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IFC and Its Role in Globalization

Highlights from IFC's Participants Meeting

Washington, D.C.

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Suellen Lambert Lazarus, Editor

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Table of Contents

Preface vii
Suellen Lambert Lazarus—Director, Syndications and International Securities, International Finance Corporation

Acknowledgments ix

Abbreviations and Acronyms x

SECTION I At the Center of Globalization

Chapter 1 The Unique Role of the International Finance Corporation 3
Peter L. Woicke— Executive Vice President, International Finance Corporation, and Managing Director, Private Sector Development, World Bank

Chapter 2 The Global Implications of Poverty 7
James D. Wolfensohn—President, The World Bank Group

Chapter 3 Globalization as an International System 10
Thomas L. Friedman—Foreign Affairs Columnist, *The New York Times*

Chapter 4 International Financial Stability and Sustained Growth 21
Horst Köhler—Managing Director, International Monetary Fund

Chapter 5 The Consequences of Globalization for Asian Banking 27
John T. Olds—Special Advisor to the Chairman, DBS Bank, Singapore

SECTION II The International Finance Corporation and Our Market Environment

Chapter 6 Update on Financing Operations 37
Assaad J. Jabre—Vice President, Operations, International Finance Corporation

Chapter 7 Portfolio Performance and Future Plans 43
Farida Khambata—Vice President, Portfolio and Risk Management, International Finance Corporation

Chapter 8 Trends in Syndicated Lending 47
Suellen Lambert Lazarus—Director, Syndications and International Securities, International Finance Corporation

Chapter 9 Restructuring Problem Loans 54
Mary Elizabeth Ward—Manager, B-Loan Management Division, International Finance Corporation

SECTION III Enhancing Value: Investing in Sustainability and Corporate Governance

Chapter 10 Sustainability: A Portfolio Manager's Perspective 59
Julie Fox Gorte—Senior Environment and Technology Analyst, The Calvert Group

Chapter 11 Sustainability: A Commercial Bank's Perspective 64
Bart Jan Krouwel—Managing Director, Sustainability and Social Innovation Group, Rabobank Nederland

Chapter 12 Corporate Governance: A Call to Action 69
Peter H. Sullivan—Chairman and Chief Executive Officer, Lombard Investments, Inc.

Chapter 13 Corporate Governance: Its Impact on Investment Flows 77
Peter C. Clapman—Senior Vice President and Chief Counsel, Investments, Teachers Insurance and Annuity Association–College Retirement Equities Fund

Chapter 14 The International Finance Corporation's Focus on Corporate Governance 81
Mike Lubrano—Senior Investment Officer, Financial Markets Advisory Department, International Finance Corporation

SECTION IV The New Basel Capital Accord: Implications for Bank Lending to Emerging Markets

Chapter 15 An Overview of the New Basel Capital Accord 87
Jonathan L. Fiechter—Senior Deputy Comptroller for International and Economic Affairs, Office of the Comptroller of the Currency

Chapter 16 Country Risk in Basel 2 96
Frans Cornelissen—Senior Vice President, Head of Country Risk Management, ABN AMRO Bank

Chapter 17 Basel 2 and Emerging Markets 100
Ernest Napier—Managing Director, Financial Services Group, Standard & Poor's

Chapter 18 Basel 2: Possible Impact on the International Finance Corporation's B-Loan Program 105
Dirk Müller—Partner, Financial Services Consulting, Risk Management, KPMG

SECTION V The Business of Project Financing

Chapter 19 Dealing with Portfolio Problems: Two Cases
Part (a): A. O. Volga, Russian Federation 111
Jyrki I. Koskelo—Director, Special Operations, International Finance Corporation
Charles Van der Mandele—Chief Special Operations Officer, International Finance Corporation
Anke Avderung—Director, Global Debt Origination, Dresdner Klienwort Wasserstein
Francis Hamilton—Senior Adviser, Syndications, International Finance Corporation
Part (b): Tuntex Petrochemical Thailand 122
Eric Jourdanet—Senior Investment Officer, Oil, Gas, and Chemicals Department, International Finance Corporation
Alma Ourazalinova—Participations Officer, Syndications and International Securities, International Finance Corporation
Vera Reusens—Senior Manager, Global Export and Project Finance, Fortis Bank

Chapter 20 Investing in Environmental Projects 133
Louis Boorstin—Manager, Environmental Markets Group, International Finance Corporation
Brooks Browne—President, Environmental Enterprises Assistance Fund
James D. Westfield—Managing Consultant, PA Consulting Group

SECTION VI Innovations

Chapter 21 The B-Loan Website 147
Andy McCartney—Managing Director, eHatchery, LLC
James Smouse—Project Manager, B-Loan Website, International Finance Corporation

Chapter 22 Investing in Education: NIIT Student Loan Program 155
Guy Ellena—Technical Manager, Health and Education Department, International Finance Corporation
C. N. (Madhu) Madhusudan—President, Strategic Alliances, National Institute of Information Technology (USA), Inc.
Nicholas Vickery—Investment Officer, Financial Markets, South Asia Department, International Finance Corporation

Program of Meeting 166

List of Attendees 173

Preface

The International Finance Corporation (IFC) syndicated its first loan in 1959. But it was not until the late 1980s that mobilizing commercial bank finance, alongside our own loans, grew into one of the central features of the Corporation's business. By then, we were syndicating B-loan participations to almost all the world's leading commercial banks, and to many smaller financial institutions. IFC has introduced banks to countries and sectors that otherwise they would not have considered acceptable risks.

With the rapid growth in the volume and variety of project risks being shared, inevitably some policy and implementation issues developed. Eleven years ago we invited a few of our leading partners to a one-day meeting in Washington, for a general discussion of the main aspects of the B-loan program. This first Participants Meeting, in April 1991, was attended by some 25 bankers, who supported the idea of making it an annual event.

At its inception we had little notion of where this modest initiative would take us. The meetings are now evidently a fixture in the diaries of many leading international project financiers. Attendance has grown to over 200 representatives from 100 financial institutions, based in all the world's major markets. Many more would like to attend, if we had room. The range of topics and speakers, the amount of detailed information presented, and the publicity generated by the meetings have far exceeded our early expectations. For senior banks working in emerging markets project finance, it is a conference of considerable importance. But the central objective is unchanged: to provide a forum for a frank and open discussion between IFC and our B-lenders. We are also pleased to reciprocate some of the generous hospitality we receive from so many of you throughout the year. We give the facts on portfolio performance, market trends, internal IFC policy changes, and some of the major transactions in our pipeline, but we also ask for, and heed, the opinions and recommendations of our partners. For example, the B-loan sales website described in Chapter 21 is an innovation based on requests from our participants for increased liquidity.

For those who have been working in this field the history of project finance is one that is not well documented. The lore of excruciating proj-

ect structuring exercises and restructurings that continue for many years is passed on from bank to bank, but seldom recorded. Each year at the Participants Meeting we discuss some important case studies. Contributing to a recorded history of project finance experience in emerging markets was part of our motivation for producing this volume.

The 2001 meeting was our best attended and most comprehensive, so much so that we also considered the main proceedings to be worthy of publication. The topic of globalization was explored in detail by Tom Friedman in his fascinating exposition on the role of globalization in transforming world affairs, by Horst Köhler on the changing role of the International Monetary Fund, by Jim Wolfensohn on the importance of alleviating poverty, and by Peter Woicke in considering IFC's role at the center of the globalization debate. The present volume is designed, therefore, to record a noteworthy event, and as an element of continuity with the 2002 meeting, to which I am now happy to welcome delegates.

Suellen Lambert Lazarus
Director, Syndications and International Securities
International Finance Corporation

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We thank the many contributors to the book for their excellent presentations to the 2001 Participants Meeting and for their careful reviews of the transcripts. I would also like to acknowledge and extend deep appreciation to Venka V. Macintyre, Alison H. Peña, and Henry Rosenbohm, who each contributed to making this book a reality. Special appreciation and gratitude goes to Deborah Barry whose striving for perfection and timeliness kept the book on track, and to Francis Hamilton who organized piles of text into a coherent and readable format. The staff of the IFC Syndications and International Securities Department work tirelessly to make each Participants Meeting a success and I thank them for their exceptional efforts.

Abbreviations and Acronyms

ACGA	Asian Corporate Governance Association
BCGF	Brazilian Corporate Governance Fund
bp	Basis points
CalPERS	California Public Employees' Retirement System
CCL	Contingent Credit Lines
CMCG	Capital Markets Consultative Group
Committee	Basel Committee on Banking Supervision
CP-2	Second consultative paper of the Basel Committee on Banking Supervision
EAD	Exposure at default
ECA	Export credit agency
EdF	Electricité de France
EPC	Engineering, procurement, and construction
GEF	Global Environment Facility
GMS	Good Morning Securities
IFC	International Finance Corporation
IIF	Institute of International Finance
IMF	International Monetary Fund
IRB	Internal ratings–based
IT	Information technology
ITICs	International Trade and Investment Corporations
LGD	Loss given default
LIBOR	London interbank offered rate
NGO	Nongovernmental organization
NIIT	National Institute of Information Technology
OECD	Organisation for Economic Co-operation and Development
PCS	Preferred creditor status
PD	Probability of default

PRI	Political risk insurance
PSAG	Private Sector Advisory Group
PTA	Purified terephalic acid
PX	Paraxylene
REEF	Renewable Energy and Energy Efficiency Fund
SMEs	Small- and medium-size enterprises
SOU	Special Operations Unit
SRF	Supplemental Reserve Facility
SRI	Socially responsible investments
TIAA-CREF	Teachers Insurance and Annuity Association–College Retirement Equities Fund
TPT	Tuntex Petrochemical Thailand
TTC	Tuntex (Thailand) Public Company, Limited
WBCSD	World Business Council for Sustainable Development

SECTION I

At the Center of Globalization

CHAPTER 1

The Unique Role of the International Finance Corporation

Peter L. Woicke
Executive Vice President, International Finance Corporation, and Managing Director, Private Sector Development, World Bank

Of all the complex forces driving the world's economies today, globalization is surely number one. For those who have embraced it globalization has generally worked well. For those who have not, things have gone badly, creating a growing gap between the richest nations and the poorest. About 250 years ago the "wealth ratio" was 5 to 1. The richest nation was five times wealthier than the poorest. Today that ratio is approaching 400 to 1. Some people might call this ratio an index of despair. Developmental bankers would call it an index of opportunity. In our eyes, globalization represents an opportunity to add local value to emerging markets.

That opportunity is the underlying theme of this volume, which brings together in edited form the papers and comments presented on globalization at the International Finance Corporation (IFC) Annual Participants Meeting held in Washington, D.C., on June 6–7, 2001.

IFC sees itself at the very center of the globalization process. No other financial institution stands at the dividing line between the entire developed world and the entire developing world, between the public sector and the private sector, between economic, financial, and environmental realities on the one hand, and government policy objectives on the other. Because of its status, because it must deal with the issues surrounding

globalization every day, and because it always operates through partnerships with other financial institutions, IFC is in a unique position to take the lead in grasping this opportunity.

Equally important, IFC has an impressive track record, with successful investments throughout the developing world. A number of its member countries—such as the Czech Republic, Hungary, the Republic of Korea, and Poland—and some sectors in its member countries in Latin America, have recently graduated from the institution's support. IFC is proud to say that it is no longer investing in certain countries and sectors because they can generally be financed by the private sector alone. In other words, IFC's business model seems to be working. At the same time, the model is changing, as IFC moves increasingly to frontier countries, regions, and sectors, each of which has an effect on the way IFC does business. That is why, in the coming years, IFC's loan syndications will become ever more innovative, both as a virtue and as a necessity.

Of course there will always be major financing needs in the advanced economies, and right now the world's major commercial banks and infrastructure companies do their core business there. However, the truly transformational opportunities lie in emerging markets. IFC's investments today cover the spectrum—from factories to power projects, and from banks to schools and hospitals. In the energy sector, for example, IFC recently closed syndications on two very large Electricité de France–sponsored steam-generation plants in Egypt. These projects are supported by 17-year B-loans, the longest B-loans in IFC's history, which were oversubscribed by 25 percent.

IFC is also finalizing financing of a high-impact pipeline project in Chad and Cameroon. Though initially subject to a good deal of controversy, the project eventually received strong support from banks and bilateral agencies because of IFC's value-added involvement and the improvements that, as part of the World Bank Group, it has promoted in environmental and social areas, including financial transparency. These improvements will reduce risks for the sponsors and IFC's financing partners, and will be of real benefit to the people of Chad and Cameroon.

IFC is also doing important work in the transportation sector, particularly with airports. In 2001 it closed a transaction that will allow Costa Rica to rehabilitate and expand its main airport. A similar transaction involving the Metro Manila Airport is of special interest because of its

longer tenor. At a time when markets are moving to shorter tenors, particularly in difficult country environments, IFC is pushing toward the 10- to 15-year range because of the importance of longer-term financing to infrastructure projects. IFC is able to mobilize loans of such tenors because of its track record and its participants' confidence in the B-loan program.

Another high-profile example of the range of IFC's business comes from Mozambique, which only a few years ago was one of the poorest countries in the world, devastated by civil war and in dire need of better infrastructure. Based on an IFC partnership with other investors and bilateral institutions that recognized the opportunity provided by Mozambique's natural resources and location, a US$1.2 billion project was launched for a state-of-the-art aluminum smelter, named Mozal. Even more impressive, the project came in under budget and ahead of schedule. The plant is now a player in the world market, and management is asking IFC to finance an expansion that would double the smelter's capacity.

Where else in the world is there such an opportunity to rise from absolutely nothing to a world player virtually overnight? Furthermore, the sponsors of Mozal are in it for the long run, determined to gain from the project, but also to benefit the local communities. In addition to providing jobs for local people, they are providing traditional safety and training programs for their staff, and anti-malaria and anti-AIDS programs. The sponsors are also helping other local companies, mainly small- and medium-size companies, by actively seeking their involvement as suppliers to Mozal. The company worked with IFC to put these value-added measures into its business plan, and it works! They make it a far better company, one that will undoubtedly improve shareholder value over time.

Government ministers have indicated that Mozal has put Mozambique on the map. Before its inception investors said they did not even know where Mozambique was; now they are willing to go there and invest their money in partnership with the country. This is extremely exciting, an overnight success, with the private sector learning a new way of doing business. It is learning from the globalization debate that successful business should also be socially responsible, and social responsibility means financial sustainability.

IFC is helping companies develop and use this model—but the task is not easy, and IFC needs help. Without financial partners, without lenders,

IFC's impact is limited. That is why it is turning away from the old model of doing business, the "Andrew Carnegie model." Carnegie called his model the "gospel of wealth." The idea was to earn one's money first, then to accept one's responsibility for inheritance and taxes through philanthropy and through grants. The problem with that model is that it creates a delay in sharing. The new model, the model that IFC promotes now, is completely different. It recognizes the speed and the needs of the new millennium. Responsibility is needed as wealth is created, not just *afterwards*. That means protecting the environment today and looking at this not as a burden, but as a value-added activity.

IFC's true mission is to be a leader in promoting sustainable development. Put simply, this means actively promoting financially sound and profitable projects that will be assets for everybody, including the local communities. To be an asset to the community a project must have sound corporate governance and transparency and be respectful of environmental and social standards. This is taken for granted in some parts of the world, as a sound business practice that is necessary to reduce risk. However, sustainability is the same everywhere, even in the developing countries. The challenge is to make this model work in every sector, in every region where IFC and its partners do business today. Examples of its successful use, which can be seen in a number of projects, clearly show that the model offers a means of adding value for the private sector, increasing developmental impact, and reducing the risks for IFC and its business partners.

All of these issues are at the intensely busy crossroads of globalization today. Private finance must not circumscribe this market, which needs to support those seeking new investment opportunities around the globe. IFC can help private finance do just that. In developing countries these investments require power, roads, water, Internet connections, schools, hospitals, and social services. Private finance needs to support local enterprises. These local suppliers, vendors, and buyers will help build stable domestic capital markets to meet changing and expanding financing requirements.

By working together, IFC and its partners can create enormous opportunities for all, including the people in developing countries. This is our unfinished agenda.

CHAPTER 2

The Global Implications of Poverty

James D. Wolfensohn
President, The World Bank Group

Instead of commenting on the latest techniques of B-loan lending and the remarkable initiatives that have come out of partnerships between the World Bank, the International Finance Corporation (IFC), and other institutions, I would like to take this opportunity to muse about some broader issues that tie in with globalization. Many of these issues are of such grand scale that one might say they are fundamentally insoluble problems. The problems that we are dealing with are, of course, poverty, growth, and—ultimately—peace on our planet.

As a result, the concerns of the World Bank Group[1] are spread across 80 percent of the world. Our concerns lie with 4.8 billion people out of the 6 billion who inhabit the earth. Those 4.8 billion account for only 20 percent of the gross domestic product (GDP) of the world. Here is a colossal problem in itself: there are many, many more people in the developing world with much less money than those of us from the developed world are blessed with. It is roughly an 80–20 split: 80 percent of the people with 20 percent of the GDP, the other 20 percent with 80 percent. This situation presents us with a moral and economic dilemma. It is clearly a social challenge.

When we look more closely at the trends within the so-called developing and transition countries that account for only 20 percent of world GDP we find that the gap between the rich and poor is expanding, not diminishing. The rich are getting richer while the poor do not do as well, and in many cases are growing even poorer. This gap is also a worrying

phenomenon for those of us in the developed countries. That is why the issues of development touch all of us on this planet. This is where globalization—and what it means—hits us dead center.

Many inside our institutions and many of our shareholders recognize that poverty in the developing world is poverty for everyone. The issues of development and the issues of globalization are very closely linked. We look at globalization and we realize that all 6 billion of us are connected by many factors: the environment, crime, migration, drugs, health, social and political conflict, trade, and finance, to name but a few. As we all know, things that happen in developing countries can shake our own markets, and can affect our interest in financing local projects.

That is why we who work in finance and development need to recognize that our imperatives today have a new dimension. We can no longer treat the moral and social issues in developing countries as though they exist only in remote parts of the world. These are issues facing the entire human race. They are emerging in a world that is ever more unified and where one cannot say that the responsibility for what happens out there in developing countries is no longer relevant to us. It *is* relevant—to *all* of us.

As we look forward we see another 2 billion people living on the planet in the next 25 years. The world's population will increase from 6 billion to 8 billion. Of that new 2 billion all but 50 million will be found in developing and transition economies. That means that by the year 2025 or 2030 these economies will be struggling to support not 4.8 billion people out of 6 billion, but 6.8 billion people out of 8 billion.

There will be enormous social stress and tension, and the differences between rich and poor will become even greater, as the pressures on resources and the environment mount. It will become necessary to double our food production, a tall order in itself. Equally worrisome, 40 percent of our planet already has inadequate water—what will it be like in 25 or 30 years? Then there is the question of space, and where we will put all these people. How will we be able to meet their health and social needs?

Countries of the developed world will have changed, too. Europe will have a smaller and older population than it does today. The European market will probably expand, but its national characteristics will change dramatically. There will also be an older United States, but its population will be larger because of immigration, and it will have a different ethnic mix.

Another continent that is changing rapidly is Africa, which today is home to 600 million people. In the next quarter century, this figure is expected to

climb to 1.1 billion, despite the enormous toll that will be inflicted by AIDS. Here, too, the effect of globalization can be seen, in that an AIDS epidemic in any one part of the world could easily spread to other parts.

I do not mention these various issues to sound a sour note about the prospects for dealing with the questions that confront us. Rather, I see in them a real opportunity to help the developing and transitional markets even as their populations grow by 50 percent. That is how we will be able to address some of the social ills present in the world today, and that are looming on the horizon. This will be a dynamic market, and it will grow at twice the rate of that in the developed world, because sheer numbers will push it forward. It is a market that will participate in trade significantly more than it does today. There will be opportunities for investment, job creation, and poverty alleviation.

Indeed, if there is to be peace on our planet, it is absolutely essential that we deal with the question of poverty. Poverty is no longer a distant idea or a minor social issue for us in the developed world. It is an issue that has large implications for global stability and peace. As bankers, investors, and advisers we must begin looking at the B-loan program, not just as a matter of investing intelligently but as the fulfillment of a vision that equates contributing to the development of these countries with contributing to peace and security. Because of globalization it is no longer a far stretch to say that. If there is no financing for these countries, instability will prevail. If there is instability, it will not be confined to developing and transition economies. Their instability will be our instability.

The point I wish to press home here is that we have unprecedented opportunities both for serious investing in growth markets and for contributing to the stability of our planet. I say this not as a sales pitch, but as a sincere call for greater private involvement in this kind of investment.

There is no way today that the issue of global peace and stability can be left to multilateral institutions or to governments alone. The stability of our planet depends also on the private sector and civil society. That is why we regard the B-loan program and its partnerships as a vital step not only toward market growth but also toward greater equity, greater social justice, and greater peace everywhere. Above all, we must do this for our future generations.

[1] The World Bank Group consists of the World Bank (comprising the International Bank for Reconstruction and Development and the International Development Association), the International Finance Corporation, the Multilateral Investment Guarantee Agency, and the International Centre for Settlement of Investment Disputes.

CHAPTER 3

Globalization as an International System

Thomas L. Friedman
Foreign Affairs Columnist, *The New York Times*

The subject of globalization has long been of intense interest to me because I believe very strongly that this phenomenon is not a trend, not a fad, and not a Nintendo game. It is, in fact, the international system that has replaced the Cold War system. That is the central argument of my recent book on this subject, *The Lexus and the Olive Tree*. In it I explain that globalization, like the Cold War system, has its own rules, logic, pressures, and incentives. In due course this system will affect everyone's country, everyone's company, and everyone's community, directly or indirectly.

While it is true that globalization is not "global" in the sense that it does not affect every region equally, nor does every region have equal entry to the system, globalization does touch every corner of the globe, directly or indirectly. These effects are best explained by comparing this new system to the Cold War system. The Cold War system was characterized by one overarching feature: division. The world was a divided place; in that system all threats to and opportunities for a country or a company tended to flow from the country or company from whom they were divided. That divisive system was symbolized by the Wall—the Berlin Wall.

The globalization system is also characterized by one overarching feature: in this case, though, it is integration. In this new system all threats and opportunities flow from the country or company to whom you are connected. This system is symbolized by the web—the worldwide web. Hence, over the last decade and a half the world has gone from division

and walls to integration and webs. In the Cold War the United States reached for the Hot Line, the line that connected the White House and the Kremlin. The Hot Line was another symbol of that division. But, thank God, only two people were in charge of it: the leader of the United States and the leader of the Soviet Union.

