quantifiable benefits or costs that constitute a compelling rationale for a higher or lower rating, these should be stated in the XPSR.

IFC's policy requires that “all its operations are carried out in an environmentally and socially responsible manner”. This is not only sound business practice, but also a necessary condition for sustainable development - IFC's Mission.

“Environmental Effects” include the project's (and sub-projects') impacts on the physical environment and social, cultural, and health and safety issues, all of which should be considered if they have entered into project performance or public perceptions of the operation. IFC's requirements⁸ are a proxy for acceptable environmental standards, but effects on the ground are what this indicator and the rating attempts to address. Whether environmental and social issues are appropriately addressed in the Investment Agreement, Board Paper, etc., should be discussed under IFC Work Quality.

The goal of IFC's environmental requirements for FIs is twofold: (i) enhance the environmental management capacity of the FI; and (ii) fund sub-projects or catalyze investments in projects whose operations meet the applicable IFC environmental requirements. The XPSR should therefore address whether both these goals have been fulfilled.

Indicators

Environmental effects should be evaluated relative to:

- IFC's⁷ current requirements;
- IFC's⁷ requirements at approval;
- requirements identified in the investment agreements and their attachments (e.g. reporting requirements, conditions of disbursement, remediation action plans, environmental management plans); and
- environmental and social management practices that go beyond compliance required by IFC.⁹

Specify which environmental category applied for the project at approval and which would apply today, including which environmental “type” the project would be in. (See IFC's Procedure for FIs.)

The following table summarizes the current requirements for FI projects:

Current requirements for Financial Intermediary Operations*

Type of financial intermediary operation:	Type 1	Type 2	Type 3
Environmental Management			
Performed reviews and required conformance as appropriate	X	X	X
Supervised projects	X	X	X
Provided performance report to IFC (if requested)	X	X	X
Sub-projects			
Comply with host country requirements	X**	X	X
Consistent with Exclusion List ***		X	X
Consistent with IFC Policies		X	X

⁸ “IFC's requirements” in this context include IFC's policies and guidelines and – to the extent they are applicable in a specific case – World Bank Group policies and guidelines, as well as host country requirements. [IFC's current requirements](#) and the *1993 procedures* are online. If you require assistance in identifying the specific at-approvals requirements (e.g. IFC or World Bank Group policies or guidelines), please contact CES.

⁹ For example: an FI Type 1 applies WBG guidelines and policies rather than host country requirements; an FI Type 2 applies IFC requirements to all investments, not just IFC-financed subprojects; an FI develops its own internal environmental training program; an FI actively fosters environmental improvements in the projects it finances, etc.

Category A sub-projects meet WBG guidelines		X	X
Category B sub-projects meet WBG guidelines			X
IFC environmental clearance for Category A sub-projects		X	X
IFC environmental clearance for all sub-projects			X
<p>*For projects where the FI provides debt or lease financing for equipment or other assets which represent a small portion of the total project or the investee company's balance sheet, the FI should use professional judgment regarding the scope of environmental and social review, the focus being on the impact of the equipment or assets financed.</p> <p>** In FI Type 1 projects, IFC's funding cannot be directly associated with specific investments made by the FI ('sub-projects'). The evaluation should address whether the FI has identified "relevant operations" (i.e. activities that could result in environmental and social impacts, such as project finance, corporate finance, leasing, etc.).</p> <p>*** IFC has two exclusion lists applicable to FI operations. The <i>General Exclusion List</i> applies to all Type 2 and Type 3 FI investments with project costs above \$500,000. The <i>Microfinance Exclusion List</i> applies to Type 1 microfinance operations, and to Type 2 and 3 FI investments with project costs below \$500,000.</p>			

For FI Type 1 projects, the focus should be on the systems and procedures established within the FI. For FI types 2 and 3, the XPSR team should also address the impacts of the sub-projects, visiting a sample of sub-projects, if at all possible. If sufficient documentation on the sub-projects is available, it may be possible to derive an informed opinion on performance from desk reviews.

Evaluation standard

The project's environmental effects should be rated as follows:

- *Excellent*: The project has materially improved either the efficacy of the FI's overall environmental risk management (e.g. through introduction of an excellent environmental management system – EMS) or the environmental performance of portfolio companies or local FIs. In addition, the project (and sub-projects, as applicable) has consistently met IFC's requirements at approval and its environmental effects are deemed acceptable in view of IFC's current requirements. IFC should be able to use projects rated *excellent* as role models for positive environmental effects. (IFC's sustainability initiative provides examples of demonstrated improvements in environmental management and process efficiency).
- *Satisfactory*: The project meets either IFC's at approval requirements or IFC's current requirements and its environmental effects are overall deemed acceptable. For FI Type 1 projects, an appropriate EMS has been in place and functioning over the project life (as reflected also in acceptable environmental standards being applied to projects financed by the FI). For FIs Type 2 and 3, the FI has an effective EMS system, is in compliance with IFC environmental safeguards policies, and the sub-projects are and have been in substantial material compliance with host country standards for the life of the project;
- *Partly unsatisfactory*: The project does not meet IFC's requirements, but the shortfalls are either being corrected or negative impacts are moderate. Examples: The EMS is adequate, but some sub-projects have resulted in environmental damage; or the sub-projects visited have acceptable environmental standards, but the EMS is materially inadequate; or an FI (type 1) initially had no EMS, but has recently introduced a functioning EMS.
- *Unsatisfactory*: The project does not meet IFC's requirements and substantial negative effects are known or likely. Examples: The EMS is completely inadequate and nothing is known about sub-project performance; or the EMS has material shortcomings and some sub-projects have negative environmental effects; or while the EMS appears adequate, a significant portion of sub-projects have negative environmental effects, or some sub-projects have resulted in substantial and irreversible environmental damage.

