At issue: The International Finance Corporation: Behind the rhetoric

To what extent is the International Finance Corporation living up to its commitment to invest in small and medium enterprises in 'frontier' countries? There is evidence that financing of small and medium enterprises, almost all of which occurs via financial intermediaries, is under-supervised, and that direct lending is still focused on large companies in emerging market economies with questionable value-added.

The International Finance Corporation (IFC), the private sector arm of the World Bank, is the largest provider of multilateral funding to the private sector in the developing world. Its new commitments reached $10 billion in 2007, double the level of just four years ago.

The IFC has been vocal about the importance of small and medium enterprises (SMEs - defined as those enterprises that employ between 10 and 300 people, with assets and annual sales between $100,000 and $15 million), particularly for private sector growth in 'frontier' countries (defined as those countries that are high risk and/or low income). SMEs account for up to 90 per cent of all firms in developing countries, and employ over half the working population. In October, head of the IFC Lars Thunell called SMEs the "backbone of most economic systems". He referred to the IFC's engagement with them as a significant example of its contribution to environmental sustainability. He also said that the IFC would be willing to accept greater risk and volatility in returns in its drive to invest in the poorest countries.

A very different position was expressed in an IFC paper in February 2000, which stated that SMEs offered no inherent benefits, and that they had to be developed simply because they represent the emerging private sector. IFC chief economist Michael Klein has similarly argued that small firms should not be rewarded simply because of their size, and that larger firms are more productive and employ more people than smaller ones.

The August 2007 study by the Bank's Independent Evaluation Group (IEG) on ten years of the IFC's development results, concludes that the IFC has more success in financing larger projects. Sixty-five per cent of IFC projects had a favourable development impact measured by volume of investment, compared to 59 per cent measured by number of projects - clearly bigger projects are pulling up the average when weighted by volume of lending. The IFC's newly instituted Development Outcome Tracking System (DOTS) also finds that project ratings are higher when weighted by size. This is consistent with the urgings of the IEG in a previous report in 2000 that found that direct lending to SMEs "was neither an effective nor an efficient model for the IFC". The IFC agreed, saying it did not have the resources necessary for handling SMEs directly, as individual loan amounts are too small, and the total number of loans too large.

If the IFC is mandated to support SMEs but isn't good at it, how can it solve the dilemma? The answer is that the IFC has come to deal with SMEs almost exclusively through financial intermediaries (FIs, see *Update* 46). FIs include commercial banks, micro-finance institutions and non-bank financial institutions such as leasing and insurance companies. Out of the approximately $4.2 billion that comprised the IFC's SME portfolio as of June 2007, just over $4 billion was channelled through FIs.

The IFC classifies its FI financing as SME if at least half of the FI's portfolio is invested in SME clients. Confusing matters is that the SME clients of the FIs are classified based not on their size, but on the amount of financing they receive. This ranges from less than $10,000 (considered micro enterprise) to less than $1 million (medium enterprise).

Given the fact that almost all of IFC SME financing is done via FIs and the emphasis that the IFC places on monitoring and evaluation, one would expect a robust method of supervision of FIs to be in place. The IEG worries however that the IFC's rating of the environmental and social effects of its financing to FIs amounts to a box-ticking exercise. The IFC does not visit most FI projects, even though the cumulative environmental and social impacts of FI sub-projects "could be significant". This leads the IEG to conclude that there is a "serious gap in IFC's knowledge of project environmental and social effects in FI operations".

This brings in to question Thunell's claim that the IFC's engagement with SMEs represents a significant contribution to environmental sustainability. Even though the IFC rates its FI support highly successful by default, thirty-three per cent of all projects evaluated by the IEG *including* FI projects still had an "unsuccessful" rating on environmental and social effects.

The profit frontier

The importance of SMEs is held to be greater relative to the scale of the economy, especially in frontier countries. The IFC's frontier strategy aims to "steer its resources toward countries where its value-added is highest". Research by US NGO Bank Information Center finds that the IFC's portfolio is becoming more concentrated in a handful of countries (over 50 per cent of its lending is in just ten countries), with commitments by volume more heavily

Golden bank

Banco de Oro is controlled by the SM Group of companies in the Philippines, one of the largest conglomerates in the country and owners of its most extensive chain of shopping malls. It has been an IFC client since 2002, expanding in that time from the 13th largest commercial bank, with assets worth $1.52 billion, to the 2nd largest in 2007, with assets totalling $12.6 billion. In 2003, IFC gave Banco de Oro a $20 million loan, to boost "medium-term lending to the middle-market". Its latest loan, of $150 million, is expected to "consolidate the Philippine banking industry" and expand Banco de Oro's capital base.

According to Banco de Oro officials in Manila, banks tend to lend to SMEs only when the economy is on the upswing, and they are assured of returns. This calls into question the IFC's claims of SME financing providing a counter-cyclical influence and suggests that there may be no correlation between their support and that of Banco de Oro to SMEs.

weighted towards non-frontier countries. Even in frontier countries, many projects approved by the IFC support large corporations, involve little risk and have questionable 'value-added' for development.