What is especially disturbing about globalization is that its internal logic exactly mirrors the logic of the Internet. Globalization, like the Internet, represents global interconnectedness. Here, however, nobody is in charge. Although some Americans think we are in charge, we are not. That is why two Filipino college graduates were able to release their Love Bug virus on the worldwide web and melt down 10 million computers and US$10 billion in data on seven continents in 24 hours: because we are all increasingly connected, and nobody is quite in charge.

The Love Bug virus was to the globalization system what the Cuban Missile Crisis was to the Cold War. Both these global events revealed humankind's vulnerability in a world divided between two armed nuclear superpowers, on the one hand, and a heavily interconnected world with nobody in charge, on the other.

Another alarming feature of this new system is the tremendous speed with which it changes. When walls fall and people become interconnected everyone is in everyone else's business. That interconnection drives the speed of change.

As I state in my book, when a country joins the globalization system it is the equivalent of taking that country public. Its citizens behave more like shareholders, and the leadership behaves more like management. Many of the shareholders from a globalized country are from abroad. Therefore, to determine what would make for a strong global *country* in such a system, maybe we should ask what would make for a strong global *company* in such a system. To pursue this idea I decided to look more closely at a company, but I had not yet chosen a specific candidate when one day, back in 1998, I happened across a copy of *Forbes* magazine in my dentist's office. The magazine, I noticed, had just named Compaq Computer the best-managed company in America. I thought, well, what better place to start than with Compaq Computer?

I called the people at Compaq in Houston and asked if I could come down there and interview its top leadership. They said, "By all means." I went to Houston, to the head offices of Compaq, to interview Eckhard

Pfeffer, the chairperson, and noticed a framed copy of the *Forbes* article hanging on the wall.

A month later, again by coincidence, I was at Stanford giving a talk at the opening of the University's School of Engineering, with John Chambers, the chairperson of Cisco Systems. I happened to mention that I had just been in Houston profiling the people at Compaq Computer, "the best-managed company in America." He pulled me aside and told me that *Forbes* had actually made a big mistake. It should have chosen Dell.

I said, "Why?"

He said, "Dell 'gets' the Internet; Compaq doesn't."

Having already invested in my Compaq interviews I decided to go ahead and make Compaq the centerpiece of my book. The book came out on April 19, 1999. On April 26, 1999, the entire corporate leadership of Compaq Computer was fired for missing their quarterly earnings by 40 percent. That was a lesson I will never forget.

Another thing that I have learned since the book came out is that the single most underestimated force in international relations today is knowledge about how other people live. That knowledge is a powerful catalyst for change because people everywhere start to demand the things that other people have. If they cannot get them they become angry.

I was first exposed to this phenomenon a couple of years ago when, at the invitation of the U.S. Agency for International Development, I was part of a panel on competitiveness that took place in Sri Lanka. The panel consisted of Garret Fitzgerald, the former prime minister of Ireland; José Maria Figueras, the president of Costa Rica; and me. I spoke about globalization, and Fitzgerald about Ireland's recent economic transformation. The star of the event was Figueras, though, whose presentation about how he persuaded Intel to come to Costa Rica and wire every high school captivated the audience of 500 young entrepreneurs—from Bangladesh, Bhutan, India, Nepal, Pakistan, and Sri Lanka.

This audience's response was truly intriguing. It was as though someone had just turned up the heat in all the countries represented there by opening the door to the Internet and to all the information it can provide about life elsewhere on the planet.

It is still too early to tell how this phenomenon is going to play out, but I see it more and more everywhere. Its effect is very hard to quantify. Also, it affects different countries differently.

But it is there. And it is a real force in international relations today.

The third thing I have learned to appreciate more is the concept of the "golden straitjacket." For me, the golden straitjacket is a metaphor for all the economic rules of the globalization system. The argument underlying this concept is that, when a country joins the global economy, it is forced to put on a golden straitjacket. Margaret Thatcher was the original seamstress of the golden straitjacket, with buttons and tailoring provided by Ronald Reagan. It is the only model on the rack this historical season. As I said, this golden straitjacket is made up of all the rules of the globalization system: rules about deficit-to-GDP ratio, inflation, privatization, and deregulation.

Two things happen to a country when it puts on the golden straitjacket. One is that economy grows, spurred by privatization, deregulation, foreign trade, and investment. The second is that politics shrink, narrowing down to "Pepsi or Coke"—that is, narrowing down to the choices approved by global markets and bankers.

This shrinking of politics and of political choices is evident everywhere in the world today, even in Greece, the motherland of politics. Not only is Greece the cradle of democracy, but in the past 50 years it has had civil war, communism, socialism, capitalism, authoritarianism, colonels, and chaos. Yet the big story in Greek politics today is social security reform. Greece may have the lowest amount of foreign investment of any country in the European Union (except Luxembourg), but it ranks number one in the Union in the number of nights out in restaurants, per person. The Greeks are just beginning to wrestle with their golden straitjacket. The point I am driving at is that globalism may make all the economic sense in the world, but it has no moral force for 95 percent of the world's inhabitants. Furthermore, it has the potential to unleash what I call the real "Y2K disease"—overconnectedness.

What will happen when, through cell phones, pagers, and beepers, we are all online everywhere, all the time? That is the real disease of overconnectedness. It is already a problem for the developed world. It will eventually become a problem for the developing world, too. In the later stages of this disease you are always in and always on—just like a computer server.

We now live in the age of what Microsoft researcher Linda Stone calls "continuous partial attention." We live in an age of the continuous partial. The continuous partial means that you are answering your e-mail, answering the phone, and helping your children with their homework all

at the same time. You are continuously involved in a series of acts to which you devote only partial attention. This, I think, is the fundamental social disease of the globalization era. Moreover, in the next five years we are going to move to IP Version 6 Internet switches, which will allow every lightbulb in a room to have a web address. Everything, including the toaster and the refrigerator, will be online. How we manage that kind of social phenomenon is going to be a huge issue of the 21st century.

Another important change that I see coming is the birth of a new kind of state: the "messy state." During the Cold War we had three kinds of states: authoritarian countries, democratic countries, and communist countries. Under globalization we have five kinds of states: authoritarian countries (Cuba and the Democratic People's Republic of Korea); democracies (France, the United Kingdom, the United States); democratizing countries (the Czech Republic, Hungary, and Poland); failed states, without the Cold War system to prop them up (Liberia, Sierra Leone); and the messy states (Indonesia and the Russian Federation). Messy states are states that are too big to fail, but too "messy" to work. They are states in which the central political authority that allocated resources and enforced contracts—the Communist Party in Russia, the Suharto family and its extended network in Indonesia—has collapsed and has not been replaced by a new, coherent authority to enforce contracts and allocate resources.

Indonesia and Russia are two of the five largest countries in the world. The other three are China, India, and the United States. India has messy features, but it is not a messy state. The biggest question in international relations today is whether China, with one-fifth of the planet's humanity, will become a messy state. If it does this will affect everything from the air we breathe to the clothes we wear, to the cost of living that we bear in the world. The defining feature of the messy state is that when the leaders pull the levers to make things happen the levers come off in their hands. That is the definition of a messy state: levers get pulled, but nothing happens because they are not connected to anything.

How does a messy state escape this condition? Historically, there were two ways to do it. One was the way the United States escaped, because we were once a messy state. We had robber baron capitalism. We had Tammany Hall. We still have messy features, if the 2000 election in Florida is any indication. We escaped it through evolution. We slowly developed the institutions, the habits, and the culture that propelled us beyond our

messy state. Institutions such as the Federal Reserve, the Securities and Exchange Commission, and the Federal Communications Commission have helped enormously. The other way to get out of being a messy state is through imperialism. This means someone comes in and occupies the state—which is what happened to Germany and Japan after World War II, or to India in the 1800s. The imperial regime imposes structures and institutions that avoid messiness. The problem for Indonesia, Russia, and many other messy states today is that they are too early for evolution and too late for imperialism. They are too early for evolution because evolution takes a long time. They are too late for imperialism because no one wants to occupy countries anymore. People now know that the only thing imperialism bestows on a country is a large bill. Nobody wants the bill anymore. So that is not an option. How, then, will these countries generate the internal will and the energy to escape messiness?

Indonesia, a fascinating laboratory, provides a few clues. About four years ago, when Suharto was still in power, I met a group of young Indonesians in their 30s and 40s who wanted to get rich without being corrupt. They wanted democracy, but were afraid to fight for it in the streets. Their strategy can be called "globalution." It was based on the knowledge that there would never be change from above. So they decided to promote revolution from beyond, or globalution, which means trying to plug one's country into every international rules-based system, whether it is the World Trade Organization, the International Finance Corporation (IFC), the World Bank, PricewaterhouseCoopers, or McDonald's. Whatever it is, they try to plug the country in and import from beyond what the country cannot generate from above or below. I think the strategy of globalution, as a short-run phenomenon, is one of the things we have that will help messy states get out their messiness.

In closing, I would like to offer a comment on two prevailing worldviews today: what might be called "America on duty" and "America online." Those with the America-on-duty outlook see the world as an entity built around walls. The job of America, they say, is to erect walls, break down walls, and defend walls. In contrast, the America online people see the world built not around walls, but around webs. In the latter view America is at the center of the web, and for them the job of American foreign policy is to extend and enrich the web, bring more people into the web, and protect and defend the web.

The wall people see the world as being divided between friends and enemies, and they care about who is on the terrorism list. The web people see the world as being divided between members and nonmembers of the network, and they care about who is on the buddy list. I believe that the greatest tension in the current U.S. administration is going to be between the web people and the wall people. I also believe that the secret to success in globalization has to do with the fundamentals of life: reading, writing, and arithmetic; church, synagogue, temple, and mosque; good rule of law, good governance, good bureaucrats, good institutions, good press. Get those right and the wires will find you. Get those wrong, and nobody will find you.

Follow-up session

After the floor was opened to questions, one audience member asked Mr. Friedman how globalization is changing issues of corporate accountability, particularly in relation to social and environmental concerns. Mr. Friedman responded that this question ties in with the next stage of politics, which involves going from national economic and political institutions to global ones. The problem, Mr. Friedman continued, is that this is a slow process. Yet many issues we now face—from the environment and the air we breathe, to financial flows and trade—are already the result of being "connected." How, he asked, can global governance standards be applied to all these issues, on which we are connected, without global government?

The answer, Mr. Friedman said, is going to have to be coalitions between enlightened corporations, enlightened nongovernmental organizations, and enlightened governments, all of which will come together to provide governance. For example, the Fair Labor Association is doing this in the area of sweatshop labor, where there is no government. That is the ideal model, he said. As long as agreements such as the Kyoto Treaty remain unimplemented, however, governments can put things off by saying they are "working on it." Corporations can also say they are working on it. Environmentalists can say, well, they are working on it too, they guess.

The case of global warming provides a prime example of the kinds of choices nations must grapple with in an atmosphere of globalization, Mr. Friedman said. They can either do nothing and see the environment continue to be damaged, or they can exercise governance to reduce the

threats, as he would urge them to do. Mr. Friedman sees himself as a radical about these issues because he travels all the time and has seen what unrestrained globalization and global warming can do to this planet. If people refuse to do more things with fewer goods, he argued, as more and more societies take on a globalization lifestyle, which is highly consumptive of hydrocarbons, petrochemicals, and bent metal, the planet will burn up faster than at any time in its history. That is why, he added, he is happy to use his newspaper column to challenge companies that back bogus science and use their financial clout to press the biggest, most powerful government in the world to "trash" the Kyoto Treaty.

Another audience member asked Mr. Friedman to comment further on the fact that nobody is in charge of the web. This speaker said he saw some distinct changes in the web, which used to look like a little city, with little roads that were alike. Nowadays, he said, the web seems to be made up of a number of extremely large cities, with main avenues, secondary streets, and dead-ends. Because everybody is using some of the main streets it seems clear, he stated, that with the structure comes power.

Mr. Friedman agreed. Some of the big companies are now dominating the web, he noted, and this is a perfect illustration of what globalization does: it makes the whales bigger and the minnows stronger, both at the same time, because it is built on networks. Furthermore, it is all about how one manages and uses those networks. As an example he pointed out that the company America Online "just gets bigger and bigger." It also just passed a two-dollar price increase through to consumers. Like countless others, Mr. Friedman himself just pays them the two dollars more a month and says now they "are going to get bigger and bigger and bigger."

Yet the minnows are surviving. One of these is tohelca.com, a small news portal in India that recently brought down the defense minister and the head of the largest political party in India by posing as arms sellers bribing the two men. This small dot.com did something no major Indian newspaper could do, Mr. Friedman noted. It exposed corruption at the highest level of the Indian government and brought down two of the most powerful political figures in the country. He drew another example from China, where a village school blew up recently in the remote province of Jiangxi. Thirty-eight children and four adults were killed. In their report to the central government local authorities blamed a madman for the incident. The truth came out shortly after, thanks to an Internet campaign

that was entirely Chinese, that was started inside China. To make up for a shortfall in funding from the central government the school had been manufacturing fireworks. The school authorities struck a deal with a local fireworks manufacturer, and during half of each day the children attending the school were forced to make fireworks. One of the fireworks went off and blew up the school.

One of Mr. Friedman's favorite websites is the *Cairo Times*, at www.cairotimes.com. This is an Egyptian magazine, he explained, comparable to the *Economist*, which covers politics and social matters, and is of high quality. Unable to get a license to publish in Cairo, it publishes in Nicosia and then imports the magazine into Cairo once a month. It has to go through the censor, he noted, and the censor removes anything that is critical of the regime.

Using bright red letters and the banner "The Forbidden File," however, its website posts everything the censor takes out. That, Mr. Friedman said, is another minnow with real power. The thing to keep in mind is that both these phenomena are happening at the same time. Despite how strong the whales are getting, the minnows are active, are multiplying, and are doing some of the "really interesting things," in Mr. Friedman's view.

An audience member then asked whether this means that the web can give people good government. Mr. Friedman responded: "It will give them more transparent government." He predicted that in five years IFC and other institutions will not be speaking about "developing" and "developed" countries, but about transparent and nontransparent countries. That is necessary for good government, he added, but of course it is not sufficient. All the other ingredients—leadership, ethics, values—will still be needed. But, he said, the web will be a net driver of transparency, just as it will also be a net driver of a loss of privacy. Both will happen at the same time, and that is why he thinks one of the big problems in this system will not be just Big Brother, but "Little Brother." Little people, he explained, will be empowered to amass all kinds of personal data on individuals, outside of any government and social controls, similar to Big Brother. In a web world Little Brother can be as dangerous as Big Brother, he cautioned.

Another audience member asked about the possible effect of globalization and the web and communication on Islam. Mr. Friedman felt that that here, too, one would see the transparency effect. Even Osama bin

Laden has his own network, "a kind of jihad online" on "JOL." He did not see that Islam, as opposed to any other religion or movement, would have more or less ability to maneuver the web. Globalization has yet to explode in many regions of the world, and the biggest explosion is not necessarily going to be in China, which is where all eyes are focused. He thinks it will take place in the territory from Morocco to the borders of India. What he calls the "wrenching transition" is going to occur there. At a recent Arab Summit, he remarked, not one of the 20 or so Arab leaders in attendance had been democratically elected. This is unlike any other region of the world—even Sub-Saharan Africa would have at least a few democratically elected leaders. That statistic, he thought, bespeaks a future full of turmoil, although he feels some will make the transition. Again, he found the little countries in the Arab world the most interesting. He mentioned that the freest elections are in small countries, such as Bahrain or Qatar, and equally important, the biggest Internet city is Dubai. Jordan just signed a free trade agreement with the United States, only the fourth country in the world to do so, after Canada, Israel, and Mexico. That is why he feels that the innovation is happening in the little countries, while the big republics run by the military (the Arab Republic of Egypt, Iraq, and the Syrian Arab Republic) are lacking in real political innovation. Sooner or later, he thinks, there will be a "reckoning."

Mr. Friedman was then asked whether he sees globalization strengthening identities or violating identities. That, he answered, is one of the 64-thousand-dollar questions about globalization. Again, it all comes down to what happens when the walls fall. He mentioned being in Singapore Airport not long ago and noticing two elderly Indian women wearing their traditional saris and shawls, looking like people steeped in their native culture. Mr. Friedman also noticed their eyes were glued to the television monitor in the waiting area. What were they watching? Two American wrestlers in Tarzan suits body-slamming each other in a ring!

It suddenly struck Mr. Friedman that this was the perfect image of globalization today: it showed two cultures in direct contact, without walls. For some countries with cultures that are not robust this contact could ignite a kind of turbo-evolution, he thought. That is why the big question about globalization is whether it will lead to homogenization—or will it, as Mr. Friedman suspects, lead to what he calls "worldization"? Right now globalization means Americanization—but the most popular

food in the world today, he said, is pizza. The interesting thing about pizza, he remarked, is that it is a flat piece of dough on which every culture puts its local ingredients. That is why he wonders whether globalization will homogenize only the surface. He thinks that if globalization begins to threaten a culture people will reject the system because they cannot exist without their sense of community and sense of identity—in other words, without their roots. He predicted worldization rather than homogenization, though it may be difficult to keep the latter at bay.

A final question dealt with the AIDS crisis and whether it would affect the globalization process. Mr. Friedman had just returned from Ghana, where he saw the problem up close. He felt that a response to this question must come from people more knowledgeable about the subject. What did strike him in Ghana, however, was that combating AIDS would take more than just inexpensive antiretroviral drugs and the efforts of pharmaceutical companies. It would take concerted community effort.

The countries in Africa that have been most effective in stemming the AIDS virus, he noted, were like Senegal: countries with strong civil societies and strong village networks where they are using multiple methods, including local advertising and women's groups, to conduct peer-to-peer education and to care for their orphans. Even in San Francisco, when AIDS first broke out there, Mr. Friedman said it was not the government that brought a sense of stability to the problem. It was gay men taking care of and educating gay men. It takes a village, he concluded, to address social problems.

CHAPTER 4

International Financial Stability and Sustained Growth

Horst Köhler
Managing Director, International Monetary Fund

This is a difficult period for emerging market economies, and for their private creditors. I would like to discuss the actions that are required from the International Monetary Fund (IMF) and from its member countries, in partnership with other international organizations and the private sector, to safeguard international financial stability and promote sustained growth in the global economy.

A Period of Testing for the International Financial System

As a result of domestic policy reforms and strong export demand from the advanced economies, most emerging markets have recovered strongly from the financial crises of 1997–98. Now there are concerns that the slowing of the global economic activity and the associated weakening of exports and capital inflows may trigger a reversal of these gains. Moreover, declines in equity prices and the recent difficulties in Argentina and Turkey have heightened consciousness of the downside risks and interdependencies in the world economy. Our best guess is still that the slowdown in global growth will be relatively short lived, with a recovery beginning late in 2001, and gathering strength in 2002. What is important now is vigorous policy action to ensure that this outcome materializes.

I am encouraged that the recent meeting of the IMF's International Monetary and Financial Committee demonstrated a growing sense of shared responsibility among our member countries to safeguard global economic growth. The decisive moves by the Federal Reserve to lower interest rates, along with the tax cut, have increased the probability of an upturn in the U.S. economy later this year. Recent interest-rate reductions in Europe and Japan were also welcome, and we are confident that these central banks will remain vigilant. Our membership has nevertheless underscored that more ambitious structural reforms are the key to stronger growth in Europe and a sustained economic recovery in Japan. During a recent visit to Japan I was heartened by the new government's recognition of the importance of accelerating overdue structural reforms of the banking and corporate sectors, which I hope will soon be translated into action.

For emerging markets it will be crucial to stay the course of structural reform and sound macroeconomic policies. Since the Asian crisis, markets have been differentiating strongly among investment opportunities—rewarding countries with sound fundamentals, and pulling back where there are major concerns about sustainability. Many countries have taken steps to reduce fiscal and external imbalances and will thus be much better placed to deal with the current strains. In the structural area, more typically, further efforts are needed to reduce vulnerability by strengthening financial sectors, improving governance, and building a good investment climate. Countries that follow through on these essential reforms, however, should experience relatively good growth performance.

I have witnessed, in the IMF's poorest member-countries, a growing sense of leadership, and an increased determination to address the home-grown causes of poverty. It is clear that an effective strategy to reduce poverty must start with, and build on, actions by poor countries to end armed conflicts, establish respect for the rule of law, improve governance, and fight corruption. There is also a recognition that the prospects for rapid growth—which is indispensable for reducing poverty—will depend on the ability of these countries to unlock the creative energies of their people and to take advantage of the opportunities of the global economy. The development of sound domestic financial sectors and, eventually, integration into international financial markets will be an important part of this process. Equally, however, poor countries can and should ask for

more decisive support for their efforts by the international community—through debt relief, capacity building, increased aid, and access to markets.

A Refocused International Monetary Fund

The IMF, for its part, can make its greatest contribution by helping to establish the preconditions for sustained growth in the global economy. This means we need to concentrate on IMF's core areas of responsibility:

- Promoting macroeconomic and financial stability in member countries
- Helping our members develop sound financial sectors, in order to protect them against vulnerability and to mobilize financing for productive investment
- Safeguarding the stability and integrity of the international financial system, as a global public good.

One of the major criticisms leveled at the IMF in the wake of the Asian crisis was that it had spread its activities so broadly that it could not do an adequate job in these core areas of responsibility. This criticism needed to be taken seriously. Many international organizations contribute to economic development and poverty reduction. The IMF also has a unique responsibility for the stability of the international financial system—if we fail to deliver, a lot is at stake. During my first year at the IMF, therefore, our membership has given its overwhelming support for our efforts to refocus.

Crisis Prevention and International Financial Stability

Of course, we are not starting from scratch. During the past three years a broad work program got under way to strengthen the international financial architecture. The steps taken since then by the IMF and other organizations—for instance, to enhance the availability of economic and financial data, to improve our analytical tools for assessing vulnerability, to strengthen domestic financial systems, and to develop and implement standards and codes—are helping to make the international financial system more resilient. The IMF has also sharpened its financial tools for crisis prevention and management, by adjusting the terms of its lending and by introducing two new facilities: the Supplemental Reserve Facility (SRF) and the Contingent Credit Lines (CCL). The SRF has already proved its worth in responding to capital

account crises, and we intend to make the CCL operational in the coming months as a way to reward first-class policies and to help countries resist contagion. While there can be no guarantees, all of these initiatives should give us greater confidence that the international financial system will withstand the current period of testing.