- *No opinion possible* where, after best efforts to obtain the relevant information, IFC cannot determine environmental performance. In these cases, the PSR should explicitly address: (1) what IFC did to obtain the information; (2) what follow-up actions IFC intends to take and a timetable.

As a general rule, for FI Type 1 operations the emphasis of the evaluation should be relatively more on the quality of the EMS and the standards applied. For FI Type 3 operations, the emphasis should be mainly on the environmental effects of the sub-projects. For FI Type 2 operations, the emphasis should be on both.

If the project was classified as category C (no impact), this does not by itself justify a *satisfactory* rating. The XPSR team should determine whether material adverse environmental impacts occurred as a result of the project, in which case the rating should be *partly unsatisfactory* (or *unsatisfactory* if negative effects were substantial). If no adverse impacts occurred, the project should be rated *satisfactory* (or *excellent* if the project resulted in substantial positive effects). If it is not possible to make a judgment, the rating should be *no opinion possible* (NOP).

The section on IFC's Work Quality should separately evaluate IFC's influence on environmental performance (e.g. through effective deal structuring to incorporate appropriate environmental procedures and through effective supervision).

Project's Impact on Private Sector Development

Concept

IFC's *Purpose*, specified in IFC's Article I, is “encouraging the growth of productive private enterprises”, and to that end IFC shall “seek to stimulate and to help create conditions conducive to the flow of private capital, domestic and foreign, into productive investment”. This indicator addresses to what extent the FI has developed into a corporate role model – positive or negative - and whether the project has contributed to IFC's purpose by spreading the benefits of growth of productive private enterprise beyond the project's FI.

Financial markets projects can contribute to this purpose in three ways: by contributing to the growth of sustainable and viable financial institutions, to the development of the financial markets in which they operate, and by financing sustainable and viable private enterprises in the real sector.

Indicators

Important factors to consider are:

- Impact on domestic financial market development through enhanced competition, increased liquidity, new products, improved services, easier access to financing for domestic clients (e.g. SMEs);
- demonstration effects in the local economy, attracting investments in other intermediaries;
- greater resource allocation efficiency beyond the project FI and resource mobilization beyond the project;
- introduction of international accounting standards and/or enhanced disclosure standards;
- new technology, development of management skills, and employee training;
- stronger local entrepreneurship or enhanced private ownership;
- the FI's governance quality, reputation and business practices as a positive corporate role model and quality investment asset ([IFC's sustainability initiative](#) provides examples of demonstrated improvements in business leadership, corporate governance and transparency);

Positive effects also include changes in the legal and regulatory framework and its administration that improved the enabling environment, for example by making transactions more secure and flexible and providing economic actors with the freedom, flexibility, and security to acquire, use, and leverage property rights. The enabling environment includes how the laws and regulations are set, administered, enforced and adjudicated. In a positive enabling environment, a non-intrusive, efficient, and respected public administration sets widely understood rules for economic activity, enforces them uniformly and universally in a predictable manner, and changes them through transparent means. Evaluate whether project-related technical assistance or the project's activities, goods and services have brought about changes in the enabling environment and cite changes in laws, regulations, or their administration. For example, the introduction of international accounting standards, enhanced disclosure, or prudent risk management practices in the market may, in turn, result in these standards being adopted by the regulatory authority/central bank.

Negative impacts may include: negative demonstration effects due to poor performance; poor reputation of the FI leading to a negative effect on the financial sector or private enterprises; poor allocation of resources in the FI's portfolio detracting financing from the private sector (e.g. increasing exposure to the government through purchases of T-Bills, or excessive volume of loans made to state-owned enterprises); project-induced restrictions on competition; delays of reforms or entry by other intermediaries; introduction of laws and regulations worsening the enabling environment, etc.

Where project impacts extend to the local financial markets (e.g. increasing the amount of term financing, introducing new products, improving the sector's liquidity), the local central bank may be able to comment or provide pre-project and current data for comparison. Appropriate indicators may include the ratio of private sector loans to GDP, the percentage of term loans in the banking system, aggregate liquidity, or the percentage of loans to specific sectors (SMEs, housing finance etc).