One such example is that of Punj Lloyd Ltd in India, a frontier country due to its low-income status. The company is ranked among the largest engineering, procurement and construction firms in India. Its operations are spread across the Middle East, Africa, the Caspian region, Asia Pacific and South Asia. It currently has around 120 clients, with 180 projects in 14 countries, and it undertakes construction work on oil and gas pipelines and processing facilities, transport, industrial and urban infrastructure, power projects and telecommunications. In 2002, the company was awarded a $90 million contract to construct a 331 km section of the controversial Baku-Ceyhan pipeline (see *Update* 46).

In 2005, Punj Lloyd raised $50 million from a private consortium led by Standard Chartered Private Equity. Punj Lloyd has access to private sources of finance, and yet in September 2007 it received an IFC loan of $50 million, for "corporate financing needs", including the purchase of new equipment. This loan would appear to violate the IFC's Articles of Agreement, the first of which states that the IFC shall assist in financing private enterprises "in cases where sufficient private capital is not available on reasonable terms". This raises concerns that it is crowding out private investment and questions its 'value-added'.

According to the IFC, the anticipated development impact includes the creation of new employment in India and abroad, particularly temporary employment of local labour in the construction of new infrastructure. The IFC also justifies this loan on the grounds that Punj Lloyd has an HIV/AIDS awareness programme for its own employees, and that "opportunities will be explored" for "working together towards deepening and expanding this initiative".

Another questionable investment by the IFC in a frontier country is Macquarie Infrastructure, also in India. Macquarie is an Australian investment bank with a global portfolio of infrastructure and specialist investments with equity under its management in excess of $47 billion. Macquarie's total assets were over $86 billion in 2006. It is the largest private operator and developer of toll roads in the world.

The Macquarie Infrastructure Group, in conjunction with the IFC, plans to set up the Macquarie India Infrastructure Opportunities Fund, designed to invest in roads, airports, ports, power generation and transmission, telecommunications towers, water and waste treatment, rail and other infrastructure-related sectors. The target size of the fund is $1 billion, with the IFC's equity share up to $150 billion. The IFC is to work with the fund to develop its social and environmental management system, "thus ensuring improved performance of all projects in which the fund invests". Helping financial intermediaries develop their environmental management systems is not the IFC's strongest point.

At the launch of the fund in India, Macquarie strategists noted that "India's population is large and young and is growing wealthier: more than 50 per cent of households will be earning $1,000-$5,000 per annum by 2010. India will experience an exponential increase in demand for consumer goods and services." The former Australian cricket captain Steve Waugh, who has a joint-venture company with Macquarie (that deals in high-end real-estate and specialises in building themed townships), was present at the launch adding that "India provides a receptive environment for innovative ideas. We are pioneering a concept of high-quality, integrated residential communities providing a quality live-work-play ethos". Swimming pools for the rich in a 'frontier' country where the presence of the World Bank Group is justified by the high level of poverty? As Zoellick stated on his recent visit, India has the same number of poor people as all of Sub-Saharan Africa.

IFC's sweet tooth

The IFC has recently supported Coke bottling concerns, Sonut in Egypt and Coca-Cola Sabco, based in South Africa. The IFC has approved a loan of $14 million to Sonut to finance equipment and improvements, packing materials and working capital. The development impact of the project includes indirect employment and micro-enterprise development through the proliferation of kiosks and small retailers. The project sponsor, Sonid, is one of Egypt's largest private sector business groups, and the holding company of several corporations that deal with construction and real estate, automobile manufacture, food and beverage manufacture, among others.

The IFC has supported Coca-Cola bottling in Egypt and South Africa

Coca-Cola Sabco, or CCS (an existing IFC client), owns Coca-Cola bottling operations in South Africa, Namibia, East Africa and Asia. The IFC has approved a loan of $40 million to support and refurbish existing plants in Ethiopia, Kenya, Tanzania, Uganda, Mozambique, Cambodia, Nepal and Sri Lanka, and set up a new plant in Laos. The IFC hopes that the project will allow CCS to deploy its experience for the benefit of local bottlers in frontier countries. Expansion is also expected to lead to generation of employment, and stimulation of micro-enterprises through the building of retail networks.

These cases suggest a mismatch between the IFC's claims of focussing on SMEs in frontier countries, and what it actually does. They are illustrative of the kinds of projects the IFC prefers to fund, i.e. existing clients, the larger the better. SMEs are not the main focus of IFC lending, and where they are, through FIs, the IFC's supervision is inadequate.

Testing the rhetoric against the reality is especially important now as the Bank embarks on its strategic review. To ensure that there is genuine 'value-added' in IFC activities, shareholder governments should demand greater scrutiny of the IFC's activities. This will require disclosure of disaggregated firm-level development impact evaluation for direct lending, and greater scrutiny of financing which passes through financial intermediaries. Ultimately, it may require shareholders to admit that their high-level rhetoric to support small firms in the poorest countries is ill at ease with the IFC's focus on the bottom line.

Tahira Thapar
December 2007
A fully-referenced version of this article is available at:
http://www.brettonwoodsproject.org/ifcatissue58

Published by **Bretton Woods Project**
Hamlyn House, Macdonald Road, London N19 5PG, UK
Tel +44 (0)20 **7561 7610**
Fax+44 (0)20 **7272 0899**
info@brettonwoodsproject.org www.brettonwoodsproject.org/subs
A publication of an independent NGO supported by a network of UK NGOs, the C.S. Mott Foundation, the Swedish Society for Nature Conservation and Oxfam Novib.