Nevertheless, it is clear that the IMF needs to work even harder to put financial markets and crisis prevention at the heart of its activities. Highest on our agenda for the coming months will be further work on early warning of potential crises. By this I do *not* mean that the IMF intends to become a rating agency. What is crucial is that we sharpen our ability to identify emerging problems and bring about early and preemptive policy action in member countries. For this, we need to combine quantitative indicators of vulnerability with judgment from the field and from the markets. To ensure the maximum beneficial impact it will be important for this work to move forward with the full participation of the IMF's membership. In the process, we will need to take care that our warnings about potential crises do not become self-fulfilling prophecies.

The new International Capital Markets Department in the IMF will play a major role in this effort. This department will serve as the IMF's center of expertise, information, and analysis on capital market issues, and as its primary point of contact with private and official institutions working in this area. By deepening our understanding and judgment about the operation of capital markets the new department will strengthen the IMF's capacities for crisis prevention and management, and for safeguarding the stability of the international financial system. Over time, it should play an important role in helping members gain access to international capital markets.

Partnerships for Growth

Refocusing the IMF also gives us a new opportunity to strengthen cooperation and complementarity with other international organizations, such as the five organizations that form the World Bank Group, and the Bank for International Settlements. We need to make sure, through good communication and division of labor, that careful attention is paid to all issues that are crucial to financial stability, growth, and poverty reduction. The commitment that Jim Wolfensohn and I made last year to enhanced collaboration between the IMF and the World Bank is already paying large

dividends. As part of our broad agenda of cooperation we are intensifying efforts to help poorer countries build a financial infrastructure that is tailored to their development needs. This should also be part of a strategy leading to their eventual integration into the global financial system, to tap this indispensable source of financing for development. Thus, we will seek to involve poor countries in the joint IMF–World Bank financial sector assessment program, while mobilizing practical, professional assistance in financing strategies for rural development and small businesses.

The International Finance Corporation (IFC) will clearly play an important part in promoting growth and poverty reduction through its equity investments and lending, its catalytic role, and its advice and technical assistance in private sector development. I welcome IFC's work on financial sector development, including the use of microfinance and other targeted instruments to meet the special needs of poor, largely rural, economies. The World Bank, IFC, and IMF have recently begun preparations to establish Investors' Councils in Sub-Saharan Africa, as a form of public-private partnership. These councils will bring the government together with private foreign and domestic businesspersons, to identify key obstacles to private investment, and options for removing them. I am confident that intensified collaboration between the IMF and the World Bank Group will strengthen the effectiveness of both institutions.

International capital markets have been an engine of innovation and rapid economic growth in the postwar era, and they will take on an even more crucial role in the 21st century. Net private capital flows to developing countries reached about US$250 billion a year by the time of the Asian crisis, while total official flows—grants and loans, bilateral and multilateral—are less than one-third of that amount. International capital markets have thus become indispensable for economic and social development. We must also recognize that markets are now much more differentiated and sophisticated than they were 10 or 20 years ago. The bulk of financing no longer comes in the form of bank loans, but through bonded debt, direct investment, and other instruments; new instruments are being devised all the time to meet the requirements of an evolving global economy. There is obviously a need to adjust economic policy concepts to these developments. I do think this change should include building a new partnership between the private financial sector and public institutions, such as the IMF.

A year ago, in outlining my initial thoughts on the future role of the IMF, I gave a commitment to work constructively with the private financial market participants. This approach is now reflected in a number of key elements of our work program—including the IMF's informal but regular dialogue with senior representatives of private financial institutions, through the Capital Markets Consultative Group (CMCG), and our framework for private sector involvement in crisis prevention and resolution. At our latest CMCG meeting, in Hong Kong, China, we considered a report on creditor-debtor relations, prepared by a working group cochaired by Stan Fischer and Robert Pozen. I believe this report suggested very useful principles for enhancing transparency and good communication between sovereign debtors and creditors. I look forward to discussing this report with the IMF's Executive Board, including the potential for taking its recommendations on board in IMF surveillance. The Hong Kong, China, meeting also examined ways that private creditors can make better use of information on standards and codes, and how the private sector can become engaged at an earlier stage in crisis prevention and resolution. This work should provide further content to the envisaged public-private partnership for international financial stability.

The basic principle of our framework for private sector involvement is that a market economy requires debtors and private creditors to bear the consequences of their decisions. This means they cannot expect to be "bailed out" by the official sector. With this in mind, I do think it is right to work as much and as long as possible with market-oriented, voluntary, solutions negotiated between debtors and creditors, without ruling out the possibility that other approaches may become necessary in extreme circumstances.

In all of these ways the IMF will continue to strengthen its partnerships with IFC and other international organizations, and with the private sector, to promote international financial stability and sustained growth in the global economy.

CHAPTER 5

The Consequences of Globalization for Asian Banking

John T. Olds
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As the primary engine of world growth the United States has no obvious replacement. Nowhere is that more obvious today than in Asia. This chapter provides an update on what is going on at ground level in Asian banking from my perspective as the chief executive officer of Singapore's DBS Group from 1988 until early in 2001. I also touch on the consequences of globalization in Asia and the eventual impact of what I call universal (as opposed to Western) business standards. Finally, I propose a slightly unorthodox approach to helping to solve Asia's banking crisis through a new kind of cofinancing.

In all stress situations there are opportunities, as well as pitfalls, that lie ahead. There will be winners and losers. After 36 years in banking, many of those years in or around Asia, I still think the glass is more than half full, despite deep-seated local inhibitions, decelerating economic growth, and yet another round of asset devaluation.

To many observers Asia dropped the ball just as it was about to carry it over the goal line. The "Asian Miracle" stopped in its tracks, and restructuring has been more than a little uneven. The necessary reforms are often observed in the breach, if at all. Domestic-demand is anemic, and export-dependency at an all-time high. As a result, the region is vulnerable to shocks, whether they are made in America or elsewhere, and many politi-

cians have decided there is less risk in doing nothing, even if it leaves Asia poised on a slippery slope. What comes next should not resemble what has gone on in Japan for the past decade, but it may. Nonetheless, I believe Asia will eventually emerge stronger. Clearly, things will not be the same, but it is going to take some time sorting them out.

The next wave of growth will likely be led by consumers and small businesses, not by crony capitalists or bogus publicly quoted corporations. Overcapacity and excessive leverage are going to hold larger companies back, as out-of-date practices virtually prohibit their access to conventional bank finance, even assuming it was available. International capital markets are reserved for the most transparent and creditworthy companies.

Ultimately, financial service providers will be forced to respond to a trend that is now all too familiar, and all but unstoppable globally: electronic distribution. What now seem to be pressing problems with special interests, or intransigent borrowers, or inept politicians, have little to do with the future of banking. Even farsighted Asian bankers are unprepared for the new age of electronic banking. Considerable resources will therefore be required from outside national borders, and maybe even from outside the region. That is the opportunity, at least, that my colleagues at DBS spotted.

DBS's experience as a direct investor in a number of countries since the crisis broke (and as a close observer of events in most of the others) reveals the extent of the damage done. In due diligence exercises DBS performed appraisals of crisis-affected assets, negotiated with overdue borrowers, and learned just how poor banking practices were. The depth of the problems uncovered stood in marked contrast to standards in Singapore and Hong Kong, China. Many countries chose to keep score without reference to objectivity or underlying values, and many borrowers and lenders came to believe that governments would bail them out when danger appeared. But why shouldn't they? In more than a few countries central banks published national account statistics and international reserve data with the same license—some would even say, "with the same sleight of hand."

A significant feature of recent events in Asia, unlike those in Latin America in the 1980s or during the second Mexican crisis of 1994, is that nobody sought to dominate them. Nobody dealt forcefully with the disarray or assumed a leadership role, hence nobody influenced the minds of the movers and shakers of international finance, or, for that matter, of the

leaders of individual nation-states. The Association of Southeast Asian Nations failed its greatest test, just as the Ministry of International Trade and Industry and the AMA failed in Japan a decade earlier.

It is true that the Federal Reserve, which eventually lowered U.S. interest rates, did stimulate a partial recovery, and that the International Monetary Fund (IMF) did what it could with the rather limited ammunition at hand. It looks increasingly, however, as if these were palliatives that just bought a little time. They did not correct the fundamental problem, which is that Asia is out of step with the rest of the world. This is not a good thing for the region or for its trading partners. Its banking systems, the principal source of intermediation, are broken. The all-too-familiar postcrisis syndrome of denial has come, but not yet gone.

In the limited remediation efforts under way from Indonesia and the Philippines to Thailand, the IMF and the World Bank are trying to superimpose modern banking practices on bad habits and creaky infrastructure. In many cases only a change in ownership opens the door to the dramatic change in mind-set that is required.

The goal of creating a pan-Asian franchise with a unified platform for the seamless, real-time delivery of products and services is an immense challenge. It is also an unavoidable one. Strong foundations built in Singapore and Hong Kong, China—with their histories of enlightened bank regulation, qualified management, and (the British) legacy of contract negotiability—may be the only hope of putting a modern regional franchise in place. Because the demand for banking services in Asia will continue to outstrip the supply for a long time to come, there is a significant opportunity waiting to be grasped.

Countries that delay the necessary reforms will slowly come to realize that time is not an ally. Weak trade numbers and further currency devaluations bear witness to their vulnerability. Whether it is a matter of months or years, they will have to reexamine the most fundamental issues, such as how to deal fairly and practically with a shortage of bank capital; industrial overcapacity and obsolescence; the notion that employment is guaranteed for life; and the redefinition of public sector roles and responsibilities. Equally important will be how to arrest a growing loss of competitiveness when China and India are rising, the European Community is sorting out the final details of its union, and the Americas are putting together a blueprint for the world's largest free trade zone.

Although there is not much chance that the Asian tigers will slip into command economy thinking, free-market solutions are neither obvious nor compelling. Besides, it is too early in the globalization experiment to become complacent. As Asia's leaders wrestle with the essential preconditions to recovery, a sound banking system is a must. One of their first priorities should be to clarify property rights. If officials have learned nothing else from the debacle of the past four years, it should be that due process, the sanctity of contracts, and the enforceability of collateral are essential to attracting and preserving long-term capital. Although some have stiffened bankruptcy laws, success does not depend on the existence of these kinds of statutes alone. It is inextricably linked to enforceability, or perhaps more precisely, to finality.

Finality is the key. Note, for example, the International Trade and Investment Corporations (ITICs) in China. It has been suggested that, as semi-state bodies, they were authorized to borrow abroad and then were encouraged by the state to walk away from their obligations. However, it is quite possible that creditors' rights will, in the end, be determined not by interpreting covenants or judicial proceedings, but by arbitration. If the arbiter is reasonable and the final determination equitable, so be it. Arbitration, after all, achieves finality. The only complaint would then be that if the ground rules had been clearer at the start, the opportunity lost might have been smaller.

In a curious way arbitration was also the key to resolving the Latin American debt crisis. After years of wrangling, seemingly intractable positions were finally resolved when the private sector swapped bank loans for publicly quoted securities, a process jump-started when Mexico securitized a portion of its obligations with U.S. Treasury bonds. When these "Brady bonds" were freed to trade at levels determined by the market, the banks' losses were crystallized and the world moved on. There was no further discussion about the appropriate discount, enforceability of collateral, or the bill for interest arrearages. No recriminations, just finality.

Another requisite for recovery and restoration of investor confidence is transparent bookkeeping. Proper accounting in the banking sphere means accurate reserving policies and clear guidelines for writing off bad debts. Having wasted the first opportunity to instill borrower discipline as a precursor to raising additional capital, the countries of Asia must try another path to bank solvency, either through some limited form of pub-

lic sector bailout, or through foreign direct investment. That is where the rubber meets the road.

There can be no traction without first clearing away the debris, no way of removing the debris and the solvency doubts without separating borrowers from their assets. There is neither (a) sufficient room in public sector budgets nor (b) the political will to bail out more than a handful of banks in each country. Although consolidating the problem by merging troubled banks achieves a certain focus there is still a finite limit to the human and capital resources required to clear the decks and start over, on calmer seas.

Another prerequisite is good corporate governance. That means publicly traded companies led by independent boards of directors, not by family members or their retainers. Even where it still deserves to exist in economies such as Hong Kong, China, and Singapore, the family banking model is rapidly becoming a dinosaur. Little banks can neither attract the talent nor withstand the level of investment required to stay relevant. They will survive for a while, but eventually the market will impose a value discount on them that will be as unacceptable to insiders as it is to independent shareholders.

An independent judiciary is another essential ingredient for the impartial determination of the divergent rights of borrowers and lenders, especially where politics and business interests intertwine. Building such an institution turns out to be a lot easier said than done, because it requires courageous as well as enlightened judges.

Can ways be found to make such international standards acceptable in these crisis-affected countries, in the time available? Asia has so much bound up in outdated practices and so-called cultural differences that the remedial actions required are often blown away before they can take root. It may sound self-serving, but I suggest that the barriers to entry that have been partially dismantled since the crisis in many countries will have to be further reduced, if not completely removed. Sooner or later difficult judgments will have to be made as to which banks survive and which do not. This will inevitably raise the all-too-familiar moral hazard question, prompting decisions about which institutions are fundamental to recovery and which are simply too big to fail. The rest will fall by the wayside.

When the politicking dies down factors that have impeded foreign investors from securing control positions and from shifting the burden for

cleaning the closets and setting appropriate operating standards must be eliminated. People will have to learn that the length of the delay in making such critical choices only increases the extent of the damage—to bank capital, to consumer confidence, and to business competitiveness. Until the survivors are known, little can be done to prepare for the new world of financial services, a world in which the Internet acts as both a deconstructor and an enabler.

By then, even those who hear the message of the market will not have an easy time catching up, because the information technology platforms required are so complex and expensive, and because Internet banking penetrates consumers' consciousness only gradually. Therefore its effects on consumer behavior are hard to predict, and much of the investment in technology and training is front-end loaded, which makes it appear risky.

Everyone marvels at the consumer's fascination with research and occasional purchases of books or clothing over the web, but for the Internet to become the channel of choice in financial services, fancy front-ends, broadband networks, and unrestricted access are only a beginning. In effect, companies such as America Online and Amazon shine a narrow beam on the path to the future. They are imperfect models, as recent events reveal. Things such as voice activation and affordable handheld communications devices are aspects of the next phase of development, and their proliferation and impact on simplification of use will lead to greater consumer acceptance, eventually, but we will probably experience a lull or two before adoption rates increase and widespread banking-by-wire becomes a reality. Inflation points in technology are very hard to predict.

Investing in electronic infrastructure for individuals and corporations, large and small, is undoubtedly a much better way to transmit best practices than by publishing treatises on accounting transparency and standards of board governance, or by revamping bankruptcy laws. That's because the feedback from technology is so positive. The most practical approach to banking in Asia lies in the creative application of technology, so getting ahead of the curve and doing something useful is the best solution. If cofinancing could be redefined it might help rebuild Asia's infrastructure, something that is at least as important to Asian economies as is recapitalizing a handful of miscreants, or publishing a bushel basket of good practice guides in glossy covers.

Please understand that I am not denigrating transparency and good

governance. I think much of the medicine that is being offered by the West either does not get swallowed or, worse, provides excuses for those who would readily deny Western practices for cultural and other reasons.

It is time to get away from the stereotypical prescriptions and the false labels. It is time to focus on the fundamental requirements of banking in the 21st century, requirements imposed by the realities of global competition, consumer behavior, and technology. Focus the solution on purchasers of financial services, not the suppliers or old elites, who have no intention of relinquishing their prerogatives or the politicians they have elected.

But make no mistake. This is about power, the purchasing power of people, a revolution that is just beginning worldwide but that is just as likely to flourish in Asia as it has in Europe or the Americas.

In fact, curiously, the backroom is just as much the Achilles' heel of developed-country banks as it is of banks in Asia. Long neglected by people who believe in the primacy of manufacturing banking products, electronic distribution will not occur without real-time processing engines. And real-time transacting is impossible without straight-through processing. That makes it necessary to get deep into the plumbing of a bank to deliver products and services in the modern era, and to spread the investment over the broadest possible geographic area.

If banks are to win the battle for the hearts and minds of consumers worldwide against monoline providers (those insurgents that focus solely on processing credit card transactions or presenting bills), they will have to form utilities with other banks or possibly with accountants, or with computer equipment suppliers. Most banks still cling to their old habits and outdated infrastructure, however, which is why so many people think the incumbents will eventually lose the battle to the insurgents. The domestic banks that are so desperately out of date and out of funds have a great opportunity to be among the first clients of these new superprocessors. Even if domestic regulators seek to protect their national turf for awhile, the only viable response to the growing demand for transaction services will require them in time to relinquish direct control of the infrastructure and encourage local banks to shift the burden to those equipped to do the job. In fact it is already happening, not just with credit card transactions or bill presenters, but also with custody and trade services providers.

The obvious solution is for the incumbents to combine their transaction flows with responsible international institutions that have the capital,

the technology, and the ability to deal with skyrocketing real-time transaction volumes and the need to ensure finality. Properly constituted, these new utilities will also have the wherewithal to invest in the software to prevent fraud and to monitor capital movements. That way, the consumer is protected and central bankers need not relinquish their ability to intercede when problems loom.

This is not going to happen overnight. There will be delays. Some delays will be caused by attacks of paranoia, others by political maneuvering, or obfuscation. But do not confuse temporary roadblocks or xenophobia with the strength of the underlying revolution. Once the battle is joined between the forces of progress and the old elites, it will become obvious that a local solution is not only inadequate, but inappropriate.

In the new world networks are not circumscribed by geography, nor are they defined by the number or location of the nodes. Networks are extensible and ultimately limitless. That is what makes them so interesting, and potentially so useful.

Beyond the standardization of processing platforms lies a more challenging environment in which banks use their licenses to serve customers as aggregators of financial products offering limitless choice and acting like *true* service organizations. The role of the intermediary will thus be totally redefined, first by the crisis and then by the opportunity. The role financial institutions might play in this scenario is wide open. Bankers can dismiss the vision and watch from the sidelines, or they can choose a partner and join in. They will need patience and a strong stomach. Building the infrastructure and getting the kinks out of it is at least as challenging as preparing for Y2K, although in a way it is also like starting afresh. Leveraging banking expertise and legal systems will require significant renewal and adaptation to survive.

Asia has the potential, and consumers will not wait. If banks do not fill the void, others will. For the moment, though, it is their business to lose. To repeat, Asia is an environment of opportunity and not of threat. Success demands enthusiasm, flexibility, and a willingness to redirect a portion of the money bet on traditional cofinancing in Asia to the infrastructure that is so essential for Asia's growth and future development. I foresee many ways of participating in this opportunity, and a healthy, well-functioning financial sector is at the core of all of them.

SECTION II

The International Finance Corporation and Our Market Environment

CHAPTER 6

Update on Financing Operations

Assaad J. Jabre
Vice President, Operations, International Finance Corporation

The International Finance Corporation's (IFC's) operations for the fiscal year ending June 30, 2001, reflect both good news and some not-so-good news. The good news is that IFC's total commitments, including investments for participants' account, rose about 8 percent. IFC's own account investments went up even more, increasing by some 14 percent. Commitments, of course, are what matter to clients, participants, and to IFC itself.

The not-so-good news is the 8 percent drop in IFC's total investment approvals in the past fiscal year. This decrease is due to the decline in approvals for loans that IFC will make for participants' accounts. A variety of factors are responsible for this decline, as discussed in the following chapters. An important factor, perhaps, is that some banks have become more cautious about the uncertainties in the world's emerging markets. Another factor is undoubtedly IFC's own investment strategy, which is moving a little more toward the frontier markets.

IFC's increased focus on frontier markets this year reflected implementation of the investment strategy that it introduced in 2000. It included an emphasis on priority sectors: namely, infrastructure, financial services, information and communication technologies, small- and medium-size enterprises (SMEs), and the social sectors. In keeping with this strategy we also introduced a number of new products; started a sustainabili-

ty initiative; and worked hard at closer and better coordination with our colleagues at the World Bank.

The approval figures reflect the changes that have occurred between IFC's fiscal years 2000 and 2001, and give an idea of business in the months to come from a participation point of view. One noticeable change is a decline in Board approvals for investments in Africa. Africa remains a priority for IFC, but we did not have as many large projects approved as we had in fiscal 2000, such as the Chad-Cameroon pipeline, which, along with the opening of Nigeria, contributed quite a bit to the increase in IFC's investments in the region. IFC is continuing to invest in Nigeria, but this year our approved investments there were a bit lower than in fiscal 2000. We currently have two large infrastructure projects in Africa that are expected to be approved next year, one of which is the Bujagali Hydropower Project in Uganda. This should help sustain a reasonable volume of investments in the region.

Investment approvals in Asia, on the other hand, went up, owing to the increased activity in China and India. Approved investments in Central Asia and Europe also increased substantially. By contrast, there was a marked decrease of approvals in Latin America, mainly because of a decline in B-loans after IFC's strategy in this region began focusing more on middle-market companies, which are not necessarily of interest to the bank syndication market. In addition, size of investment in such projects is not necessarily big enough to syndicate. In the Middle East, however, IFC's program was very prominent, with investments rising from less than US$100 million in 2000 to something like US$1 billion in 2001, not the least because of what IFC has accomplished with Meditel in Morocco and with Electricité de France on two power projects in the Arab Republic of Egypt.

IFC has given priority to infrastructure, financial services, and information and communication technologies, which represent about 70 percent of our investments. Although the social sectors have also become a high priority they are not tabulated separately, mainly because IFC is still proceeding cautiously in this relatively unfamiliar sector. We do not want to do something that is inappropriate or that will come back to haunt us in the years to come.

Nevertheless, innovation remains at the heart of our strategy, because that is what will keep IFC relevant in the challenging business environ-

ment facing our developing–member countries. One new endeavor of the past year that reflects this strategy is the development of local currency products. Already there are about 12 emerging markets in which we can have access to local currency through the swap markets and other means. We have also introduced the use of partial credit guarantees to help raise financing for our clients in local currency, thus expanding our ability to offer this kind of funding.