Evaluation standard

Rate the performance according to these standards:

- *Excellent*: considering its size, the project considerably improved the enabling environment or otherwise made a substantial contribution to the growth of private enterprises or efficient financial markets
- *Satisfactory*: the project had some, but no major positive impacts
- *Partly unsatisfactory*: the project had mostly negative impacts, which, however, are not expected to be of long duration or broad applicability (e.g. a failed project without substantial negative demonstration effects)
- *Unsatisfactory*: substantial negative impacts of broad applicability and/or expected to be of long duration

Briefly describe which of the above factors (or others) were most important for the rating and why.

Impact of the investment climate

Discuss, but do not rate, the impact of the investment climate on the project's development outcome and IFC's investment outcome. "Investment climate" refers to country conditions, including the legal, regulatory, and judicial framework, rule of law, institutional capacity, investment incentives and barriers, peace and order situation, level of corruption, and access to cost-effective labor, domestic finance, business support services, information, infrastructure, and other productive inputs. You may want to use Institutional Investor Country Credit Ratings (IICCR) and the Heritage Foundation Index of Economic

Freedom at project approval and at present as proxies for estimating investment climate characteristics and changes.

DEVELOPMENT OUTCOME RATING

Concept

This rating is a synthesis of the overall impact of the project on the development of its host country, and thus implicitly addresses how well the project has contributed to fulfilling IFC's *purpose and mission*.

Indicators

Each of the four development outcome indicators measures a distinct aspect of the project's performance in fulfillment of IFC's Article 1 purpose and mission. The development outcome rating is a bottom-line assessment of the project's results on-the-ground, and not an "average" of the four indicators.

Evaluation standard

Considering the four indicators, rate the operation's overall impact on the development of its host country on a six-point scale:

- **Highly successful:** A project with overwhelming positive development impacts, and virtually no flaws. Indicates the type of project IFC should use publicly to illustrate the contribution of private sector development to the World Bank Group's mission.
- **Successful:** A project without material shortcomings, or some very strong positive aspects that more than compensate for shortfalls.
- **Mostly successful:** A project which may have some shortcomings, but with a clear preponderance of positive aspects. The guiding principle should be: if all of IFC's projects were mostly successful, we should just be able to justify our existence as development institution.
- **Mostly unsuccessful:** A project with either minor shortcomings across the board, or some egregious shortcoming in one area that outweighs other generally positive aspects.
- **Unsuccessful:** A project with largely negative aspects, clearly outweighing positive aspects.
- **Highly unsuccessful:** A project with material negative development aspects with no material redeeming positive aspects to make up for them.

For any rating of *mostly successful* or better, IFC should be able to convincingly explain (without embarrassment) to a public audience why it rates this project a "success".

IFC INVESTMENT'S PROFITABILITY

Concept

Investment performance is essential to IFC's sustainability and to accomplishing its corporate purpose. This section assesses the extent to which IFC has realized to date, and expects to realize over the remaining life of the investment, the loan income and/or equity returns that were expected at approval. If IFC made both loan and equity investments, they are rated separately, as follows:

Indicators and evaluation standard

Gross Contribution -- Loan

Note: These ratings guidelines refer to senior loans. Other loan-type investments (e.g. convertible loans and other quasi-equity investments) are too diverse to set one evaluation standard. Therefore, please contact OEG. The primary indicator for this rating is whether the FI is current on its payments to IFC (interest, fees etc.) It is also important to assess the likely future debt-servicing capacity of the client FI – for example, recent payments may have been made, but the outlook for future payments is doubtful, which may be caused by the deteriorating macroeconomic situation in the country, deteriorating interest income of the FI (possibly due to poor portfolio performance), excessive foreign exchange or off-balance sheet exposures that could produce a large one-off loss to the FI.

- *Excellent*: Fully performing and, through sweetener (e.g. income participation), expected to earn significantly more than a loan priced “without sweetener” would have earned if paid-as-scheduled. There is no indication that debt service payments will not remain current in future;
- *Satisfactory*: (i) loan expected to be paid as scheduled or (ii) loan is prepaid and IFC has received at least 65% of the interest (net of prepayment penalties received) expected over the original life of the loan; or (iii) loan has been rescheduled and is expected to be paid as rescheduled with no loss of originally expected income; or (iv) IFC guarantee: all fees are expected to be received, and guarantee is not called, or called but expected to be fully repaid in accordance with the terms of the guarantee agreement; (v) IFC swap or other risk management facility: IFC has not suffered any loss and expects no loss due to non-performance of the swap counterparty. There is no indication that debt service payments to IFC will not remain current in future;
- *Partly unsatisfactory*: (i) loan is prepaid and IFC has received less than 65% of the originally expected interest income (net of prepayment penalties received); or (ii) loan has been rescheduled, or guarantee is called and in either case IFC expects to receive sufficient interest income to recover all of its funding cost but less than the full dollar margin originally expected. If all payments to IFC are current, but there is doubt whether payments can remain current in future, then a *partly unsatisfactory* rating may be preferable;
- *Unsatisfactory*: (i) loan is in non-accrual status, or (ii) IFC has established specific loss reserves, or (iii) loan has been rescheduled but IFC does not expect to recover at least 100% of its loan funding cost; or (iv) loan has been or is expected to be wholly or partially converted into equity in restructuring of a “problem” project; or (v) IFC experiences a loss on its guarantee or risk management facility. In some cases, IFC may establish “flag” loss reserves of modest size ($\leq 10\%$) for reasons such as country conditions, which are not related specifically to IFC’s project. In these cases, a *partly unsatisfactory* rating may be used rather than *unsatisfactory*.

Gross Contribution -- Equity

Calculate the nominal equity IRR for IFC (also called return on equity, or ROE) and compare it to the projected equity IRR. Unless more recent information is available, the equity IRR calculated by the Corporate Portfolio Management Group (CPMPM) should be used. If the XPSR team recalculates the equity IRR using projected dividends and capital gains, it should explain the reasons for divergences from CPMPM's estimate and attach the calculations and detailed assumptions.

In projecting equity cash flows, dividend projections should be based on discussions with FI management on dividend timing and payout considerations, and should take into account local company law (e.g. concerning reserve requirements), the FI's loan covenants, and its minimum cash constraints. Indicate how and when IFC is likely to sell its investment, and any plans by the FI for broadening of ownership. Where IFC's exit is expected to be through a put at a contractually specified price, assess the enforceability of the put and the prospects for timely realization of the put value.

The rating criteria for equity investments are based on the actual (or notional) fixed rate loan interest rate (FR) that was (or would have been) approved. (cost of funds, notional fixed rate loans, and spread ranges for specific projects with equity investments are online in Fixed Rate Loan Interest Rate.¹⁰)

(A) For **closed investments or active investments with put options that specify a minimum return** to IFC (and IFC expects to exercise the option at that value) the following ratings should be assigned:

- Excellent: Equity IRR > FR+xxx basis points (bp)
- Satisfactory: Equity IRR > FR+yyy bp¹¹
- Partly unsatisfactory: Equity IRR > FR
- Unsatisfactory: Equity IRR < FR

Where IFC's expected equity exit is by means of a put option specifying a minimum return but enforceability is doubtful, the equity investment should be treated as an active investment with more than 50% of undiscounted positive cash flows still-to-go by more than 12 months (scenario (C)).

(B) For **equity investments firmly planned to be fully sold within 12 months of the XPSR date**, such that the exit value is reasonably well-established, zzz bp should be added to the benchmark ranges in (A).

(C) For **equity not fully sold and more than 50% of undiscounted positive cash flows are still-to-go by more than 12 months**, 2*zzz bp should be added to the benchmark ranges in (A)¹².

¹⁰ The "fixed rate" (FR) loan (equivalent) is determined as follows:

- Investments which have a fixed rate senior loan in addition to the equity: FR is the actual interest rate for the fixed rate loan.
- Investments which have a variable rate loan in addition to the equity: FR is the Cost of Funds (CoF) plus the spread approved for the variable rate loan. CoF is the 10-year fixed rate swap equivalent of 6-month LIBOR as of the investment's commitment date.
- Equity-only investments: Notional FR is the CoF plus the country spread (from IFC's Weekly Pricing Guidelines) prevailing as of the investment commitment date.

¹¹ For example, if a notional senior loan would have attracted a fixed rate of 10%, the satisfactory equity IRR would be xx% to below yy% for a closed equity investment.

¹² For example, if a notional senior loan would have attracted a fixed rate of 10%, the satisfactory equity IRR range would be ww% to below zz% for an equity investment not yet sold.

IFC'S INVESTMENT OUTCOME RATING

The investment outcome rating, when both loan and equity gross contribution have the same rating, is the same as the two indicator ratings. In other likely combination cases, the following guidelines should be used.

Investment outcome rating for different gross contribution - loan and equity ratings

Loan Rating	Equity Rating			
	E	S	PU	U
E	E	E	S	S, PU or U*
S	E	S	S	PU or U**
PU	S	S	PU	PU or U**
U	***	***	U	U

E = *Excellent*, S = *Satisfactory*, PU = *Partly unsatisfactory*, U = *Unsatisfactory*
 * S if weighted average of effective loan interest rate and equity IRR \geq FR + www bp; U if < FR - www bp; otherwise PU.
 ** PU if weighted average of FR and equity IRR \geq FR - www bp; otherwise, U.
 *** For this unlikely event, consult OEG.
 Weights: dollar amounts of IFC's disbursed investment.

If the XPSR team believes the above guidelines to be inappropriate in specific circumstances, they may present a rationale for a different rating.