Two transactions along these lines have taken place in India: one for Bharti Telecom and the other for Ballarpur. IFC partially guaranteed local bond issues made by these two companies, thereby helping them get better ratings and access to institutional investors who can invest only in AA-rated or similar paper. This product—guaranteed local bond issues—is proving very useful, especially for clients who want to mitigate exchange risk on infrastructure or domestic market projects where revenues are in local currency. It is certainly a much safer way to go about this. Although the product is still at an early stage of development, IFC has great expectations for its success.

Among its other interesting activities in the past year, IFC approved financing for student loans in India with Citibank and the National Institute of Information Technology. When the proposal for this financing first came to IFC's Investment Committee the idea of becoming involved with student loans met with some skepticism, and concerns were raised about the impact of such a line of business on our profitability, at least if we were to enter this field on a large scale. Nevertheless, we were able to develop an innovative and prudent structure that has the potential to be replicated elsewhere. The transaction was structured more or less as a securitization. Basically, our partners agreed to take first loss, while we were involved mainly in second loss, making it possible to securitize the balance of the financing.

Another new area for IFC is distressed debt. We are testing these waters in the Czech Republic and the Slovak Republic, and we will be assessing carefully the outcome of the transactions and the potential for replicating them in other markets. We want to do this with players that have had experience with distressed debt. In the Czech Republic, for instance, we joined Goldman Sachs in an effort to buy such assets. We also offered our services to all prequalified bidders on another package of distressed debt in the Slovak Republic. It is clear that IFC has to go a little beyond its tra-

ditional approaches in helping to reform financial systems in its developing–member countries.

Yet another interesting new product concerns small- and medium-size enterprises (SMEs), which play a major role in our developing–member countries and are at the center of IFC's strategy. IFC's early experience with SMEs, which consisted of direct financing, did not go terribly well, and our collection rates were not up to par, at least when we were financing smaller enterprises (which fortunately involved modest amounts of money). Nevertheless, we learned some important lessons along the way. The fact is we cannot stay in this business offering only long-term financing and not having a retail network. So we decided to do things differently, involving more local financial institutions. We have already had practice financing SMEs through financial intermediaries experienced in this sector. This product has done well, and we expect lending through financial intermediaries to continue to increase.

But the institution is also moving in a new direction, by approaching corporates to help shoulder some of the SME risks. Many corporates already active in emerging markets have an interest in working with SMEs. After all, SMEs are an integral part of their supply chain. Corporates can provide services to those SMEs and can help us assess their risk and share in it. IFC has approved three such transactions so far this year. In one case it is sharing the risk with Edenor in Argentina, and in another it is working with Ispat Karmet in Kazakhstan. In the third case, which will be going to IFC's Board of Directors shortly, and which has been mentioned in the press, we will help finance some of Shell's contractors in Nigeria. This product appears to have considerable potential.

Another important innovation, highlighted in chapter 1, is IFC's sustainability initiative. By that we mean we would like to be able to measure ourselves more according to a triple bottom line: (a) the financial viability of the corporation and its projects, (b) the economic soundness of our projects, and (c) our projects' contributions to environmental and social sustainability. Although IFC has certainly been concerned about all of these issues for some time, it probably has not approached them as systematically as it could. The idea is to build sustainability into the very fiber of the institution, to make sure that everyone in IFC—every investment officer, every engineer, every syndication officer—focuses on those three objectives. That is to say, all three must have equal importance throughout

the process—when appraising projects initially, conducting due diligence, negotiating with the client, and monitoring project implementation. On the environmental and social fronts, in particular, our approach so far has been to emphasize compliance and to insist, somewhat authoritatively, that the clients meet some of our environmental and social standards. There are other ways to add value, and to show our clients how to benefit from adopting best environmental and social practices. In fact, there is a growing market for people who cater to eco-friendly constituencies.

Whether this approach works will ultimately depend on whether we can persuade our clients that it makes good business sense for them to join us in this initiative. Some big oil companies and mining companies are already engaged in such initiatives. They are not doing it for philanthropic reasons, but because it makes good business sense for them to do so. The business case may be more difficult to make when it comes to our middle-market and small clients, although some early projects here suggest that it can be done, but certainly not overnight.

Sustainability cannot be achieved without good corporate governance, meaning that our clients must adopt "best practices" in areas such as accounting, board operations, and treatment of minority shareholders. IFC is concerned about corporate governance for two reasons. First, IFC has a large equity portfolio, and good corporate governance is crucial to the success of our equity investments. Second, and perhaps even more important, corporate governance has great bearing on the institution's development mission. IFC is well aware that it cannot meet all the needs of developing countries or of their private sectors. Our clients must be able to attract private money in order to realize their own growth potential. Corporate governance greatly affects their ability to attract that money.

To help us better meet our strategic objectives we have stepped up our cooperation with the World Bank. The latest strategic discussions at the Bank have made improvement of the investment climate one of the Bank's strategy pillars; another pillar is direct poverty reduction. There is growing recognition in the Bank that private sector development is essential to growth and poverty reduction, and we at IFC are convinced that we can make a bigger difference by leveraging the Bank's resources. As a result, IFC and the Bank have been working to coordinate their country strategies more closely. We recently prepared joint strategies for some of IFC's main client countries. The joint IFC-Bank departments created last

year—the global product groups—have made a good start, although they have yet to realize their full potential.

As should be clear by now, IFC today faces some enormous challenges. One is how to encourage participants to take a greater interest in emerging-country markets. Some banks, I am disappointed to say, are leaving those markets. We would like to see them come back. We would also like to see institutional investors entering these markets in greater strength. The countries concerned and IFC must do everything in their powers to persuade participants that this is the right thing to do. That is why IFC is constantly reviewing its products and investment strategy to determine what transactions and deals will be of interest to its participants and to the markets in general.

The second challenge that we are facing relates to the implementation of our sustainability initiative. We must continue to work very hard at translating it into operational objectives to ensure it succeeds.

We also have to balance our frontier strategy with greater attention to profitability. Profitability and development impact clearly go together. I do not know of any loss-making project that makes a great contribution to development. One of IFC's main contributions to development is to show that it is good business to invest in the developing countries. In tackling its new initiatives IFC is finding that it must do many more things than it did before in terms of technical assistance, advisory services, and the like. Those new initiatives are costly, and we need to find a better way to finance them.

IFC will also continue to work very hard on its problem loans. We are not yet happy with the results, although we have had some successes in this area in the past year, notably, in the case of A. O. Volga of Russia (see chapter 19a). The participant banks got all their money back, and so did IFC.

Last, but not least, we must continue to work on our responsiveness to clients. We need to offer products that the clients want, not just those that we have and wish to impose on them. We need to find a way to make investing with IFC a more attractive proposition. With our operations more decentralized, with most of our regional directors now located in the field, and with our focus on new product development we will make good progress in this area in the coming months.

CHAPTER 7

Portfolio Performance and Future Plans

Farida Khambata
Vice President, Portfolio and Risk Management,
International Finance Corporation

This presentation will introduce the International Finance Corporation's (IFC's) portfolio by region and sector. It will also touch on portfolio performance and our plans for managing the portfolio in the future.

IFC's portfolio amounts to about US$11 billion, which has substantially increased from US$4 billion in fiscal 1990 and US$7.5 billion in 1995. This own-account portfolio comprises loans, equities, and quasi-equities. The separate B-loan portfolio (for account of participating financial institutions) stands at around 90 percent of the A-loan volume.

In both A-loans and B-loans the Latin American region is the single largest exposure, followed by Asia. Africa is the region where IFC has deliberately tried to increase its exposure, though not in B-loans. Recently, IFC has made a deliberate effort to reduce its exposure in Latin America, since it was felt that the need for IFC in some of the key countries was not as significant as it once was. For this reason we reduced the A-loan exposure for Latin America from about 48 percent of the portfolio to about 40 percent. But conditions in world financial markets have now changed, and the flow of private capital to emerging markets has been significantly reduced. As a result, IFC is considering increasing its exposure to Latin America again, but this will probably be done through investments aimed at the Andean region.

In terms of ranking, Argentina and Brazil are prominent recipients of both A-loans and B-loans. Mexico is third on the list, and Thailand ranks somewhat lower, although Thailand is a very important country for the B-loan portfolio.

The breakdown by sector is also interesting. The three most important sectors (manufacturing; financial markets; and oil, gas, and chemicals) are the same for both A-loans and B-loans, but the ranking is somewhat different. A-loans have their largest exposure in manufacturing, followed by financial markets, then by oil, gas, and chemicals. B-loans have their largest exposure in oil, gas, and chemicals, followed by manufacturing, and then by financial markets. Incidentally, financial markets make up about 40 percent of IFC's approvals on a yearly basis. IFC expects this trend to continue.

Credit quality has been a major concern for IFC. To address this issue, it developed a credit-rating multivariate model to rank the credit quality of its projects by taking into account factors such as country, market, greenfield or other kind of project, capital structure, management, finance to date, and financial projections. Each project is scored on a scale of 1 to 7, with 1 being outstandingly good and 7 being at the other end of the spectrum. These credit ratings are key inputs in IFC's Monte Carlo simulation loss-provision model. Looking at current credit quality by region we find that Asia has several projects with a high credit–risk rating. Some of our large projects in Asia are currently experiencing problems that are taking time to resolve because of legal and jurisdictional issues. This picture is improving somewhat now that these markets are beginning to get over the recent crisis. Overall, Latin America remains our most profitable region.

In terms of write-offs, our levels have historically been low: since IFC's inception in 1956 they have been less than 5 percent. This is primarily because of IFC's philosophy not to write off, but to work on difficult projects over many, many years, until we get it right. There have been some spectacular success stories, such as A. O. Volga, which took much time and work but proved, in the end, to be financially very satisfactory for both IFC and its B-loan participants (see chapter 19a). Not surprisingly, Asia now has the highest nonperforming loan rate. Europe's record is adversely affected by two factors. One is the former Yugoslavia and a number of problems inherited from previous regimes. The other is a very large project in Europe that recently went into nonaccrual status. Latin America, as

mentioned earlier, has done well, as has the Middle East and North Africa. Sub-Saharan Africa appears to be doing well, but it is difficult to know at this time how much of this performance is attributable to the sharp growth in the portfolio in the past couple of years.

Some operational changes may also be having an impact on the overall performance of the portfolio. We now have a Credit Review Department, which we recently strengthened. This department provides a second pair of eyes to look over each project during the appraisal stage. It gives management input from a global perspective, since it vets all the projects that go through the system. We have also created dedicated portfolio units in each of the departments.

The portfolio units' main function is to be more actively involved with IFC's portfolio companies and to maintain high-quality supervision. In many cases our portfolio units now have specialists in the financial sector to handle the specific problems faced by financial sector companies. We need this expertise both for new operations and at the portfolio level.

What does the future hold for us? For one thing, we are going to be actively involved in overall portfolio management, not just at the transaction level. This has several dimensions. For example, we now have a dedicated equity sales desk. Now, if it is deemed that IFC's developmental role has been fulfilled in a project, the project is passed on to the equity sales desk to make the divestment decision. From time to time we also write derivatives on our equity portfolio. These are all covered calls, because we never take naked exposure.

We are also looking at our overall portfolio, by sector and by region, to see if we should alter our exposure through credit derivatives. In addition, we have a Risk Management Unit that is increasingly looking at IFC pricing based on a risk-oriented framework.

The Special Operations Unit (SOU) is much more actively involved in difficult problem projects. Its philosophy regarding workouts is to maximize the returns for IFC and its participant banks with the least fallout possible. We are strengthening SOU in terms of both people and resources, and it is working more proactively with our operational departments, often just as problems are beginning to surface, so that we can benefit from this department's global restructuring expertise.

Yet another area of activity involves "deadwood equity," which refers to an equity investment where our developmental role is completed and

there is little upside potential. In most of these investments IFC has written off its equity but continues to be a shareholder of record. This exposes IFC to potential reputational risks. IFC is actively involved in divesting from these investments. In some cases several multilateral development banks each hold small separate equity positions in the same company, making the individual investments unattractive for a potential sale. In such instances we are considering combining our equity holdings so that, collectively, we have a critical holding that might be of interest to a potential strategic investor.

Finally, we are seeing ever more innovative financial engineering techniques in developed markets. It is IFC's hope that we can bring these techniques to our clients in the developing world, so that they too can enjoy the benefits of innovation.

CHAPTER 8

Trends in Syndicated Lending

Suellen Lambert Lazarus
Director, Syndications and International Securities,
International Finance Corporation

Overall Flows

My aim is to provide an overview of trends in syndicated lending to emerging markets—a snapshot of what is currently happening in the market and how it is affecting the International Finance Corporation's (IFC's) B-loan syndication activity.

To begin, let us look at private debt flows to emerging markets by region over the last five years (see figure 8.1). These are net aggregate amounts. The main feature is the dramatic drop in net flows to Asia (from about US$120 billion in positive flows to US$60 billion in outflows) between 1996 and 1998. Since then, the Asian trend has recovered and may be positive again in 2002, largely because of flows to China. In Latin America, after falling to near zero in 1999–2000, net flows were expected to be strongly positive in 2001, but this has failed to materialize, largely because outflows from Argentina have exceeded inflows to Brazil. The crisis in Argentina is having a harsh effect on flows to the region.

On the other hand, *official flows* (that is, flows from multilateral and bilateral agencies, and governments) are projected to increase in 2001, because of International Monetary Fund programs to Argentina and Turkey. *Private equity flows* are expected to remain stable. This is due to several large acquisitions, including Citicorp's recent purchase of Banamex in Mexico.

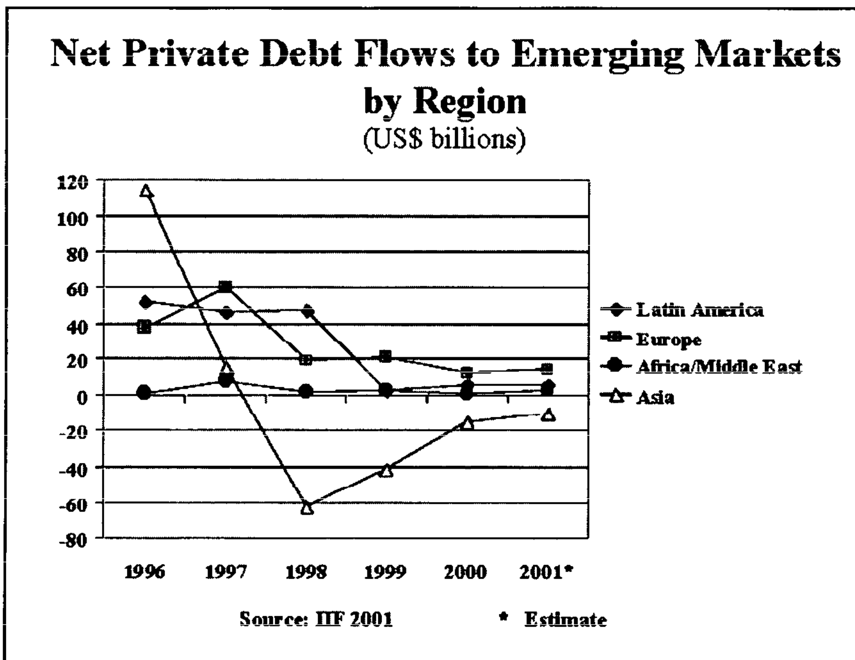

Figure 8.1 Net Private Debt Flows to Emerging Markets by Region
Source: Institute of International Finance, Inc. 2001. "Capital Flows to Emerging Market Economies." April.

Figure 8.2 disaggregates private debt flows between *bond financing* and commercial bank lending. It is projected that bond financing will again decline in 2001; in all likelihood this decline is related to the inability of several major borrowing countries to implement economic reforms in accordance with market expectations. *Commercial bank outflows* are beginning to stabilize, and the good news is that 2002 will probably see positive inflows from commercial banks to developing countries for the first time in five years. The other benefit for emerging markets, as shown in figure 8.2, is that spreads are narrowing, overall. This is largely in response to the Federal Reserve's interest cuts in the United States, which tend to affect spreads elsewhere.

Figure 8.3 shows new commercial bank lending activity for the years 1996—2000. These are not net figures, but are rather gross new flows in syndicated loans to emerging markets. One of the marked changes in 2000 was that commercial bank lending to developing countries was up, although this was related to increases in a few countries, rather than an overall increase in a broader range of countries.

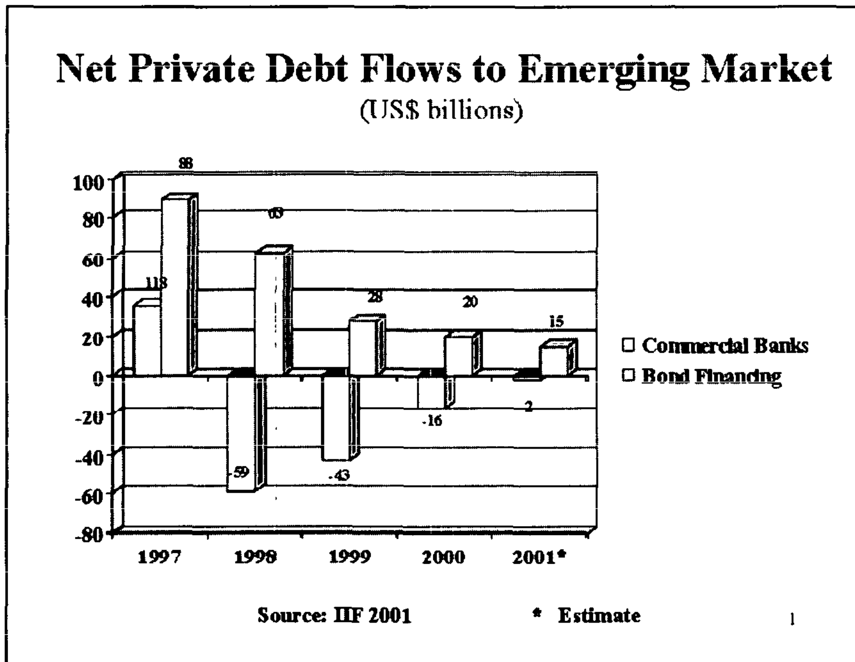

Figure 8.2 Net Private Debt Flows to Emerging Markets
Source: Institute of International Finance, Inc. 2001. "Capital Flows to Emerging Market Economies." April.

The International Finance Corporation and the Bank Marketplace

Compared with the commercial bank market, IFC is a small player: its B-loan program represents only about 1.5 percent of total syndicated flows to emerging markets. The importance of our impact, however, is that commercial bank long-term lending is very limited in many of the frontier countries in which IFC specializes. In these countries we can be a very important player.

This year we have found that there is a limited market for broad distribution through general syndication. More frequently, financings are arranged as "club" deals, among banks in the finite universe of banks that are interested in the transactions from the start. The market is often not much larger than what you see and are aware of initially. This has affected how we have structured our syndications, relying more on a core group of underwriters or arranging banks.

The second noteworthy trend is that, as in the commercial loan market, our spreads have come down this year, although not as dramatically

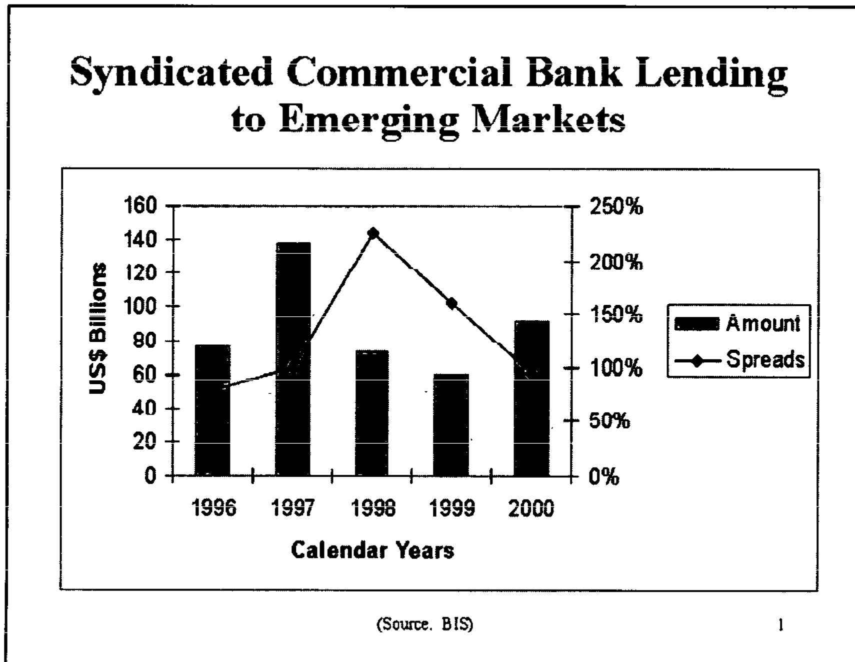

Figure 8.3 Syndicated Commercial Bank Lending to Emerging Markets
Source: Bank for International Settlements. 2001. *BIS Quarterly Review* March.

as for the overall market. This is largely due to the fact that IFC's tenors are considerably longer than those for most commercial bank loans.

Third, the fundamentals driving syndicated lending are much the same as they have always been—only more so. Relationship lending is more important than ever; and strong project fundamentals are an absolute prerequisite to syndicated lending. An experience that we had in Turkey earlier this year illustrates this fact. To raise term finance for a top-tier Turkish corporate, which was financially strong and highly respected for excellent management but not well known internationally, we had planned initially to go to the institutional investor market. However, it soon became clear that this market was closed to the Turkish private sector. For institutional investors, their opportunity-cost is the Turkish sovereign spread over U.S. Treasuries. Relationships with project sponsors and related business is not a consideration. Thus the spreads required by the investor market, together with the other costs of the issue, were too high for the borrower. Instead, we were able to arrange a substantial volume of B-loan financing through the bank market—at a time of general

market crisis—because of the company's strong relationships with commercial banks. Loans can be made in difficult markets, but relationship lending remains fundamental to successful lending.

I should mention, briefly, the new Basel Accord, discussed in detail in other chapters. As currently proposed, it will certainly have an impact on our syndication activity, just as it will on the work of major banks that play large arranging roles. Syndication activity will be further constrained if smaller banks are forced to exit the project finance market as a result of excessive capital requirements associated with this business line. The prospect of the new Accord has also begun to generate the use of sophisticated capital allocation models and a more cautious use of balance sheets.