IFC'S WORK QUALITY

Concept

This section addresses three areas of IFC's operational performance: (1) screening, appraisal and structuring; (2) supervision and administration; and (3) role and contribution. Did IFC apply good practice standards in these areas, such as those identified in its policies and procedures and guidance notes (e.g. IFC's Credit Notes)? The analysis of appraisal projections against actual outcomes in Section 4 of the Evaluation Findings should help identify the strengths and weaknesses of IFC's operational performance, as well as valuable operational lessons. However, do not let the outcome unduly affect the work quality ratings. An unsatisfactory development and investment outcome can be caused by external factors, unforeseeable (e.g. force majeure), or foreseen (e.g. realized market risk). A satisfactory outcome can be achieved even though IFC did a poor job appraising and supervising the project, had insufficient role and made no contribution. However, if IFC did (or could have and did not) improve the project's development or investment outcome, this should be reflected in this section. For example, if the environmental performance is other than *satisfactory*, the XPSR should specifically address IFC's environmental effectiveness.

Screening, Appraisal, and Structuring

Concept

Evaluate to what extent IFC has professionally executed its front-end work to a sustainable corporate performance standard. IFC's operating policies and procedures, as well as its credit notes provide guidance on what IFC considers an appropriate professional standard.

Indicators

Evaluate IFC's processing of the project at entry. Identify materially deficient or particularly commendable areas in IFC's screening, appraisal, and structuring.

Screening and appraisal: examine the Board paper and the various supporting documents – CIC meeting minutes, decision meeting memorandum, appraisal reports, BTO reports, etc. Consider whether project objectives set at approval (as stated in the Board report and CIC meeting) were realistic. Analyze and comment on the effectiveness of IFC's assessment of project risks (risks that the project would fail to meet the intended development objectives or generate adequate returns), using IFC's Credit Notes¹³ as the best-practice guidelines for analyzing the assessment at appraisal of the project's creditworthiness. Did the screening/appraisal team adequately identify the main risks? What, if any, were missed? Review the assessment at appraisal of sponsors/management (their capacity, character, commitment, experience and reputation), country conditions (political; economic - local currency value, inflation, and interest rates; legal; business environment); project concept (fit with the likely market, competitive strength); local financial market characteristics (depth and liquidity; number, size, and types of participants including state-owned FIs; asset-liability profiles; income structure; and related systemic risks); non-FI private sector characteristics (size and depth compared to the state-owned enterprises, prospective borrower credit quality or potential investee profitability, subsidies and other relevant distortions); risks inherent in the project FI (governance quality; capitalization; loan portfolio quality and concentration; income composition and profit history; fund manager's track record for funds; etc.). Review the financial plan and assumptions used in the project's financial projections for completeness. In hindsight, were the parameters used in the sensitivity analysis at appraisal consistent with market and FI situation at the time? Were the assumptions realistic? Also review the effectiveness of implementing IFC's at-approval procedure for environmental appraisal. Did project appraisal assess the adequacy of policies or supervision standards of the local environmental authority? Did the appraisal identify training needs and procedural adjustments? Did IFC take into account available relevant lessons from other operations? (See for example IFC's Lessons of Experience and Lessons Retrieval Network.) If issues or concerns were raised at appraisal – for example in IFC's review process, by the World Bank, civil society or other stakeholder groups – were they appropriately addressed?

Structuring: Were the risks identified at screening/appraisal addressed in the structuring of IFC's project, and was their proposed mitigation adequate? Were the terms and conditions suitable for both the FI's and IFC's needs? Was loan pricing commensurate with market practices and risks? Were there any conflicts or coordination issues with the terms of co-financiers' loans? Evaluate whether, in hindsight, IFC's loan covenants were relevant, practical, and contributed to mitigating risks and realizing objectives. Loan covenants should be adapted to the particular country and project, depending on the adequacy of local supervision standards, local financial market development, and the FI's track record. Still, as a necessary minimum, covenants should include the minimum capital adequacy ratio (based on risk-weighted assets); maximum open loan exposure (or other loss provisioning guideline); single borrower, group, and industry exposure limits (including, if necessary, specific sectors); related party exposure limit; and maximum foreign exchange exposure¹³. If needed to ensure the FI's prudent functioning, covenants may also include maximum maturity and interest rate gaps; minimum liquidity ratio; maximum investment in government securities/T-Bills; off-balance sheet exposures; etc. Appropriate reporting requirements should be incorporated into legal documentation to enable IFC to monitor compliance and track the fulfillment of development objectives identified by IFC at approval. Were the identified training needs and procedural adjustments, particularly with respect to environmental matters, reflected in project design?

¹³ See also the minimum covenant requirements for banks under “Credit Notes – banking operational guidelines”.

In the case of targeted funding, the XPSR team should check whether IFC's project documentation included a definition of "eligible borrower" for credit lines or "eligible investee" for equity funds, so that the FI would be aware of IFC's targets and requirements. Reporting requirements for targeted funding should include regular and detailed reports on sub-projects.