Increasingly, IFC's responsibility is to ensure that banks and their managements understand the risk-mitigation features of our products. These features require more in-depth analysis than, for example, those of political risk insurance (PRI). Insurance has an obvious appeal to banks, since it provides clearly defined contractual protection and, in the case of PRI, in some institutions may result in excluding the insured loans from country-risk exposure calculations. This simplifies the risk analysis considerably. Therefore, it is a challenge for IFC to make sure that banks give full weight to the risk-mitigation features of B-loans. IFC has also been working closely with some of the private credit insurers to see where there is scope for our products to complement each other. We recognize that fees are a vital component of banks' calculations of overall return, and—particularly in our larger transactions—we are increasingly reliant on fee-earning arrangers and underwriters. In larger deals we are also linking our syndications to export credit facilities, when possible, since we know that export credit agency (ECA)–backed business is attractive to banks. The commercial risk coverage yet lower spread of the ECA-loan, together with the risk mitigation features and higher spread of the IFC B-loan, provide an attractive risk-return profile for banks. This packaging together of export credits with B-loans has become an important structure for our clients.

Within IFC there has been a general push to get closer to our clients in member countries. We have rapidly expanded our presence in developing countries and decentralized out of Washington. We have adopted a similar approach with our syndication partners. We now have two senior syndications officers in London and two in Singapore. In Singapore, where we are working with banks on many of the restructurings in the region,

one of these officers is a restructuring specialist. His responsibility is to ensure that the banks in the region are regularly informed about what is happening on each restructuring and that their input is fully taken into account in developing the restructuring plan. We are also looking at local currency structures, including syndicating guarantees for local currency loans or bond issues.

The International Finance Corporation Syndication Activities in 2000–01

Turning to IFC loan approvals for our fiscal year 2001 (to end-June 2001), A-loans alone, which are the senior loans held for IFC's own account, are expected to reach about US$2 billion and B-loans about US$1.7 billion. This is a decline from last year, and largely reflects IFC's current strategy of moving more into frontier markets and reducing our activities in the more developed countries in Latin America, which have good access to international financial markets. For many years Latin America had been IFC's largest syndication market.

Signings of A-loans this year are expected to be about US$1.1 billion, and of B-loans about US$1.4 billion, which is a slight decline from last year. In this case, timing is the main cause: several large B-loans that we expected to be signed in June ended up slipping into July.

Last year, Latin America and the Caribbean accounted for 62 percent of new B-loan signings, and Asia another 22 percent. This year is a very different story. The Middle East and North Africa region represents 45 percent of new B-loan signings, a dramatic increase, while Latin America and the Caribbean represents only 27 percent, and Asia 9 percent. The numbers in Sub-Saharan Africa for this year have also risen considerably, to 12 percent, which is another success story. As noted earlier this changed pattern reflects IFC's decision to push the frontier and to enter new markets. It was noteworthy that these deals were so successful in the Middle East and North Africa region. The Electricité de France power projects in Egypt, and a major telecommunications project in Morocco, involved large B-loans with unprecedented tenors. In Sub-Saharan Africa major syndications were the Chad-Cameroon pipeline and a telecommunications project in Ghana. Again, these were precedent setting.

The sectors in which our activity took place this year also tell a changed but interesting story, reflecting market conditions more than

IFC's own internal strategy. Last year our biggest syndications sector was financial institutions, accounting for 38 percent of our business, followed by oil, gas, and chemicals at 24 percent of new signings. This year financial institutions will represent only a small component of the program, although business for IFC's own account in financial institutions is quite high. Historically, IFC has been very active in syndications for financial institutions in Argentina and Turkey, and the decline reflects difficult market conditions in those two countries. Over 75 percent of our program this fiscal year will be in telecommunications, power, and infrastructure. Next year, however, we expect to bring very little to market in telecommunications. For all of us the world is rapidly changing and this directly affects our business mix.

There has also been some change in the roster of financial institutions that were most active with us this year. Dresdner continues to be our largest single participant, and HypoVereinsbank remains number two. They both did a substantial volume of new business with us this year. ABN AMRO moved to third place, and Barclays Bank and Deutsche Bank moved up. Among other interesting developments, Mashreq Bank participated in two B-loans, as a direct result of our increased program in the Middle East. Citibank is also coming up the league table, as are several Spanish and Italian banks. Activity with Standard Chartered and WestLB has also increased.

To sum up some features of our syndications in fiscal year 2001: one-third had underwriters or co-arrangers playing significant lead roles alongside IFC; 70 percent were oversubscribed; spreads were down to an average of 2.31 percent compared with 2.74 percent in fiscal 2000; and tenors were up substantially. Our average tenor of B-loans in fiscal 2001 was a remarkable 10 years, in contrast to seven and one-half years in 2000—and this was at a time when market tenors generally were shortening.

Deals in the pipeline for next year suggests substantial activity in the power and mining sectors. This business amounts to about US$1.8 billion. In terms of regional distribution we expect to see a return to Latin America, at over 55 percent of upcoming deals, and some recovery in our Asian program, although not to prior levels. While next year we expect to revert to the traditional pattern of Latin America and Asia dominating our B-loan activity, with less activity in the Middle East and Sub-Saharan Africa, the pattern can change quickly in today's unpredictable world environment.

CHAPTER 9

Restructuring Problem Loans

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As of March 31, 2001, the International Finance Corporation's (IFC's) portfolio consisted of 274 B-loans, representing a committed portfolio of US$7.4 billion. This is a decline from the level at the end of the last fiscal year, when B-loans numbered 285 on commitments of US$8.1 billion. The reduction in the participant loan portfolio reflects that, on an aggregate basis, the portfolio is paying down—through regular amortizations, prepayments (in some cases related to the successful closing of restructurings), and cancellations—at a faster rate than new business is being booked.

Thirty-seven of the 274 B-loans are currently nonperforming,[1] totaling US$1.1 billion, or 14.9 percent of IFC's committed B-loan portfolio. It is noteworthy that three loans accounted for 60 percent of the total nonaccruals. As in the case of the A-loan portfolio the most important story continues to be Asia, accounting for about 78 percent of B-loans in nonaccrual status, with the region itself representing 33 percent of outstanding IFC B-loans. Three countries in the region—Indonesia, Pakistan, and Thailand—contain the bulk of the problem loans in Asia. More important, two large B-loans in the region account for 46 percent of the total amount of all IFC nonperforming loans. Both are in late phases of restructuring or settlement, and should soon reduce the nonperforming figures significantly.

Fifteen percent of the nonperforming portfolio is in Europe, predominately attributable to Yugoslavian nonaccruals, and one large project is in Central Europe. Only 7 percent of nonperforming loans are in Latin America, the region that accounts for approximately half of the B-loan portfolio.

The trends in the A-loan and B-loan nonperforming portfolios are similar, with higher concentrations in the Asia B-loan portfolio. The numbers for the Middle East and North Africa and Sub-Saharan Africa portfolios look strong, but exposure in these regions continues to represent a small (albeit growing) proportion of B-loans, at 6 and 5 percent respectively. Only 2.3 percent of committed loans in Latin America are nonperforming. Argentina and Brazil account for over half of the B-loans in the region, yet defaults have remained low, even in the face of economic pressures in these countries.

Despite the current level of nonperformers IFC has proved to be effective in facilitating the restructure and recovery of problem B-loans. We currently have 32 B-loans in restructuring, amounting to US$940 million, and involving 197 individual participations. We have already discussed regional distribution. In terms of industry concentration some of the largest deals are in the power sector, and in the oil, gas, and chemical sector. Agribusiness and cement projects also figure prominently in terms of number of deals, although the aggregate outstandings and deal sizes are relatively low.

As of June 2001 we have closed 14 B-loan restructurings covering US$728.5 million in rescheduled or prepaid exposure this fiscal year. To accomplish this we obtained unanimous consent from 115 participants. By comparison, in fiscal 2000 we closed just eight restructurings covering US$184 million in B-loan exposure, and with 31 participants.

IFC has achieved particular success in leading restructuring efforts in some of the most complex projects in Asia. Our Special Operations Unit has committed significant resources to restructurings in the region, with an experienced team of workout specialists based in Jakarta. We also posted a participations officer to Singapore this year, to provide quality client service to participants, ensure timely information flow, convene participant meetings, and obtain their unanimous consent on restructurings.

In last year's Participants Meeting we dedicated a session to the restructuring of Thai Petrochemical Industries in Thailand. Earlier this

fiscal year the restructuring agreements were finally signed, and I am pleased to report that debt service payments have resumed. IFC continues to play an active and leading role on the creditors' committee, which gives us—and in turn our participants—high-level access to information. Another restructure of interest is the Tuntex Petrochemicals deal in Thailand, which is discussed in detail in a separate chapter (chapter 19b). Asia is not the only area where restructurings have closed, however. We have also succeeded in closing restructures in Argentina and in the Russian Federation.

This work would not have been possible without close cooperation, frequent communications, and, ultimately, the unanimous consent from our participants. Working cooperatively on restructurings with our partners has been essential to bringing a good number to successful closings.

[1] IFC defines a loan as nonperforming when any amount due to it is 60 days past due

SECTION III

Enhancing Value: Investing in Sustainability and Corporate Governance

CHAPTER 10

Sustainability: A Portfolio Manager's Perspective

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Sustainability is a difficult concept to pin down. Many definitions have been proposed but most do not work. Yet everyone has a general idea of what sustainability means, and, as the old saying goes, you know it when you see it. Many indicators have also been suggested, but all are imperfect. Since financial firms deal with imperfect things all the time—as proxies for the information we seek—the best way to handle these imperfect indicators is to use as many of them as possible to understand their limitations, and beyond that to use a fair dose of judgment.

Our indicators and our definitions are affected by the fact that we are living at a time when we know more than people have ever known, yet we do not know as much as people will know in the future. Hence what we think we know about sustainability will change. Just look at the changing views toward forest management, for instance. A generation ago, when a forest was cut, the best thing to do was to clean up the site afterward, to get rid of all the slash and bark and other things that did not go to the mill. That clean up is now frowned upon. It is regarded as more environmentally beneficial to leave as much of the biomass on the site as possible in order to provide for nutrients for the next generation of forest management. Views of good forest management have changed—and it is no different in the financial field.

The point is, it is very difficult to know when our investments are sustainable, but we do know what is *un*sustainable. In other words, we know what not to do. The challenge, then, is to figure out what to do to develop the indicators, the right matrix, the knowledge, and the ability to make sound judgments. This is not so much a matter of knowing exactly where we want to go, as of arriving at a place we will recognize when we are there, and just making continuous midcourse corrections en route.

Ideally, a sustainability matrix should measure both stocks and flows, or, in other words, both output and performance. Many of the measurements used today are strictly for stocks: they measure the amount of carbon dioxide in the atmosphere, or the amount of ozone in the stratosphere in certain places. What is not known in many cases is the rate of change in these measurements.

Information is needed on both output and performance, yet much of what is available is based on input. Take the case of forest management again. We know what is spent on it, but do we know what it is accomplishing? This is much more difficult to quantify, yet everyone wants as many quantitative indicators as possible.

This also applies to socially responsible investments (SRI). According to figures for 1999 the United States invested more than US$2 trillion in SRI portfolios during that year. That means about US$1 in every US$8 of equity investment went to some form of SRI in the United States. The rate of SRI may be increasing even faster in Europe, and it might grow faster in Asia, in the future. A good deal of this is in separate accounts, by the way, as opposed to vehicles such as mutual funds. These investors are high net worth individuals who want to put their money in something that fits their values. A broader set of investment products is now available for the growing number of households with about US$50,000 to invest. These individuals are not going to hire a portfolio manager or a separate account manager.

Until recently the competitive performance of SRI was quite vigorous, although stock-market dives of late have made a major impact—somewhat like a bomb crater—on SRI in our business and in everybody else's. Nonetheless, most SRI products are growth products. Morningstar ratings and the weights of SRI firms in various categories indicate that they are doing fairly well in the areas where SRI is represented. Another indicator of how they are doing comes from Innovest, an agency that completes statistical and industry research and provides reports for investment man-

agers, among others. A number of in-depth studies there have included some quantitative analysis of whether there is a statistically verifiable double– or triple–bottom line, that is, whether it can be proved, as many SRI firms believe, that there is a financial bang out of managing the work force, or out of an improved impact on the environment or human rights. On the basis of its research Innovest ranks the environmental performance of corporations within an industry. For example, it will look at electronics industries and rank every corporation in that industry. Its universe, I believe, is the Standard & Poor's 500.

In one yearlong study of SRI performance Innovest back-tested the AAA-rated portfolio against the average portfolio, and then did the same for an A-rated portfolio. It found that the higher the rating, the greater the spread between the performance of the average portfolio or industry and the sample of highly rated firms. Back-testing of portfolios that passed some proxy or metric for environmental performance has produced quite a bit of evidence of this kind.

At The Calvert Group we have subadvisers who use such research to measure SRI performance. Not all SRI firms do this. We have 14 portfolios that are socially screened. All of those, with the exception of our bond portfolio, are managed by outside subadvisers. They do the financial due diligence and the research, and then they call us and ask if the company is a candidate for investment based on our social screening. As a result, we put every company in our portfolio through a comprehensive analysis that compares the company to its industry in terms of environmental impact, workplace practices, human rights, the community, product safety, and indigenous people's rights.

We look at a company at a moment in time and at everything leading up to that moment, all of which means maintaining eternal vigilance over it. We monitor the company's behavior. We watch with whom it merges, who it acquires, and its performance on all the social and environmental issues. All of this requires an entirely new bottom-up analysis. That, in turn, means we must constantly update our information.

When it comes to screening we have both positive and avoidance screens. Avoiding the so-called sin stocks—nuclear products, gambling, alcohol, tobacco, and the like—is one of the main screens for SRI assets. Our main goal is to investigate companies thoroughly. If we want to determine whether a particular company is good for the environment or

has a lower environmental impact than its peers in its industry we conduct extensive analysis. Even then we sometimes end up having to exercise our judgment because the screens are hard to implement and it takes a fair amount of time and expertise to perform this analysis. That is why funds requiring this kind of scrutiny have higher fees.

Another aspect of SRI that I should mention is shareholder activism. When a company has problems or when something has happened that concerns us, we enter into a dialog with the company; this can go on for years. If we reach an impasse with a company and it no longer seems to be responding or is just not going to go anywhere with us, we may file a shareholder resolution, which is straightforward and easy to do in the United States.

If we get a 3 percent vote in the first year, we can refile it the next year. If we get 6 percent, we can refile it the following year. If we get 10 percent, we can refile it again. And at 10 percent—sometimes even at 3 percent—we usually get management's attention. Then the dialog can proceed. But we may still reach an impasse; and in some cases when we get to this point we just decide to divest.

To get the information needed to manage this kind of investment requires a formidable amount of research. That is why we subscribe to dozens of journals, search services, and both proprietary and public databases. In the United States we are extremely fortunate to have a great deal of information available publicly. For example, details on the environmental performance of every company with an office in the United States are available to the general public from the Environmental Protection Agency and Virofax. To my knowledge, the only other place where this is true is Canada.

An additional challenge, then, is to obtain this kind of information on companies that are headquartered here but have establishments offshore, or on companies that are headquartered overseas. That is a much harder task, in part because the United States has different standards, although the bottom line for everyone everywhere is "Do you obey the local laws?" At times obeying the local laws is not enough for us, but it is an absolute minimum in every case. And since laws differ, we also need to have considerable local legal knowledge.

We also have some trouble with mid-cap and small-cap companies, because there simply is not much information available on them. Again,

that involves extensive data gathering. Some people might wonder if all that work is worth it. In our view, it is well worth the trouble, in the same way that financial due diligence separates managers with mediocre performance from those whose records are consistently better.

Are there linkages between social and financial performance? In the past, the general view was that SRI had diminished returns. Not any more. It is not difficult to find a socially responsible product that will give a return that is competitive with a product that is not socially screened, especially in growth industries. However, my parting question is, "Can such products do better than the competition?" That, I am afraid to say, has yet to be established.

CHAPTER 11

Sustainability: A Commercial Bank's Perspective

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The financial sector needs to play a key role in achieving a sustainable society. Fortunately, the International Finance Corporation (IFC) has been putting sustainability higher and higher on its priority list. To this end, it has been changing its criteria to meet the demands of sustainable equity management. With many of society's demands also changing there is an increasing pressure for banks, insurance companies, pension funds, asset managers, and others in the financial sector to include sustainability in their initiatives. More of us in this sector must lead the way in setting trends. We have to change the world in developing new products and services related to sustainability issues. I would like to talk about how we are doing that within Rabobank.

Before I address the way we are addressing sustainability, let me give some background on our institution. Rabobank is a cooperative, which means it does not have shareholders, only members and stakeholders. It is the largest bank in the Netherlands's domestic market, and the third largest international bank from the Netherlands. Hence what we are doing within the Netherlands seems quite different from what we are doing outside the country. In both spheres, however, we are constantly looking for ways to cooperate with other financial institutions all over the world, for

ways to use the instruments we have in products and services in order to support a sustainable society.

In fact, we have a special group for this purpose, the Sustainability and Social Innovation Group. As managing director of this group I am directly linked to the chief executive officer of our company. The group has a department devoted to green banking, which was set up a few years ago when the Dutch government created rules for green financing. These rules make it possible for depositors to participate in a so-called green fund, which means they do not have to pay any income tax on the return on their investments. Since income tax can be avoided in this way almost everyone has begun putting money into a green fund.

The fund provides a very cheap form of finance that we can provide to investors, to the initiators of green projects. This money can be invested in different kinds of green projects in the Netherlands. It is also possible to provide green money for projects in developing countries. This is, in theory, one way to offer cheap money to countries in Central and Eastern Europe, Africa, Latin America, and Asia. However, things do not quite work this way in practice. Because this money is so cheap it becomes a problem if we, the banks, have to cover all the credit risks and currency risks within the very low rate of interest. We are not willing to do that.

The question, then, is how can we find nongovernmental organizations (NGOs) and other companies to which we as Dutch banks can make this very cheap green money available, so that local branches of their own, or of other banks in developing countries, can provide the money directly to their local projects?

We also have seed capital—green seed capital—for sustainable development. To help channel this capital into worthwhile projects we have a number of experts in different fields: sustainable agriculture, sustainable construction, renewable energy, and the like. These experts join up with the bank's commercial people—with the account managers and others—to advise customers about how to set up new activities related to sustainability. If a customer of a local bank says, "I'd like to set up a new company or a new building, how can I do it in a sustainable way?" we are set up to advise them how to do that.

Rabobank has four societal funds, donating money from its profits to different kinds of projects with a special goal: to set up new cooperative initiatives, especially in developing countries, but also for other purposes

within the Netherlands. We are also establishing a department for innovation and development, whose scientists will assess the demands for Rabobank's financial services five to ten years down the road. The innovation platforms will be established by groups of young managers with high potential from a management development program. They will create new products and services, if possible with sustainability in mind.

The bank also has an ethics committee, which oversees various ethical problems related to financial deals. For example, it might be called on to look into a bank-to-bank deal earning a great deal of money using the differences between the tax systems of different countries. The committee may ask whether it is ethical for a bank to do that. Because we have a code of corporate social responsibility we are committed to examining the ambitions of our group, of our financial institutions, to make sure that what we are doing meets our "Triple-P" goals: goals that involve people, planet, and profit.

One of our important departments, as I mentioned earlier, is the Green Banking Department, or Rabo Green Bank. On the Triple-P side it is doing extremely well, not only in making profits but also in investing money to give people the opportunity to set up new economic activities. The social and ecological—or planet—side of our activities also receive special attention, through the Department of Sustainable Development. In the green financing area we have already contributed more than €600 million to projects such as forest and nature reserve development. As everyone knows, the Netherlands has many greenhouses. At Rabo Green Bank we are looking at "Green Label" greenhouses, which are new types of greenhouses using less energy. Many different projects have already received cheap green money from Rabo Green Bank.

Nearly 50 percent of our funded projects involve organic farmers. Organic farming has become important in recent times, in view of agricultural problems such as foot-and-mouth disease. As a result, many mainstream farmers are changing to organic farming, and they can be financed with green money.

We can finance green projects outside the Netherlands, too, although I believe that so far a total of only 10 projects abroad have been financed on a green basis by the Dutch banks. These include wind-energy projects, usually financed against security provided within the Netherlands. In our domestic market Rabobank has a market share in green projects of about

50 percent. Part of my group is Rabobank International Advisory Services, a consulting group that is active in rural development, especially in developing countries.

A very important development in the financial sector today, in my opinion, is that we are working to set up alliances between different organizations in the interest of protecting the environment and promoting sustainable development. Some years ago Rabobank, along with other banks, signed the United Nations Environment Programme statement on environmental and sustainable development, and committed itself to such development. About 190 banks all over the world signed the statement, but some large banks did not. In addition, Rabobank is a member of organizations such as the World Business Council for Sustainable Development (WBCSD) and of the European Partners for the Environment. This is what more of us should be doing—sitting together as financial institutions, signing the same statements, or being a member of the same organizations, and developing financial products and services for a sustainable society. One outcome of this development is a recent workshop in Geneva hosted by the WBCSD. The International Finance Corporation (IFC) was represented there, along with other financial institutions from around the world sitting together for the first time, discussing how we could cooperate at a global level.

One of the main problems for such endeavors—and I do not know which organization to turn to for advice here, perhaps IFC, the World Bank, or the Organisation for Economic Cooperation and Development—is how to harmonize the world's myriad financial and tax rules to avoid barriers to achieving this sustainable society. Often, interesting financial products and services are tax-driven—but different tax rules in different countries create barriers that make it difficult to stimulate private individuals to buy these products.

As financial institutions we have a duty to inform our customers of these possibilities to buy sustainable products and services to support their efforts to achieve a sustainable society. What deters many people from looking at these possibilities, even within my own company, is that they do not believe it is possible to earn money from sustainability. Many think that sustainability is only for gurus or idealists, but not for businesspersons. I believe I can prove otherwise. In fact, asset managers can earn substantial money on sustainability projects—and of course it is

necessary to earn money on them, because if we did not we would not survive as financial institutions, and if we cannot survive we cannot provide.

In conclusion, I urge financial institutions as a starting point to sit together with other financial institutions, governments, and NGOs to try to achieve a sustainable society. We have reached a point where it is essential to make common products and services for such a society. It is our duty, and our corporate social responsibility!

CHAPTER 12

Corporate Governance: A Call to Action

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Corporate governance matters. It matters a great deal to a private equity firm contemplating an investment in a distant country where the laws, regulations, and traditions are quite different from those of the firm's home country. Quite simply, this is because good corporate governance *does* enhance enterprise value, while the lack of good corporate governance amplifies risks for the prospective investor.