Evaluate the decision to take equity (if applicable) and the structuring of the equity investment (see also IFC's Equity Investment Strategy). Was there a significant upside potential and a realistic exit option to realize a return commensurate with IFC's risk? Where the expected exit was through a put option, evaluate to what extent it was enforceable, and whether the pricing was adequate. If the anticipated exit was by means of the stock-market, evaluate whether this exit was realistic given the depth of that market.

Did IFC consider improvements to the FI's governance and operating standards, and require that the FI adopt or amend operating policies? In case of an equity investment, were the interests of minority shareholders, including IFC, appropriately protected in the operating policies and/or shareholders' agreement? Note that, even if IFC's loan has appropriate covenants, it is usually preferable to also cover key issues in operating policies (since loans may never disburse or be (p)repaid before the equity is sold. Consider whether this was, or should have been, done within the project reviewed in the XPSR. For funds, did the structuring align the fund manager's incentives with those of the investors? Was the role of technical advisor (if any) carefully defined? Where a technical advisor also had a shareholding, were the separate responsibilities of advisor and shareholder formally documented to avoid conflicts of interest?

In summary, did IFC identify the most important risks that could reasonably have been identified at the approval stage, and mitigate them to the extent possible? Keep in mind that not all risks can be mitigated, but the risk-reward profile should be acceptable.

Evaluation standard

Rate IFC's screening, appraisal and structuring:

- *Excellent* if IFC's front-end work could serve as a best-practice example;
- *Satisfactory* if it materially met IFC's good practice standards (see for example IFC's credit notes);
- *Partly unsatisfactory* if there was a material shortfall in at least one important area;
- *Unsatisfactory* if there were material shortfalls in several areas or a glaring mistake or omission bordering on negligence in at least one important area.

Supervision and Administration

Concept

Evaluate to what extent IFC has professionally executed its supervision, taking into account that the appropriate level of supervision will depend on a project's circumstances. IFC's Operational Procedures provide guidance on what IFC considers an appropriate professional standard.

Indicators

Review previous PSRs prepared on the project/FI, compare them to the XPSR findings, and explain any major discrepancies. Assess whether the FI's reporting and IFC staff visits were adequate to monitor developments, ensure compliance with covenants, identify and effectively mitigate emerging risks, identify opportunities, and more generally contribute to the operation's financial and developmental success. Evaluate the adequacy of IFC's monitoring of the FI's environmental performance. Did IFC identify emerging problems, and were IFC's responses timely and appropriate?

If IFC has Board representation, did IFC use it to enhance its supervision of the FI and gain better access to market and country intelligence? Did IFC's Board nominee help monitor whether the operating policies and procedures of the FI reflected good practices and were implemented appropriately? (See IFC's Policies and Practices for Directorships for guidance.)

Evaluation standard

Rate IFC's supervision and administration:

- *Excellent* if IFC has always kept itself promptly and fully informed about the project's and FI's performance in all material areas and used this knowledge proactively to improve the project's development outcome and/or IFC's investment outcome;
- *Satisfactory* if IFC has kept itself informed to react in a timely manner to any material change in the project's and FI's performance and took timely action where needed;
- *Partly unsatisfactory* if IFC's supervision was insufficient to monitor the project's and FI's performance; and/or IFC did not take timely and appropriate action;
- *Unsatisfactory* if IFC missed material developments and did not use information to intervene timely and appropriately.

IFC's Role and Contribution

Concept

IFC's Article I specifies its developmental role, which is captured in three basic operating principles ("IFC's ABC"). This section evaluates how well IFC fulfilled this developmental role.

- **Additionality/Special Contribution Principle** - *"IFC should participate in an investment only when it can make a special contribution not offered or brought to the deal by other investors."* What was IFC's additionality? Highlight any pioneering or innovative dimensions, and evaluate whether IFC's financing could have been replaced by private financing on acceptable terms if the same security had been offered. If IFC has Board representation, to what extent did IFC use it to provide assistance and direction to the FI and to improve its governance, financial performance and developmental results? Did IFC contribute to improving the project's or FI's environmental performance? Comment on the effectiveness of project-related technical assistance, if applicable.
- **Business Principle** - *"IFC will function like a business in partnership with the private sector and take the same commercial risks."* Did IFC accept the same commercial risks and earn the same returns as private participants in the same risk categories (e.g. equity co-investors, co-lenders)? If performance materially surpassed IFC's appraisal projections, did IFC receive any upside gain commensurate with its investment risk? If IFC obtained special recourse security, such as a fixed-return put or guarantee, explain the circumstances and rationale.
- **Catalytic Principle** - *"IFC will seek above all to be a catalyst in facilitating private investors and markets in making good investments."* Did IFC bring private investors and lenders to the project opportunity, mobilize funding, or attract better terms for the FI than would otherwise have been the case? (Since IFC's B-loans confer certain advantages to commercial banks, the test is whether they would have entered into the transaction, and on terms as favorable to the FI, absent IFC's involvement.)