A colleague of mine likes to say that "governance" is a threatening word to most people. Children associate it with their parents: when they are playing the approach of parents—governance—means games must stop and misbehavior end. Adults, too, have negative associations with governance. Imagine a husband and wife driving along a freeway. What does the driver do when the spouse says a police car is behind them? The driver will immediately slow down and check the speedometer, even if he or she is not speeding! And some managers fear governance, because they equate it with regulation and new controls on business—and inevitable new demands on money and time.

Corporate governance should be seen only as positive, however, because its objective is to strengthen and sharpen financial performance and corporate management. Although there may be some losers in the process there is no doubt that the majority of managers, board members, and especially shareholders will benefit from good corporate governance.

What is Corporate Governance?

In recent years there has been considerable discussion over what the term "corporate governance" means, and how far it should extend. The term can be defined narrowly—to include only issues relating to managers, board members, and shareholders—or it can be defined more broadly—to include issues involving stakeholders (such as customers, employees, creditors, the business community, or society). In the former case corporate governance relates to the fiduciary responsibility of management and boards to protect shareholders' rights. The latter, broader definition would include the responsibility of management and boards to act as good corporate citizens, and to contribute to the betterment of society. Personally, I prefer the latter definition, but my remarks today will focus for the most part on the narrower interpretation, because our topic concerns enhancing shareholder value. In any case, the elements of good corporate governance are compatible, and certainly not mutually exclusive, under both definitions.

If we view corporate governance as the fiduciary responsibility of management and boards to protect shareholders' rights—and in the process to enhance shareholder value—then the key concepts are fiduciary responsibility and shareholders' rights, and the key actors are management and the boards of directors.

Fiduciary responsibility means, in effect, that the board and management of a company must act as trustees of a company's assets and capital. They have a duty to exercise loyalty to shareholders, to manage the assets prudently, and to monitor performance.

Shareholders, in turn, have the right to expect that management and the board will be accountable and transparent, that the company will be run equitably, that voting methods will be fair, and, crucially, that shareholder value will be maximized.

Elements of Corporate Governance

There are a number of factors that constitute or define good corporate governance. One way of viewing these factors is to use the definition of good governance adopted by my former employer, the Asian Development Bank. That definition focuses on four critical elements:
(1) Accountability, (2) Transparency, (3) Participation, and
(4) Predictability.

Accountability

Management must be accountable to a board of directors, and both the board and management must be accountable to shareholders. A balance between board and management, with both striving to uphold shareholders' rights, would be the ideal world. In reality, however, this is rarely the case. More likely, management—and especially the chairperson—controls the board, and board members are often either executives of the company (and so are not independent), or friends, relatives, or close contacts of management. This is especially true in many Asian countries, given the closely held nature of many Asian corporations. The Korean chaebol, the Japanese keiretsu, and the Chinese family company are examples of these closely held corporations. Management that is not rigorously supervised may too often act solely in its own interests.

How to resolve this problem? One solution is to aim for the inclusion of independent directors on each board, and independent board committees—audit committees, nomination committees, and compensation committees, for example. Independent board members do not necessarily have to be in the majority (although that helps), but they must be prepared to work hard and to remain independent, and they must have access to information, power, and respect.

Shareholders need to play a role here, also: they can and must act like owners, and ensure that the board is properly representative and includes outside, independent directors. The presence of strong institutional investors—such as the International Finance Corporation (IFC)—can be a very valuable asset in this regard. Such institutional investors have the "clout," experience, and know-how that small, individual investors lack.

An active, involved set of shareholders and a board that includes active, capable, and independent members can go a long way toward ensuring accountability on the part of management.

Transparency

Investors, shareholders, and the board of directors must have confidence in the information available about the companies with which they are involved. This includes financial information, and information on corporate vision, mission, and structure. While accounting standards may vary from market to market, international standards are now being widely adopted. Good corporate governance requires use of internationally accepted accounting and auditing standards. Nothing else should be acceptable.

Participation

All shareholders deserve equal treatment, whether local or foreign, majority or minority. Minority shareholders' rights, in particular, must be carefully observed and protected. Voting methods must be transparent and fair, and shareholders have an equal responsibility to participate in annual meetings, to request information, and to play active roles in overseeing the performance of their companies.

Predictability

Understanding the rules of the game is critical for a shareholder, an investor, or a board member to make an informed decision. That means the rules of the game should be set out in a clear and timely manner. A number of steps may help in this regard:

- *Codes of best practice.* Each market needs a code of best practice for corporate governance to define the relationship between management, board, and shareholders. Such a code should also set forth legal, accounting, and other standards that companies must meet. Companies should adopt such codes as their own guidelines. In the absence of such codes in a given market companies should develop and publish their own codes.
- *Corporate vision, mission, and values.* Boards and management should formulate long-term strategic visions for their companies, mission statements to set forth how to accomplish the vision, and value statements to outline the ideas and principles around which the company culture will be built.
- *Corporate strategy and structure.* A mission statement helps to develop the corporate strategy, and the corporate structure in turn flows from the strategy. Both the board and management should play active roles in developing these elements.

An Investor's Experience with Corporate Governance

The firm I am with, Lombard Investments, actively invests in the developing markets of Asia. We have participated in private equity investments in economies ranging from the Republic of Korea; China, including Taiwan and Hong Kong, China; to the Philippines and Thailand. We are actively working with IFC, the Thai government, and a number of institutional investors in Thailand, to put together a Thai Equity Fund that we expect will close in the near future. We have established a $252

million Asian Private Investment Company cosponsored by the Asian Development Bank. Our major source of capital is the California Public Employees' Retirement System—or CalPERS—which is notable for its activist role in sponsoring corporate governance. All of these institutions are extremely valuable partners in helping to assure the practice of good corporate governance in investee companies.

Working with an institution such as IFC provides additional benefits, beyond its size and experience, due to its links to its public sector affiliates in the World Bank Group. The World Bank can provide policy-based loans in the public sector, which help governments of emerging markets develop the legal frameworks, laws, and regulations that are necessary to stimulate, nurture, and sustain good corporate governance. The feedback from IFC's own investment experiences can help in an iterative process to get those laws and regulations right.

We have observed a wide diversity in standards of corporate governance in our investment activities in Asia. Unfortunately, diversity is not always good. We learned quickly, through an investment in one company where the board did not have sufficient independence and where accounting and auditing standards proved not to be up to international standards, that we would have to play an extremely active role to protect our interests, although we were only a minority shareholder. We have had to build coalitions of other shareholders to replace management and part of the board in order to develop good corporate governance, and have had to expend substantial amounts of time and energy to try to rebuild the company to recover our investment.

A happier example was an investment made shortly after the Asian currency crisis in Korea's fifth largest securities firm. As a co-investor with Hambrecht & Quist Asia Pacific, we have changed the make-up of the board, and, working with new management, we have helped to implement best international practice in corporate governance. We have set up independent committees on governance, risk, compliance, and compensation. A promotion system based on seniority was replaced with a new one based on merit; many other changes followed. Management of the company—Good Morning Securities (GMS)—firmly believes in corporate governance, and indeed GMS itself now actively sponsors the development of corporate governance throughout Asia. Did it pay off? Well, Lombard recently sold 20 percent of its holdings in GMS for a 352 percent gain.

Lombard believes so strongly in good corporate governance as being critical for shareholder value enhancement that we have a lengthy checklist on corporate governance issues that we use as a basis for evaluating each possible investment we may make. We talk through the concept of corporate governance with each potential investee company's management, and require agreement on any improvements necessary to existing arrangements.

In a company in the Philippines, for example, we agreed, before making an investment, on a series of steps to improve corporate governance. These included introducing an outside chief financial officer into the management of what was until then a closely held family corporation. The management—previously all family members—have welcomed our advice and assistance in helping to restructure a family corporation into a company that can be taken public with an outstanding record for corporate governance.

This is not always easy. The corporate governance standards we demand often exceed those of the market we are in. This may mean an investee company may have to make financial disclosures to the public, for example, with adverse tax consequences, while its competitors do not make such disclosures. (In this regard, perhaps the definition of corporate governance approaches the broader definition that involves being a good corporate citizen.) This obviously makes the investee company's task in the marketplace more difficult. But, in the long run, we believe this will not only raise the standards of the community or market we are in, but will also provide greater financial returns to us from the investee company.

We believe in this so strongly that we helped to establish the Asian Corporate Governance Association (ACGA)—a Hong Kong, China–based, not-for-profit organization launched in 1997 with support from business leaders from seven Asian economies—and we continue to provide ACGA financial support. This association helps persuade Asian companies that corporate governance makes good business sense; it disseminates materials, hosts seminars and conferences, and provides advice and assistance to Asian firms.

The Bottom Line: Does Corporate Governance Enhance Shareholder Value?

Does corporate governance enhance shareholder value? I answered this question in the affirmative at the outset of this presentation, and I

hope the few examples I have cited from Lombard's own experiences help to demonstrate why I did so. Let me also note evidence from the work of others, which supports the proposition that investors who take corporate governance seriously will be rewarded.

Between 1992 and 1995 CalPERS asked two financial consulting firms—Wilshire & Associates, and The Gordon Group, Inc.—to study the relationship between active shareholder-investor pursuit of corporate governance, and an improved bottom line.

Wilshire & Associates, which looked at investee companies at which CalPERS had been proactive in corporate governance issues, found that:

- The stock price of 42 companies targeted by CalPERS between 1987 and 1992 outperformed the Standard & Poor's 500 index by 41 percent. (Refinements of the study suggested the outperformance was actually closer to 53 percent.)
- In the five-year period before the active involvement by CalPERS these same companies had trailed the index by 66 percent.

The Gordon Group studied the issue of corporate governance more generally, and concluded that:

- "The overall evidence...shows that over the past several decades active investment strategies have consistently led, on average, to significant value increases."

An article by Philip Day in the May 1, 2001, edition of the *Wall Street Journal* described a recent survey of 495 emerging market companies, with the findings demonstrating a strong linkage between good corporate governance, earnings, and stock values.

Lombard's own experience with corporate governance has convinced us that good corporate governance, and a willingness of management and board to maintain or improve corporate governance, are fundamental requirements for any future investment we will make. This is not altruism. As a private equity firm we know we are ultimately judged and rewarded by the returns on our investments—that is, by the extent to which the enterprise value of our investments is enhanced.

A Call to Action

The importance of corporate governance—whether to the bottom line, or to the community—cannot be underestimated. It is both a meaningful issue for investors and shareholders, and one that is vital for the marketplace.

To ensure good corporate governance, shareholders must assert their rights to protect their interests, and board members must assert their independence from management.

For the rest of us, the following steps will help:

- Influential investors and lenders should actively pursue new corporate governance standards;
- Governments should be encouraged to adopt or promote corporate governance regulations; and
- Governments, investors, and lenders should support the adoption of uniform auditing and accounting standards and practices worldwide.

I know that international organizations such as IFC, and investors such as Lombard, will be willing agents for these changes, but I sincerely hope you will all join us in promoting the development of good corporate governance. It does enhance value—for all of us.

CHAPTER 13

Corporate Governance: Its Impact on Investment Flows

Peter C. Clapman
Senior Vice President and Chief Counsel, Investments, Teachers Insurance and Annuity Association–College Retirement Equities Fund

The primary hat I am wearing in my remarks about corporate governance is that of the Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF), probably the largest pension system in the world, with more than US$300 billion worth of assets. About two-thirds of those assets consist of equity securities, mainly in the public markets. Approximately 20 percent of these equity divestments are diversified abroad. As is true of any mutual fund, TIAA-CREF is judged on how it does in comparison with averages and with its competitors. After all, we are selling our products in a competitive marketplace.

For our organization good corporate governance refers to the manner in which shareholders, management, and the boards of directors relate to each other, in terms of their roles and responsibilities. In the U.S. context that means wanting a substantial majority of outside directors on boards, having boards that function in a true sense rather than those that just reflect the views of the chief executive officer of the company, and having key committees of the board (such as compensation, audit, and nominating committees) consist of entirely outside, independent directors who know how to do their job to the benefit of their shareholders. In the case of TIAA-CREF, which invests in some 5,000 companies worldwide, we are, of course, unable to be in the boardroom of our investee companies.

Instead, shareholders rely on the boards of directors to successfully manage these companies.

Culturally, corporate governance in our organization goes back about 30 years, although 10 years ago our program did not yet have a global context or global scope. At that time, the idea of working with different cultures that have quite different ways of looking at governance was a little daunting. We were not sure what a U.S. investor could do abroad, and how we could possibly get across messages that we think are important to investors in a way that would not be misrepresented locally. In other words, the question we faced was how to effectively maintain a corporate governance program abroad when we are acknowledged foreign investors.

A couple of significant events then took place that led us to examine the foreign markets more closely. First, we found in many instances, even in Western Europe, that controlling shareholders took advantage of disparate voting rights to effect unfair merger-and-tender offer situations to destroy outside shareholder value. Furthermore, local investors raised no opposition to this. The key question for us was, "Why did that happen? Why were other shareholders who were being disadvantaged the same way that we were not uttering a peep?"

We quickly learned that many countries of the world have been very slow in developing their own institutional investor constituency. The essential ingredient for us—namely, "a home-grown constituency" for corporate governance or for fair treatment—was missing. Until it was there, we were going to get nowhere. However, the landscape was changing, especially in Western Europe, because institutional investors were beginning to appreciate that to be a global investor, which very often was their ambition, they had to give credibility to the market. They had to show that within their countries they were enforcing shareholder rights, were interested in the same issues that concern any shareholders, and were willing to take a stand on those issues.

Second, as the company became more involved in the global scene, we began interacting with other organizations. For example, we began working with the International Finance Corporation (IFC) on a couple of major projects in emerging markets, and we became part of the International Corporate Governance Network, an organization of investors representing 26 countries around the globe. Corporate governance is now a leading issue for the members of this network.

The fact is that global investors such as TIAA-CREF are not *required* to invest anywhere in the world—and if they do not invest in a country or a company, there is no need to explain to anybody why they are not doing it. They just do not do it.

People are beginning to notice this, and to realize that corporate governance affects the flow of money into a country, the success of the companies in that country, and ultimately the success of the economy. As a result investors are now looking for explanations why poor investment occurred during a period when corporate governance principles were ignored. In effect, corporate governance is now being appreciated as having a definite nexus and connection with the entire investment process.

Another realization is that, while the World Bank and IFC are strong and important, in the long run it is private capital that will significantly affect the economies of different countries. But that private capital is not going to flow in until basic issues of corporate governance are understood and resolved.

Peter Sullivan, in chapter 12, reviewed many of the corporate governance issues that are important to his firm. Those concerns are very similar to our own. We believe, for example, in fair treatment of shareholders, meaning "one share, one vote." It is very hard to see how any culture can treat shareholders fairly unless there is one share, one vote.

We also believe that majority shareholders owe a fiduciary duty to minority shareholders. That is a fundamental principle in the United States, but it has yet to be adopted in most other places in the world. We also think there should be no barriers or restrictions to effective voting rights. Many parts of the world have such barriers. In addition, we strongly uphold the concept of accountability. It should be made crystal clear that directors are accountable to somebody. We think that they should be accountable to the shareholders; to some extent, they could also be accountable to other stakeholders.

An equally important issue concerns public governance. That is, a country may have its codes, but if its courts do not enforce those codes, if the regulators do not effectively regulate, and if there is a lack of credibility and fairness in the investing society as a whole—investors are going to find out. They may discover it after some hard knocks, but they will soon know it and will not invest there any longer, which is the key message that needs to be conveyed, especially to emerging market countries.

This is what we tried to do recently in Brazil, in collaboration with IFC. We brought together meetings of institutional investors, the head of

Brazil's Securities and Exchange Commission, and a number of companies with disparate voting rights, such that majority shareholders could take advantage of minority shareholders in takeover situations. At our meetings we noted that the country's economy is doing all right and direct private investment is coming in, yet public equity is going out. We made it clear that as long as there is unfair treatment of minority shareholders, and this kind of majority control situation is in effect, investors are just not going to come in.

What we found encouraging, however, was that a group of public officials attending the meetings understood these issues and saw that some way had to be found to modify their corporate culture to encourage investors to come in. These meetings have already had some important results. For one thing, a listing standard, known as the Novo Mercado, has been established. The Novo Mercado is based on some key corporate governance principles, including fair treatment and good accounting principles at a high level. To be listed on Brazil's stock exchange, a firm must now comply with these principles.

What Brazil is now doing is permitting its institutional investors to invest a higher percentage of their shares—again that nexus with the institutional investors of the home country—in companies listed on the Novo Mercado. How this system will eventually work is still uncertain, although it clearly has the backing of governmental officials. The uncertainty relates in part to cultural issues. By way of example, one corporate official in Brazil told a *Wall Street Journal* reporter that "dealing with shareholders is like inviting the maid to sit at dinner with you." Obviously, that kind of patronizing attitude has yet to be overcome.

The message of our presentations is a consistent one: corporate governance is not an abstract issue. It has great relevance for investors and their returns. Moreover, it has important implications for a country's economic success. Many countries that are suffering extreme poverty are unable to attract the long-term capital they need to get back on their feet, in part because of poor corporate governance. The burden rests with governmental officials to improve public governance practices and to meet the standards that investors demand. The corporate culture also needs to change. Whether it can do so remains to be seen. However, the enormous progress that has been made in just the past 10 years leads me to look ahead with optimism.

CHAPTER 14

The International Finance Corporation's Focus on Corporate Governance

Mike Lubrano
Senior Investment Officer, Financial Markets Advisory Department, International Finance Corporation

The International Finance Corporation's (IFC's) activities in the area of corporate governance dovetail nicely with the work done by the World Bank Group as a whole in this area. As an institutional investor IFC is deeply concerned about corporate governance for a number of reasons, prime among them portfolio risk. Obviously, investing in a company with weak corporate governance is a serious risk for IFC. Our experience with company failures has all too clearly shown that poor corporate governance can lead directly to poor corporate performance.

Even when a company's financial performance is not affected, other kinds of problems can arise. In a recent case in which we were involved, poor protection of minority shareholders enabled the controlling shareholders to delist the company, making us a low-ball bid to take us out. In a situation like this we either have to sacrifice all liquidity, or accept the low-ball bid and get out.

IFC is a direct practitioner in corporate governance in quite a few companies around the world. When IFC makes an equity investment it is not uncommon for us to negotiate for the right to nominate a member of the board of directors. We do not exercise this right in all cases, but where we do (in about 200 out of 300 companies where we have such a right) it

is mostly in bank and nonbank financial institutions. Obviously, we want the directors we nominate as well as the other directors to know what they are doing. We want them to contribute to their company's operations, and we want them to be aware of the liabilities implicit in what they do.

Another factor that concerns us is reputational risk. If a company has massively ripped off its shareholders or has a serious internal control problem, it will not go unnoticed in the press that IFC is an investor, if that is the case. Instead, we want the companies in which we have an interest to be in the newspapers as examples of international best practices.

Good corporate governance is not only an integral part of company success—it also has an important effect on the development of capital markets. There is an important role to be played by good companies in developing deeper and broader capital markets, and IFC wants to be part of that. On the capital markets side IFC has a long, and, I think, fairly glorious history of investing in the development of local financial markets institutions. We are a founder of the emerging markets committee of the International Organization of Securities Commissions, and the unit that I work for is more or less the successor to the IFC global capital markets department that was set up in the 1970s.

Let me present a brief inventory of seven areas in which IFC contributes to better corporate governance and related aspects.

1. One thing we have always done to some degree is to appraise and monitor the corporate governance of our investee companies. Our most recent activity here was to create a checklist, or scorecard, for IFC investment officers, to help them take a more organized and structured approach to assessing the governance of companies in which we invest. This checklist, which was developed by one of our regional departments, is now being "road-tested" in the field. It will probably need to be tailored individually to the regions and to the different types of investees: public companies, private or family-owned companies, and start-up joint ventures. The results of this testing will eventually have implications for our governance supervision methods and our cooperation with co-investors.

2. As already mentioned, IFC frequently nominates company directors. About a year ago we began a program with the U.S. National Association of Corporate Directors, offering training for individuals

in the specifics of director service and director performance. We are also providing IFC investment officers and other staff with more comprehensive training in corporate governance, to include some of the lessons, both good and bad, that we have learned in recent years. We are currently putting together a database tracking IFC's work with investee companies that has improved their corporate governance, and in turn their financial performance and market valuation.

3. We have compiled some specific case studies. One of these (prepared with a former IFC staffer, the Harvard Business School, and the Yale School of Management) concerns Yukos, an oil company in the Russian Federation that had a notoriously bad reputation for corporate governance, but that is trying to turn that reputation around.

4. We are planning a specific training course for IFC investees and other companies, to combine corporate governance monitoring work with human resource management in Latin America. The course is scheduled to take place in Rio de Janeiro in the fall of 2001, in collaboration with the Brazilian Institute of Corporate Governance and human resource experts at the Ford Motor Company and the United Nations Development Programme.

5. We have a series of grass-roots corporate governance projects that derived from the mass privatization programs that IFC supported in Eastern Europe. These are large projects aimed at turning newly privatized enterprises into functioning corporations by giving them charters; setting up their boards of directors; explaining how shareholder meetings are managed and how accounting works; developing university curricula for management, legal, accounting, and investor education; and providing technical assistance to regulators.

6. One well-publicized aspect of IFC's work in this area is in promoting portfolio investments that give due recognition to corporate governance issues. A case in point is the Brazilian Corporate Governance Fund (BCGF), which will be managed by Bradesco-Templeton. This is a public fund, not too large, that will invest in companies in Brazil that demonstrate good corporate governance. One of its missions is to identify companies that want to practice good corporate governance, help implement the changes necessary

for them to do so, and signal to the markets that such companies have improved their governance.

Brazil was an ideal place to start, because it is currently developing mechanisms to this end. One of these mechanisms is the Novo Mercado, which is a stock market listing segment for companies that agree to certain verifiable and objective criteria of good governance. In this way Brazil is encouraging companies to give markets better signals about what they are doing. Peter Clapman and the Private Sector Advisory Group (PSAG)[1] have contributed enormously to the development of market-sensitive mechanisms for this purpose. IFC will be investing in the BCGF, therefore, and we feel that the case studies and our other work in corporate governance will contribute to the success of this fund.