Consider these three operating principles if and as material to your evaluation, and also consider the following:

- **IFC's Timeliness, Efficiency, and Client Satisfaction** – Were IFC's interactions with the sponsors and FI timely and efficient? Comment on any issues relating to staff continuity and whether and how it has affected the operation. Note any positive or negative feedback from the client or suggestions for improvement.
- **Relevance within IFC's country strategy** – Was IFC's support for the project relevant in addressing the country's development priorities and consistent with IFC's current country strategy? Where the country strategy has evolved over time, you may also want to comment on changes since the project's approval.
- **Governance:** One of the ways IFC can have an impact on developing financial markets is through introducing improved standards of governance. This goes beyond good front-end work in formulating covenants and operating policies, and can be especially significant where IFC has a board member. IFC's contribution may include assistance with audit committee creation and functioning, formulating asset-liability policies, credit policies, clarifying the distinction between the roles of shareholders/sponsors and management, helping protect minority shareholders, and clarifying the role of technical advisors. Did IFC's involvement encourage the FI to improve corporate governance? Did IFC insist on introducing higher standards in policies and procedures and was IFC's effort successful?

Indicators

Assess the project's genesis, the rationale for IFC's support, IFC's role in the project at approval, and ongoing contribution. As the basis for assessing IFC's role and contribution, consider what would have happened if IFC had not financed this project.

- Would the FI (and/or sub-projects) have found alternative financing (on similar terms)?
- Would the project have been more or less successful financially and developmentally?
- Did the FI actively seek alternative financing before coming to IFC, and what was the outcome?
- Did IFC maximize opportunities to improve corporate governance?

Consider what IFC added and what further added value IFC could have contributed to the project's design, or done differently to improve project or FI performance and development impact. For illustrative examples of what constitutes significant added value by IFC see IFC and sustainable development.

Evaluation standard

Apply the following rating guidelines:

- *Excellent:* IFC's role was essential for the project to go ahead and IFC made a major contribution to make it a success;
- *Satisfactory:* IFC's role and contribution were in line with its operating principles;
- *Partly unsatisfactory:* IFC's role or contribution fell short in a material area; and
- *Unsatisfactory:* IFC's role was not plausibly additional and IFC did not deliver its expected contribution.

IFC'S WORK QUALITY RATING

Based on the ratings of the three indicators - (1) appraisal, (2) supervision, and (3) role and contribution - rate IFC's overall work quality on a four-point scale: *excellent, satisfactory, partly unsatisfactory, unsatisfactory*. Bearing in mind that IFC's ability to influence the quality of an operation is greatest

between screening and disbursement, this rating should reflect the overall value added by IFC, at each stage, to the operation's development outcome and to IFC's profitability.

The IFC work quality rating can be no lower than the worst indicator, and no higher than the best indicator. The rating should be:

- *Excellent*: IFC's performance was exemplary;
- *Satisfactory*: IFC's performance was materially up to a high professional standard;
- *Partly unsatisfactory*: There was a material shortfall in at least one area;
- *Unsatisfactory*: There were shortfalls in several areas or an egregious shortfall in one area which led (or could have led, under less favorable circumstances) to a less-than-*satisfactory* development or investment outcome.

EMERGING LESSONS FROM EXPERIENCE TO-DATE

Issues and Lessons for Improved Performance

From the experience to date, identify the most important issues and the lessons for improving IFC's business in order of priority: Focus on how IFC can improve the development and investment outcome of its operations, and its own operational work quality. In particular, identify lessons that illustrate the business case for sustainability: for example, how a good environmental management system or good corporate governance improved the FI's competitiveness or vice versa. Address drivers of ratings other than *satisfactory*. The lessons may be positive (things that worked and should be repeated) or negative (mistakes that should be avoided). Good, well-written lessons: are specific but widely applicable; describe lessons learned rather than general principles; are derived directly and specifically from the experience of the operation and are self-contained. Be responsive to the following guidelines and suggestions.

- Focus on issues and lessons of general relevance to IFC operations that could guide IFC in screening, structuring, appraisal, negotiation, supervision and post-evaluation.
- Consider (i) the issues' materiality and relevance to the operation's outcome, and (ii) what, with hindsight, IFC should have done to improve the operation's overall performance.
- Be specific and focus on suggestions to improve quality. For example:
 - If FI management was weak, consider how IFC could have (i) discovered this weakness at appraisal, (ii) better mitigated the risk, and (iii) intervened more effectively when the problem was detected. It is not a helpful lesson to write "ensure that FI management is strong;"
 - If the financial projections proved materially optimistic, consider the underlying reasons (e.g. flawed forecasting models, little experience of the forecasters, poor training, and too much optimism) and formulate the lessons and recommendations for achieving a better forecast next time. It is not a helpful lesson to write "make realistic projections;"
 - If the project featured negative sociological or environmental effects, consider whether and how IFC's procedures should be adapted to address these potential effects in the appraisal, covenant formulation, disbursement and supervision stages. It is not helpful to write "make sure that adequate account is taken of environmental effects;"
 - If IFC's investment featured essentially equity risk but limited upside potential, consider (i) whether the screening tools should be sharpened to make this prospect more evident, or (ii) whether and how IFC might have structured its investment to better balance the risk and reward prospect.
 - Avoid repeating what happened, and be concise in elaborating the underlying issues.

The lessons will be added to IFC's on-line lessons database ([LRN](#)) and should thus be self-standing, transparent, prescriptive, and operationally oriented with a view to providing guidance for improving future performance. They should be helpful to other IFC staff and presented in the format of the following example:

- ***What IFC expected at approval*** - In 1996, IFC financed a project to support SMEs in Thailand. Since the local currency had been stable and the FI's risk management procedures (including those for foreign exchange) appeared well-established, IFC did not consider devaluation a risk.
- ***What actually happened*** - The local currency experienced a steep devaluation which led to huge losses for the FI and many of its sub-borrowers.
- ***Why things turned out the way they did*** - Because of a regional crisis.
- ***Lesson for future operations*** - Given the volatility of exchange rates in emerging markets, IFC should undertake sensitivity analyses to understand the impacts of sharp swings in exchange rates – appreciation or depreciation – on borrowers and sub-borrowers, and try to mitigate risks accordingly (e.g. lower net open foreign exchange exposure, FI's ability and willingness to target sub-projects able to bear foreign exchange risks, etc.).

Examples of sustainability-related lessons:

- ***What IFC expected at approval*** – In 1998, IFC financed MCN, a start-up microfinance bank, and expected it to demonstrate the benefits of a commercial approach to microfinance compared to a traditional grant-funded, NGO-operated scheme.
- ***What actually happened*** - MCN outperformed the economy in terms of asset growth and profitability, while the quality of its loan portfolio has been excellent. MCN reached operational break-even in 12 months, has been sufficiently profitable to fully absorb the technical assistance costs, and has captured an estimated 15% share of the total micro- and small enterprise loan market, with nearly 50% of MCN's loan portfolio having been extended to low-income women - an unusually high incidence for the country. MCN has exposed borrowers to best-practice standards in areas ranging from client service to disclosure of financial information to environmental and social considerations when appraising potential investments. Advisory assistance offered by MCN (upon clients' request) for financial planning and development of business plans has contributed to the growth of private productive enterprise.
- ***Why things turned out the way they did*** - MCN's business success is due to the sound lending methodology, credit practices and procedures, realized synergies with Unibank (MCN's local partner) and personnel management techniques developed for MCN by IPC (the technical partner) and shareholders. In addition, MCN's shareholders closely collaborated on designing an appropriate corporate governance structure for a model microfinance FI and model governance documents. These included the Charter, Shareholders' Agreement, Operating Policy Guidelines and environmental review procedures developed for MCN.
- ***Lesson for future operations*** - The successful implementation of MCN underscores the viability of IFC's commercial approach to microfinance, even in extremely difficult political and economic environments. Unlike other industries, experience¹⁴ seems to indicate that the performance of well-run microfinance FIs is rarely significantly influenced by the performance of the economy. It appears that a professionally-managed microfinance FI with best-practice operating policies, professional management, strong governance, strong support of committed

¹⁴ (e.g., Caja Los Andes in Bolivia, MEB in Kosovo, MEB in Bosnia & Herzegovina, Sociedad Financiera Ecuatorial in Ecuador, among others).

sponsors and access to long-term commercial sources is most likely to perform well, even in countries with difficult economic conditions.

- ***What IFC expected at approval*** – When IFC invested in IDFC, an infrastructure finance company in India, IFC expected that IDFC would develop an environmental management system to enable it to apply environmental and social performance standards to its sub projects equivalent to those applied by the World Bank Group.
- ***What actually happened*** - Initially, IDFC management sought to ease environmental and social performance requirements in order to establish a portfolio of subprojects. With IFC guidance, IDFC management eventually agreed to meet WBG standards and established an Environmental Management and Social Development Group (EMSD). Strong senior management backing has helped the EMSD develop into an independent and effective team of specialists supporting IDFC investment staff in the assessment and processing of all pipeline projects. With considerable support from IFC’s Environment and Social Development Department, the EMSD has succeeded in mainstreaming environmental and social risk assessment and management in IDFC’s investment decisions. In addition, the EMSD team plans to expand their activities to include training and capacity building for IDFC clients, environmental and social development policy initiatives, and advisory services to clients. IDFC has one of the strongest environmental and social review capacity of any FI in the South Asia region.
- ***Why things turned out the way they did*** - From IFC’s standpoint, the persistence of IFC’s environment department and its ability to negotiate a practical approach to the assessment of sub projects. From IDFC’s standpoint, the realization on the part of senior management of the importance of environmental and social considerations to the business model and support for the hiring of a talented and energetic staff to ensure IDFC’s good performance in these areas.
- ***Lesson for future operations*** - IFC’s consistency in its requirements for the environmental and social performance of its clients, and its willingness to provide support and guidance to clients to meet those requirements, helps clients develop a more sustainable approach to their business.