7. Finally, I should say a word about the technical work of my department in IFC. We have always been the central unit for technical assistance on securities market work, although our regional departments also perform such technical assistance. An integral part of the work is advice to member-countries' regulatory authorities and stock markets on improving corporate governance. One such project, in Chile, consisted of advising the authorities on tender offer legislation. We have also provided similar advice in Argentina and Brazil, and are currently working on corporate governance code projects in various countries in Africa.

IFC's work in the area of corporate governance can best be summed up in the words of Ira Millstein, chairman of PSAG:

> The task is to provide emerging and developing economies with insurance that capital is more likely to flow to those countries and companies that demonstrate responsiveness to corporate governance issues.

[1] The Organisation for Economic Co-operation and Development and the World Bank Group, along with some donor countries, has established the Global Corporate Governance Forum (www.gcgf.org) to coordinate their work in fostering better corporate governance in emerging markets. The Private Sector Advisory Group (PSAG) comprises business leaders and internationally recognized experts on corporate governance, who advise the Forum from a private sector perspective.

SECTION IV

The New Basel Capital Accord: Implications for Bank Lending to Emerging Markets

C H A P T E R 15

An Overview of the New Basel Capital Accord

Jonathan L. Fiechter
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In January 2001 the Basel Committee on Banking Supervision[1] (the Committee) issued a second consultative paper (CP-2) proposing major revisions to the original Basel Capital Accord that had been issued by the Committee in 1988. The goal of the 1988 Accord, a relatively straightforward capital framework, was to establish uniform minimum regulatory capital standards for large internationally active banks. The proposed 2001 revisions to the 1988 Accord are far-reaching, complex, and, in some areas, controversial. My presentation examines the January 2001 proposal from a regulatory perspective.

The 1988 Capital Accord was a crude attempt to introduce risk-based capital requirements that would apply to all internationally active banks in the G-10 countries (the 11 G-10 countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States). The 1988 Accord was intentionally kept simple, and was applied by U.S. regulators to all insured U.S. depository institutions. The 2001 proposed revisions to the 1988 Accord are intended to make the Capital Accord more risk sensitive; consequently they are much more complex. The proposed Accord seeks to establish a regulatory capital requirement that more closely mirrors bank managements' own internal analysis of how much capital is needed to operate the bank.

In applying the 1988 Accord the focus of bank management has been on compliance with the capital requirement. While the 1988 Accord imposes a capital requirement that banks are required to meet as a regulatory matter, most banks have established their own internal capital targets on a very different basis. To the extent that the 1988 Accord imposed capital charges against assets and activities that differ from banks' own internal assessments of the necessary capital banks have restructured their operations to minimize the regulatory capital requirement. For instance, the requirement under the 1988 Accord that 8 percent capital be held against all private sector corporate debt has led banks to move high-quality debt (against which the market requires far less capital) *off* their balance sheets while, at the same time, banks have retained low-quality debt *on* their balance sheets. The result is that the current Accord may encourage banks to hold a riskier portfolio of loans.

A major objective of the proposed revisions to the 1988 Accord is to narrow the gap between the levels of capital that regulators require a bank to hold, and what bank management itself believes is necessary. The challenge facing the Basel Committee in achieving this objective is to create a rule that is both sensitive to the many risks facing banks and that recognizes the significant institutional and national differences among internationally active banks and supervisory regimes within the G-10.

The proposal issued in January 2001 (the product of lengthy Basel Committee deliberations over the last several years) is a complex document that includes a draft rule of more than 170 pages, with 330 pages of accompanying annexes. Developing this new capital Accord has been a massive undertaking, and one that remains very much a "work in progress." A number of the components of the proposed capital rule are still being developed.

The proposed CP-2 revisions have four objectives:

1. *To maintain current capital levels in the banking system.* The intent of the revision is not to raise the overall level of capital held in the banking system, but rather to make the capital rule more risk sensitive.

2. *To make the Accord more equitable.* Banks with different amounts of risk should have capital requirements that reflect that risk. Because of the simplicity of the 1988 Accord banks with very different risk characteristics may face identical capital requirements. This puts

banks with low-risk balance sheets but high-capital requirements at a competitive disadvantage.

3. *To narrow the gap between regulatory capital requirements and what bank management believes is the appropriate capital level.* Regulators would thus limit the incentive for banks to restructure their portfolios simply for regulatory rather than for business purposes.

4. *To apply the principles of the new Accord to all banks in all countries rather than only to internationally active banks in the G-10.* We recognize that, given the complexity of CP-2, the proposed Accord is unlikely to be adopted over the near term by emerging market supervisors, however.

The proposed Accord has three parts, or "pillars" (see box 15.1). Pillar I, the key pillar, is a formulaic approach to determining how much capital a bank needs. Put simply, the first procedure consists of identifying various classes of assets or activities, applying a formula to the asset or activity to derive a capital charge on the basis of perceived risk of default, and then adding up all of the capital charges to develop an overall capital requirement.

Pillar II recognizes that the formulas and methodological framework under pillar I are crude and are unlikely to fully capture differences in the risk profile of banks. For instance, some areas of risk, such as interest-rate risk or liquidity are not captured under pillar I. Pillar II, therefore, sets forth the basis on which supervisors should assess the adequacy of the overall capital requirement computed under pillar I. In essence, it creates a framework under which experienced supervisors will assess the results of pillar I against the perceived riskiness of a bank, and will adjust the capital requirement accordingly.

Pillar III takes into account the complexity of bank operations and the limitations of any supervisory assessment of risk by seeking to encourage more informed market discipline—through the rating agencies, market analysts, and counterparties—by means of expanded bank disclosure requirements.

Under pillar I the capital requirement may be calculated in one of two ways: either under a standardized approach or an internal ratings–based (IRB) approach. The standardized approach expands the number of risk

Three Pillars

- **Pillar 1** (regulatory capital charge): Formulaic rules that establish minimum capital requirements. There are two approaches presented in the Accord.
- **Pillar 2** (supervisory review): Supervisors need to (a) ensure that bank's capital position is consistent with its risk profile and strategy and (b) approve use by banks of more advanced capital models.
- **Pillar 3** (market discipline): Expanded public disclosure by banks to facilitate market discipline.

Box 15.1 Three Pillars

"buckets" for which there are specific capital requirements. For instance, under the 1988 Accord a loan to a private corporation has a minimum 8 percent capital requirement, regardless of the riskiness of the corporation. By contrast, the proposed standardized approach differentiates between lower-risk and higher-risk corporations, and introduces four different risk buckets. If a bank lends to a AAA-rated corporation the capital requirement against that loan will be equivalent to a 2 percent capital charge compared with 8 percent for a loan to an unrated corporation. An effort has also been made in the proposed revisions to take into account techniques to reduce or mitigate the credit risk of loans with guarantees and high-quality liquid collateral. Under the proposed Accord a loan to an unrated corporation that is fully guaranteed by a strong company will have a capital charge equivalent to a loan to the strong company.

The IRB approach, which is for more sophisticated banks, relies on the internal credit–rating systems of the individual banks for determining the capital charge against an asset. If the bank can convince its supervisors that it has internal credit systems in place that accurately assess how much risk an individual borrower poses, based on an analysis of the probability of default (PD) and the expected loss given default (LGD) and exposure at default (EAD), then the bank may use its own internal risk assessment to set its capital requirement. The IRB has two approaches—the

Sovereign Risk Ratings

- **Key change is the move away from OECD membership as the key risk weight determinant to one based on external ratings**

Examples of Changes in Risk Weights on Sovereign Debt:

Country	Current Weight	S&P Rating*	Proposed Weight
Ecuador	100%	CCC+	150%
Hong Kong	100%	A+	20%
Mexico	0%	BB+	100%
Singapore	100%	AAA	0%

*Standard and Poor's sovereign rating for long-term foreign currency exposures as of May 18, 2001

Box 15.2 Sovereign Risk Ratings

Foundation approach for banks that can determine the probability of default of the borrower but will need to rely on supervisors for estimate of the likely loss in the event of default, and the Advanced approach for banks that can estimate PDs, LGDs, and EADs for their borrowers.

The proposed Accord has three primary implications for emerging markets. These pertain to the sovereign-risk ratings (see box 15.2), corporate-risk ratings (see box 15.3), and credit-risk mitigation. In the case of the sovereign-risk ratings, under the 1988 Accord the Basel Committee's approach to sovereign risk was quite simple. A country that is a member of the Organisation for Economic Co-operation and Development (OECD) was presumed to have a sensible and credible financial infrastructure, good corporate governance, and a stable government, and so received a zero risk rating—the government, by definition, was viewed as a strong credit. As a result, banks that lend to OECD governments do not have to hold capital against such loans.

Countries that earn high external-credit ratings, but are not members of the OECD, are understandably upset with this "club" rule. At the same time, not all OECD countries are in fact low credit risks. The Basel Committee is sympathetic to the criticism and has, therefore, proposed relying on external-credit ratings of individual countries as the basis for

Corporate Risk Ratings

- Standardized approach: Risk weights are tiered based on external ratings.
- Internal ratings-based approach (IRB): Based on:
  - probability of default (PD);
  - exposure at default (EAD); and
  - loss given default (LGD) for each exposure.

Box 15.3 Corporate Risk Ratings

assigning capital requirements. It has also taken into account the fact that not all countries will have external-credit ratings from one of the major credit-rating services, and so has proposed that the published ratings from export credit agencies may also be used to set capital risk weights.

Under the standardized approach the external-credit rating is the primary factor that determines how much capital is required. If a bank has graduated from the standardized approach and is following the more advanced IRB approach it can utilize its own internal credit-risk rating of the country. In such cases the amount of capital required against a sovereign loan will be a function of the bank's internal assessment. Banks can reference external ratings, but the ultimate capital charge will depend on the bank's own determination of the credit risk posed by the individual facility. In such cases the capital charge could fall below that suggested by an external rating.

The proposed Accord takes a similar approach toward loans to corporations. Under the standardized approach a bank looks at the external-credit rating of a corporation and uses this rating to determine its capital requirement against loans to that corporation. If the bank has qualified to use an IRB capital approach, the bank must assess the probability that the borrower will default, the recovery rate if there is a default, and the outstanding exposure at the time of default. To receive approval to use the IRB, banks must demonstrate to their supervisors, on the basis of several

years' data, that their systems accurately predict their actual loss experience on a portfolio of loans.

As mentioned earlier the Basel Committee has attempted to incorporate into its capital proposal risk mitigation from collateral and guarantees. It has established rules governing hedges when the maturity of the hedge is different from the underlying exposure or is in a different currency.

The Committee has been very cautious in its treatment of physical collateral and assets such as trade receivables. It is extremely difficult to estimate the value of such collateral over a full credit cycle; there is recognition that the proposed Accord is already quite complicated. Banks have argued that such collateral does, in fact, reduce credit risk, and that the Committee should give some capital recognition.

The Committee has been more open to incorporating the benefits of guarantees into risk weights. If a AAA-rated entity agrees to provide a guarantee against a loan to a lower-rated borrower, the lending bank can rely on the credit rating of the guarantor. For capital purposes the loan is assessed as though the bank lent to a AAA-rated borrower, and the credit rating of the guarantor is substituted for that of the borrower. Whether or not such a guarantee is treated as a full substitution will depend on the identity of the AAA-rated guarantor. Guarantees from government entities and banks are given more weight than guarantees from other entities, such as insurance companies.

The proposed Accord does not make any allowance at this stage for the fact that, for the lending bank to lose money, both the guarantor and the borrowing entity would have to default. For example, a bank that lends to a AAA-rated borrower, which is also guaranteed by an AAA-rated insurance company, receives no capital relief from the addition of the guarantee.

Preliminary reactions to the January 2001 proposal have been mixed. Early indications are that, in general, banks support the overall framework and direction and like the idea of regulatory capital requirements being more in line with banks' own internal calculation of required capital. At the same time, banks have raised a number of issues.

One concern is that the IRB approach is quite complex, and will be very expensive to implement, yet the potential capital relief under the IRB approach (compared with the present capital Accord) is modest at best. The Committee had intended that there be a capital incentive, other things being equal, for banks to move from the simpler standardized

approach to the more complex IRB approach. Banks, however, have reported that the proposal does not provide such an incentive. Rather, banks have found that they need less capital under the simple standardized approach than under the more advanced IRB approach. This is a flaw in the proposal. The Committee is reviewing the calibration of the capital charges under the proposed Accord to correct this irregularity.

Another concern is the treatment of operational risk in the bank. In establishing the capital requirement under pillar I the Committee has included credit, market, and operational risk. While some banks may have very high-quality assets in terms of credit risk, there are risks arising from inadequate or failed internal processes, people, and systems that need to be taken into account in setting overall bank capital requirements. As a result the Committee included a crude operational risk component that covers fraud and losses from weak internal controls as part of its overall capital requirement. This component has generated significant comment from the industry. Banks argue that the operational risk weight generates a significantly higher capital charge than what banks internally allocate; that the proposed methodology for determining operational risk (which uses gross profit as a proxy for the level of operational risk) is unrelated to the actual risk in the bank; that for low-frequency, high-loss events, capital is not the answer; and that there is no capital incentive for a bank to reduce its operational risk.

A more general concern of banks is that the January 2001 proposal was incomplete. Notwithstanding its length, a number of details on items such as the treatment of retail credit, asset securitization, project finance, and the treatment of equities are still being worked out. As a result banks have been unable to calculate the effect of the proposed rule on their regulatory capital requirements. Banks have urged the Committee to reissue the full draft Accord for comment, taking into account industry comments received on the January 2001 proposal, including a recalibration of the capital weights to avoid sharp spikes in required capital. This request is sensible.

In closing, I would like to emphasize that the Committee is eager to work with interested parties on the many issues raised by the draft Accord. We need to understand the consequences of the proposal for the banking industry. Even though the official comment period ended May 31, 2001, suggestions and information on the practical application and implica-

tions of the proposal are welcome. It is only through open and candid industry dialogue that the Committee will be able to develop a sensible and practical rule.

[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank governors of the G-10 countries in 1975.

CHAPTER 16

Country Risk in Basel 2

Frans Cornelissen
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ABN AMRO Bank

As most would agree, the 1988 Capital Accord had some shortcomings. For one thing, it was too crude in the way it analyzed corporate credit risk. For another, it was not too fair in treating AAA-rated companies; it did not treat them the same way that it treated emerging-market companies. All it did about country risk was to make a distinction between Organisation for Economic Co-operation and Development (OECD) countries and non-OECD countries, which, of course, was too simple. It failed to take into account collateral and credit derivatives in the right way, and operational risk was not in there at all. Even capital arbitrage was going on.

The purpose of the proposed Accord is to address these problems. Hence banks were asked to make comments on drafts of the new Accord. The first round of comments ended in mid-2000, and the second round ended on May 31, 2001. As Jonathan Fiechter pointed out in chapter 15, however, banks still have an opportunity to submit their suggestions.

In the first round of comments a special group—the Working Group on Country Risk—was organized by the Institute of International Finance (IIF). One of the Working Group's major concerns was that the Accord had capped the rating of the private sector entities by the rating of the sovereign. The Group's paper argued that capital controls are becoming more rare, and

that even in cases of capital controls or sovereign default certain companies performed. In the second draft of the Capital Accord the cap was removed.

The IIF Working Group on Country Risk also stated that a distinction should be made between sovereign risk and country risk. Furthermore, it looked at how different banks were actually treating country risk. This is where the risk issue becomes more complex, because the banks seem to have different methodologies. Some banks took country risk implicitly into account since the rating of obligors included factors such as inflation and the legal environment. Others have a special country risk-rating system that affects the obligor rating, sometimes as an explicit add-on to the credit risk. The second draft of the Capital Accord has been trying to address country risk in such a way that it leaves ample room for the banks to determine exactly how country risk should be incorporated, especially in the internal ratings–based (IRB) approach.

In my view, the Capital Accord should not explicitly require an add-on for country risk, in addition to the credit risk. This would not take into account those banks having credit risk models that take country-risk factors more implicitly into account.

In the second round of consultations a new issue came up: how to deal with foreign currency as opposed to local currency. The Capital Accord states that, in the case of foreign currency–lending, the risk that the foreign currency might not come back because of capital controls (transfer risk) should be included in the obligor rating. The banks discussed this subject at length.

In the case of a sovereign, the statistics provide clear evidence that there is quite a difference between the local currency claims on the sovereign and the foreign currency claims. A sovereign can print local currency and cannot print foreign currency, so clearly the distinction must be made. The Capital Accord, although not too explicitly, is allowing room to do just that. In the standardized approach, one can even put a zero-risk weight for local currency financing to sovereigns.

In the case of corporates, however, the issue is a little more difficult to address. Of course, intuitively it is very clear that foreign-currency lending is more risky. The question is, why? Is it more risky because, if a company is borrowing in foreign currency while it has a local currency income, there is a currency mismatch? But that type of risk is not uncommon in the developed world as well as in the developing countries. For

example, if a U.S. company is going to borrow in euros and does not have revenues in euros, it will also have risks. This type of risk, the currency mismatch, has to be kept separate from the transfer risk. If the transfer risk, the risk on the foreign currency flows from emerging markets, is relevant and we want to make the distinction between foreign currency flows and local currency flows, the banks are not against that. However, one has to be able to prove it for five years. In other words, one has to show that the companies have been defaulting on foreign currency loans and not on local currency loans, which might not be that easy. It will be interesting to see how this issue will be treated in the final Capital Accord.

As for the Accord's qualitative impact on banks, it is clearly promoting better risk management. Much effort will have to be put into building new risk systems, especially for emerging-market banks. At the same time, one cannot be too ambitious here or one might end up with a risk system that incurs too many costs. It is also clear that the quantitative impact will be that higher risk credits will need more capital. That is rather bad news for emerging markets because more capital is needed for lending to these markets.

One feature of the new Capital Accord that will benefit some non-OECD sovereigns is the removal of the distinction between OECD and non-OECD countries. Some OECD sovereigns will lose from that. The same is true for some banks in OECD countries.

Especially in relation to lending to emerging markets the Accord is not very transparent. This is because banks are expected to use different approaches for calculating the capital for lending to emerging markets. Emerging-market banks will go for the standardized approach, but international banks are likely to go for the IRB approach, which will give different results on the same risk. With regard to the financing of sovereigns and banks for periods of less than three months, there is also the possibility that the emerging-market supervisors, since they have some authority there, can set the risk rate for the local currency financing. This again could lead to different capital requirements on this risk for different banks.

Another major concern is that volatility on lending to emerging markets could increase at times, especially in an emerging market crisis. If the ratings are lowered, then you need more capital, of course—so things could work out to be procyclical.

In trying to predict the outcome for the standardized approach as opposed to the IRB approach, it looks as though the latter will require

more capital for lending to emerging markets. Banks will need higher margins for the lower-rated companies to make up for the higher required capital. In other words, margins for lending to emerging markets will need to go up.

In the case of the B-loan, capital requirements and the value of the preferred creditor status will depend on how the final Capital Accord handles the distinction between foreign-currency lending and local-currency lending.

CHAPTER 17

Basel 2 and Emerging Markets

Ernest Napier
Managing Director, Financial Services Group, Standard & Poor's

As the preceding presentations have made clear, the proposed new Basel Accord is an ambitious blueprint aimed at strengthening the banking system on a global scale. My remarks focus on three aspects of the Accord of particular interest to Standard & Poor's (S&P): the setting of regulatory capital limits, the implications for emerging market financial institutions, and the possible treatment of the International Finance Corporation's (IFC's) B-Loan ("Participations") Program under the proposed changes.

To start, I should say that S&P continues to support the Basel Committee's efforts to strengthen banking regulation around the world. We think that much progress has been made in the second consultative paper in terms of the three pillars: capital requirements, improved supervisory oversight, and the effective use of market discipline. At the same time, as one of my colleagues has pointed out to me, this Accord is a journey and not a destination. Perhaps some day we will arrive.

The cornerstone of the new proposal is its two suggested options for improving the risk adjustment process for calculating minimum levels of regulatory capital: the standardized approach and the internal ratings–based (IRB) approach. S&P finds pros and cons associated with each of these options. In its view, the major drawback of the standardized approach is not enough differentiation among the various types of risk. Whether a bank is AAA-rated, BBB-rated, or so on, the amount of capital

that it is required to put away does not vary as much as we would perhaps like. Looking at the two options under this approach—to tie the rating of banks and other entities to the sovereign, or to assess banks individually—S&P considers the first option to be the weaker of the two. By lumping the good players with the bad players it does not give enough credit for the better-quality banks out there. S&P would see that as a limitation, and therefore finds the second option a much fairer approach.

If we had to tip the scales one way or the other, S&P would probably favor the IRB approach, mainly because it allows one to put more capital away, depending on the risks involved. In other words, the IRB approach does not try to use a one-size-fits-all treatment. It allows greater credit differentiation, which we feel is a good thing.

Where the IRB approach falls short, however, is that it might not go far enough in suggesting how much capital banks need. Its probabilities-of-default scenario could lead to some questionable conclusions. For example, just using a three-year average would not necessarily pick up what would happen to a bank in a worst-case recession environment. One has only to look at what has been going on in most mature markets over the past five years, which have been a relatively benign environment. If banks were required only to put away capital based on default statistics for the past three years, that would greatly underestimate the amount of capital that banks would need if things were to take a turn for the worse. Thus one of our major complaints with the IRB approach is that it does not allocate capital based on an economic cycle.

Table 17.1 shows how things can change depending on the time period. In this example, average probabilities of default for a three-year period rose dramatically, from about 1.6 to15 times the average level, depending on the rating during this broad period. As the statistics confirm, the longer the time period used, especially for the worst period within the cycle, the better the model in terms of assessing how much capital is needed. Despite its minuses, however, the IRB approach is basically superior to the standardized method.

The second point I want to address arises from the oft-heard criticism that emerging markets may end up getting the worse of both worlds under the new Accord, and ultimately this may cause the initiative to fail entirely. Any regime that imposes higher capital allocations based on borrower quality, so the argument goes, definitely works against emerging-

Default Rates For Static Pools 1981-2000

	CCC	B	BB	BBB	A	AA	AAA
1 year Average Rate	21.94	8 3	94	22	.05	00	00
3 Year Average Rate	34 37	21 00	4 62	0.74	0.17	0.00	0 03
Cumulative							
Minimum (3 yr)	6.67	8 24	1.22	0.00	0 00	0 00	0.00
Maximum (3yr)	58 33	24.38	14 18	2.99	1 15	0 86	0 45

Table 17.1 Default Rates for Static Pools 1981–2000

market banks, owing to both the composition of their loan portfolios and the environments in which they work. In addition, most emerging-market banks lack the empirical data on default incidents, default correlations, rating transitions, and recovery rates in order to legitimately qualify for the IRB approach. Furthermore, the IRB approach is very expensive, even prohibitive for some of the emerging-market banks. Hence the IRB approach may not be to their advantage.

The question is, what can these banks do about this situation? Since most emerging-market banks will be using the standardized approach, there are actually a few ways to "level the playing field." For one thing, they can go shopping for external credit assessments that will give them the most favorable capital charge. Under the standardized approach, claims are broken down into three categories: claims on sovereigns, claims on banks, and claims on corporates (see table 17.2). If a sovereign is rated below B–, or if a bank is rated below BBB–, or a corporate is rated below BB–, it may be in the best overall interest of the bank to request that this customer not get a rating, because reverting to the unrated status would invite a more favorable treatment. Any system that promotes this type of distortion, and therefore is not promoting market transparency, is flawed and could eventually backfire.

S&P also believes there would be political pressure on regulators to allow banks in their country to use rating agencies that might give them

Standardized Approach

Claim on Sovereigns

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	20%	50%	100%	100%	150%	100%

Claim on Banks

Credit Assessment Of Banks	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Riskweights under Option 2	20%	50%	50%	100%	150%	50%
Riskweights for Short-term claims	20%	20%	20%	50%	150%	20%

Claim on Corporates

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk Weights	20%	50%	100%	150%	100%

Table 17.2 Claim on Sovereigns, Banks, and Corporates

the most favorable results. That would also be a distortion. In S&P's view this Accord could have an adverse impact on emerging market banks and this could ultimately unravel the whole scheme.

The treatment of B-loans raises further concerns. S&P has felt there is some value to preferred creditor status. Indeed, there is probably enough evidence now to suggest that lenders such as IFC do get preferential treatment, and therefore are only subject to the underlying credit risk of the borrowers to which they lend. As a result, banks participating in the B-loans get the same sort of currency protection that IFC does, and they, too, only have to worry about the underlying credit risk. Therefore a strong argument can be made that the capital charge should be less, given the fact that this eliminates the transfer risk.

Despite some limitations, which we hope will be worked out before 2004, the Basel Capital Accord is definitely a step in the right direction for global banking. According to S&P's estimates, about 40 percent of the largest international banks in Australia, Europe, and North America will probably be eligible to use the IRB approach from the very outset. We feel confident that this proposal will not cause an overall decline in capital.

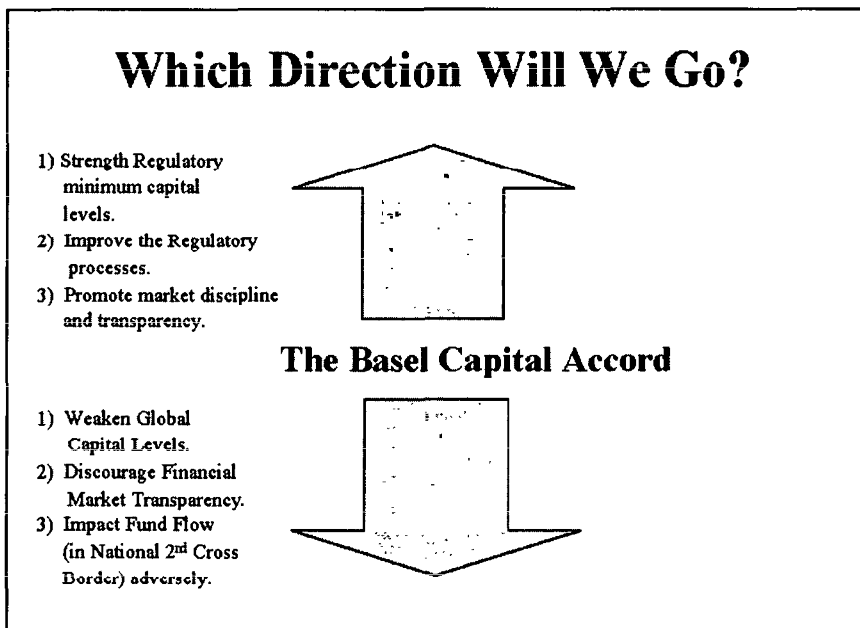

Table 17.3 Which Direction Will We Go?

What the internal economic models of most banks today suggest is that banks feel as if they are overcapitalized. I am sure that the bulk of the studies on the IRB approach will confirm this. If that is the case it could lead to a reduction in capital. S&P does not believe that most banks around the world are overcapitalized. Rather, S&P believes that they are adequately capitalized for the risks they are taking. If capital goes down but the risk profiles of those institutions stay the same, it could result in rating downgrades (see table 17.3).

A global rating distribution of banks for the last decade already shows quite a dramatic change. When I first started working in this industry, banking was a AA-rated industry. Right now, it is probably a single-A industry at best. Any system that would create ways for banks to weaken their capital without mitigating their risk profiles would be very negative. Perhaps in the end there is nothing for any of us to worry about, but then again that is what a rating agency is paid to do: to worry even when there is nothing to worry about.

CHAPTER 18

Basel 2: Possible Impact on the International Finance Corporation's B-Loan Program

Dirk Müller
Partner, Financial Services Consulting, Risk Management, KPMG

The central question I wish to explore is how Basel 2 will affect the International Finance Corporation's (IFC's) B-loan program. In the context of emerging markets, one leading concern will be country risk. As mentioned by other speakers, the Basel Accord gives little guidance on how to treat country risk. Therefore there has been considerable discussion in the banking industry about how to deal with this risk under the proposed new ruling.

A second important issue for the B-loan program is project finance. Here, too, the Basel Accord is not very specific, although alternative approaches are now being discussed, and further details may be forthcoming in the weeks to come.

A third concern for the B-loan program is whether preferred creditor status (PCS) will be available under the new Accord and thus whether B-loan participants can have access to PCS benefits.

Fourth, which approach—the standardized or internal ratings–based (IRB) approach—will most of IFC's B-loan participants go for? That will make a significant difference to the risk rate. Under the standardized approach the risk rate would be a maximum of 150 percent, whereas under the IRB approach it could reach 625 percent for loan business with a higher probability of default.

From an emerging-market business point of view, then, there is no incentive at all to go for the sophisticated IRB approach. In fact, there may be no choice in the matter at all. In Germany, at any rate, it looks as though our regulators will ask all the internationally active banks to go directly for the IRB approach by 2004, so there is no other choice there. Banks using internal creditor models to allocate economic capital might already be allocating similar amounts of economic capital, so there would not be a significant change if one compared economic and regulatory capital.

The question banks should therefore be asking is: How can those that decide to go for the IRB approach benefit from the B-loan program? As I just mentioned, the PCS has not yet been made part of the risk mitigation under Basel 2. One could argue that PCS, because of its political overtones, helps reduce country risk, by which I mean transfer and convertibility risk but not the borrower's risk. As everyone knows, rating agencies such as Standard & Poor's acknowledge PCS in some cases through an improved foreign currency rating. Thus it might make sense to pursue the IRB approach simply to implement PCS as part of the rating process of the IRB. This could be a possible solution even if Basel 2 does not mention PCS explicitly, for it would then be possible to benefit from this model.

To illustrate, let us look at the IRB approach a little more closely, as regards the key factor of probability of default. I believe that PCS can have an impact on the probability of default when it comes to distinguishing between the foreign-currency rating and the local-currency rating. This status could be built into the rating analysis and thus would be similar to what the external rating agencies are doing now.

Of course, one cannot simply assume that PCS always reduces the probability of default and therefore the risk. As with all other risk factors under the IRB approach, one has to prove that the historical default data comply with the ratings, for example by means of statistical tests such as back-testing.

Basel 2 has imposed a number of conditions that have to be met before internal rating systems for the IRB approach can be approved by the regulators. For instance, there has to be a five-year history of the probability of default. The history must be available by 2004. Also by 2004, the rating system must already have been in use for at least three years. Although the accord permits banks to have a transition period up to 2007, these

requirements will probably delay everything, not only in making PCS part of the rating system but also in winning general approval for the rating system.

There are other requirements, of course, but they are more qualitative in that the rating process must be transparent and independent. But there is some incentive to follow through with this. By way of example, suppose that a company has a local currency rating of BBB and a solvent foreign-currency rating of BB. Suppose, too, that PCS improves the company's foreign-currency rating and brings it to the same level as a local-currency rating. This would mean that the foreign-currency rating for the company would be BB without PCS, and BBB with PCS.

We can now look at the probability of defaults, based on statistical data from Moody's. The likelihood of default would be 1.79 percent for BB and 0.16 percent for BBB+. That is to say, if one takes this example as a given, then under the standardized approach PCS would make no difference, because having a BBB or BB rating would both lead to a risk rate of 100 percent for the corporate model. However, under the IRB approach there would be a significant difference. Without PCS the company with the BB foreign-currency rating would have a risk rate of about 180 percent. With PCS, it would have a risk rate of 40 percent. This is a very simple example, of course, but it shows what can be done under the IRB approach.

To sum up, there seems to be little doubt that the new Basel Accord will lead to a significant increase in regulatory capital for lending to emerging markets, especially under the IRB approach. When one compares economic and regulatory capital, it looks as though banks with sophisticated internal creditor models that are already allocating economic capital will not necessarily face a significant change in capital. Furthermore, the B-loan program, with its proven PCS, should reduce controversy significantly under this new Capital Accord. A way to have the benefits here would be to implement PCS as part of the internal rating process. To achieve this, though, banks would have to meet certain requirements.

SECTION V

The Business of Project Financing

CHAPTER 19

Dealing with Portfolio Problems: Two Cases
Part (a): A. O. Volga, Russian Federation

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Jyrki I. Koskelo—Director, Special Operations, International Finance Corporation

Many important lessons can be gleaned from problem projects. This presentation deals with one such project, undertaken for a paper manufacturer in Nizhny Novgorod, in the Russian Federation. Let me first explain the International Finance Corporation's (IFC's) general approach to such problems.

Problem projects such as A. O. Volga are handled by our Special Operations Unit (SOU). SOU is a relatively small unit staffed by about 20 highly specialized, highly experienced individuals. It has three field offices: one in Jakarta, one in Bangkok, and one in Prague. Essentially, it operates

in areas where IFC has significant problems. The way it gets involved in a project is a transparent process relating to internal credit ratings.

Once an IFC project deteriorates beyond a certain rating threshold the relevant investment department turns to SOU for advice. In the past year the unit has made considerable progress in learning to tackle problems in their early stages, which is a cost-effective approach. In addition, IFC has been trying to become more proactive and has initiated a "SWAT"-team review process to improve our position in areas (countries or industrial sectors) where crises are expected to develop soon. SOU is now less isolated from the rest of IFC, and much more team-oriented, than it used to be. There is excellent teamwork between the unit and IFC's Syndications and Legal departments. Our most pronounced successes to date have occurred where a small group of highly experienced people from different parts of IFC has focused on a problem project.

Our perception is that the only area where SOU's recovery strategy tends to differ from that of our participant banks is in trying to maximize ultimate return. SOU's time horizon tends to be longer than that of a commercial bank, which means that we are seldom anxious to sell and get out quickly. Where a commercial bank might try to sell a problem loan at 50 to 80 cents on the dollar and close the file, SOU will keep working and waiting for the chance to get 90 or 100 cents back. As the A. O. Volga case illustrates, to achieve this goal the unit will go from good times to bad times, and back to good times again, in a single project—a process where patience, persistence, and continued trust in one's own assessment of the value of the asset or loan are needed.

Charles Van der Mandele—Chief Special Operations Officer, International Finance Corporation

To explain the A. O. Volga project, I am going to call it "High Noon in the Wild East," and treat it as a dramatic play in six acts. It starts with a prologue, which provides the setting: democracy in the former Soviet Union, and the creation of the Russian Federation.

In Act 1 the Russian Federation enacts economic reforms, which are well received, and introduces privatization. A particularly important development at this point is the increased domestic demand for all consumer goods, particularly for information, and therefore for news from the mass media.

A special feature of this drama is the dynamic local government in the province of Nizhny Novgorod, which was very anxious to show its reformist credentials. Boris Nemtsov, the reform-minded governor at the time, and other prominent people from that region promoted a very aggressive privatization of assets in the province.

The A. O. Volga project was sponsored by a well-known German paper trading company, which had built up a significant equity position in A. O. Volga, largely to reinforce its trading relationship with it. This prominent German company helped bring several large German banks into the project, and they subsequently joined IFC as participants in the B-loan. The project's objectives were to upgrade A. O. Volga's existing papermaking facilities, improve the quality of its products, increase production, improve environmental controls (which were, at that time, dismal), and provide highly needed working capital.

In further support of the loan, IFC made an equity investment of US$11 million, initially for 25 percent of the company. Hence all the elements were in place for a US$75 million loan for a US$150 million project that was expected to be profitable and have a major demonstration effect in the new Russia.

Act 2, therefore, opens with total euphoria. The loan was approved in February 1995 and committed by May 1995. The loan was well secured against the fixed assets of the company. There was a very complex escrow account that made everybody happy. The shares of the company were pledged to IFC. Most important, the foreign sponsors' shares in the holding company were also pledged to IFC, because there was, for tax and other reasons, a holding company above it. It looked as though nothing could go wrong in the first year. We had record net selling prices, low production costs, and record production and sales volumes, primarily for export, which was of course a good thing. We also had highly favorable exchange rates between the U.S. dollar, the Deutsche mark, and the Russian ruble. The debt service, consequently, was highly regular. The German sponsor company was able to pay itself high management and marketing fees. By the end of 1995 everybody was happy.

However, Act 3 then brings despair. In 1996 and 1997 the company was adversely affected by a sharp price decline in world paper markets, a result of reduced demand overseas. The scenario changed. The Internet was beginning to make inroads into Russian society. Domestically, people

were reading newspapers less and less, and therefore local demand for newsprint was falling. Meanwhile, large paper companies were adding capacity. As a result of all this, A. O. Volga's ex-works price declined by 33 percent. That was a big drop that was never recovered. The dramatic downward trend in newsprint prices caused volumes to decline, because nonprofitable production capacity had to be curtailed. With prices down by 33 percent, production volume went down, and sales volume dropped by 50 percent. To make matters even worse, there was also a project cost overrun of US$20 million, or about 15 percent.

The German sponsor then had to look with some desperation for additional capital, which it finally found in the form of an equity investment of US$40 million by a private U.S. investment company. Six weeks later the new investor had to be told that its money was gone! Fortunately, the company was able to keep IFC and the B-loan participants reasonably happy, because it had built up an escrow account providing a source for some payments and, at least during 1996, a loan default was not yet contemplated.

The local tax authority then suddenly decided to freeze local bank accounts, claiming that the company was in default. At that point things really started going bad. The German sponsor all but backed out, leaving some production going, and appointed a local successor management. By the end of 1997 the company was in formal default. Local management, using paper clips, Scotch tape, and a few other things, tried to keep things together, but the biggest problem was the lack of working capital, which forced the company to reduce capacity further. They begged us to release some of the escrow account. Given the tremendous uncertainties, though, the B-loan participants and IFC remained firm on not releasing those funds, and thus indirectly contributed to the general despair.

During this period the company and its main sponsor continued their efforts to identify a new foreign strategic investor. By then, IFC's SOU had become involved. We had to travel to several places in Scandinavia and elsewhere to see if we could find a company that could provide new management, marketing support, and, above all, working capital.

The problem at that stage was that the market continued to be very weak and people were very concerned about Russia and where the country itself was going. Now that the foreign sponsor had deserted it, the company could no longer support the financial consequences of its obligations. It was, itself, a publicly traded company. Then management tried

to cobble together a transaction with the local provincial governor, who was very anxious to prevent a total collapse of the company and project, especially since A. O. Volga was a major local employer.

The governor promised to make some funds available, with which the company would then make us a prepayment. We were even talking about some discount at that stage. It is a measure of the despair that even the governor backed out of that deal at the 11th hour, and we had to start from scratch again, which meant IFC had to foreclose on its escrow account. We lost a little leverage, then, because, with the company already down, we had no more favors to grant, and therefore the shareholders and management no longer considered us an interesting party to talk to.

This marks the beginning of Act 4, titled "Restructure." IFC continued to try to recover the money bit by bit, through a continuing dialogue, indicating that it was in the company's interest to keep us as a good friend. We were, after all, trying to help it. Little by little, the company began paying us, and sharing part of its excess cash flow with us. In retrospect, the most important element in our security package proved to be the pledge of the shares to us. That allowed us to tell the shareholders, and the management, that if they did not cooperate with us we might in the end have to take over the company, and that we would not hesitate to do so if we found that it was not acting in good faith.

Paper markets remained weak, however, and prices never fully recovered. One positive development was that A. O. Volga's new management, which at that time consisted of a mixture of Russians and some foreign people, succeeded against all the odds and without working funds to lower their production prices and also to lower their selling prices for volume orders. Because they succeeded in selling larger volumes, rebuilding production volume, and lowering cost, they started operating at about cash flow breakeven.

This was very important when, in 1998, the ruble collapsed, changing the economics of the company totally. The bulk of its costs were in rubles, but revenues were largely in Deutsche marks and U.S. dollars, which obviously became worth much more with the collapse of the ruble. Suddenly, the company was making serious cash. This opened the way for discussions on the restructuring of the debt. An important development in the meantime was that the shareholders were taking a greater interest in the company, and were becoming involved in corporate governance. In other words, we were no longer relying on discussions with management alone.

Serious negotiations began in mid-1999. It took awhile to finally arrive at a restructuring agreement, after one of the shareholders offered a small amount of desperately needed cash for a significant shareholding. That opened the door to a restructuring agreement, which was signed on September 1, 2000. As far as we were concerned, we had a decent restructuring agreement in place. The company was delivering good cash flows again, and by the fourth month into the restructuring we were again being serviced properly and adequately.

Act 5 then brought opportunity. Almost immediately after the restructuring agreement was signed IFC was approached by a not unknown Russian conglomerate. IFC got in touch with A. O. Volga's management, which began talking about a leveraged buyout. The conglomerate offered to purchase IFC's loan at a discount, which was very tempting at that time. We had just come out of a long struggle. But when we discussed it with the B-loan participants we all agreed that we were quite comfortable with the new situation, and there was no need for us to take any discount whatever. We would be quite happy to tie our fate to that of the company for the next four to five years, as had been foreseen. The first conglomerate accepted that and said it might come back, but in the meantime it wanted to become a majority shareholder, by buying out the other shareholders.

The conglomerate approached the U.S. private investor that had lost all of its equity during the period of despair (Act 3), and made a bid for those shares. Then a bidding war suddenly erupted, when a second Russian conglomerate entered the picture and started bidding, first for the U.S investor's shares and then for the other shares, including those owned by IFC. At that stage, IFC made it clear that we would not deal in our shares until our loan, and our responsibilities to the B-loan participants, had been addressed.

From its first discussions, IFC concluded that the other stakeholders, including the shareholders, were not very happy with the second conglomerate, whose offer could become hostile and therefore detrimental to IFC's position as a lender, so it started preparing defensive action with the pledge of shares as its principal weapon. By that time IFC had also made it clear to the first conglomerate that, if necessary, it would foreclose on the shares pledged to it. If IFC subsequently also exercised its preemptive rights, it would have gained majority control and would effectively have become the owner of the company.

Act 6 (High Noon) occurred when, in a dramatic week in February 2001 people began arriving from all parts of the world to talk to us. IFC succeeded in attracting offers for its loan, which had previously been quoted at perhaps 40, 50, and 60 percent, then gradually went up to 80 percent and 90 percent. At one stage, we even got an offer for 120 percent of our loan—the face value plus interest. This came from the second conglomerate, which had finally been persuaded that IFC was holding the trump card in the form of the pledge of shares. Notwithstanding the higher offer, IFC, supported by the B-loan participants, accepted the slightly lower offer from the first conglomerate.

First, the offer was better substantiated. It was friendly—in other words, it enjoyed the support of all the stakeholders. There was a strong likelihood, of which we were aware, that the first conglomerate would align with the sponsor and simply prepay the IFC loan. Even after we accepted the offer, however, the second conglomerate cried foul and demanded an auction. Given the risk of negative publicity, IFC reluctantly agreed, which caused a minor delay in concluding the transaction. Then came the happy ending, though, as had already been anticipated by IFC. The first conglomerate bought out the foreign sponsor and then used the latter's right to prepay the IFC loan in full, including all interest, penalties, and costs.

This experience yields a number of important lessons. First, we made sure that the workout was co-owned by the B-loan participants through the dissemination of regular and detailed information. Second, we had a good idea of the value of the loan and could resist efforts to sell it below intrinsic value. Third, IFC had a strategy. It knew what it wanted, but it was flexible. We were able to keep an eye open for opportunities as they arose. Fourth, together with our lawyers, we knew the agreements inside out, and through intimate contacts with all parties had a solid grasp of what made the company and the stakeholders tick. That made negotiations a lot easier. And fifth, throughout the process, IFC was transparent, was seen to be honest about its position and its objectives, and was therefore credible when it counted.

Anke Avderung—Director, Global Debt Origination,
Dresdner Klienwort Wasserstein

The largest lender in the A. O. Volga transaction was Dresdner Bank. It was also the agent for the security accounts, and therefore had to struggle

with all the minor administrative details; it was closely involved in all aspects of the transaction. Many have asked what it was like to work with IFC. I think the main point to mention is that in difficult situations such as this, or in any workout situation, it is essential to agree on a common set of goals. This rule holds true for any banking consortium, but even more in a consortium where IFC is in the lead. As mentioned at the beginning of this presentation, IFC may have a slightly different attitude toward timing, toward staying in the deals, and taking a more long-term view on action, compared with commercial banks. In the A. O. Volga transaction it was essential to put the project quickly back on a solid basis and to try to get the money back, too. It was equally important to see what we could do over the long run.

The second important point, especially in relation to B-loan structures, is the possibility of a conflict of interest. That means that IFC—in its double position as lender and shareholder—might have different attitudes from its two positions. In this particular project, and I think in all workout situations, IFC decided to act first and foremost as a lender, which makes it important to have a common understanding with the banks and a joint approach in this regard. In fact, IFC's shareholding in the project was a key factor to its eventual success, but during the workout period it was important to focus on IFC in its lending position.

Coordination and consultation were equally important, especially in a banking consortium such as ours, with five commercial banks plus IFC. Coordination could be a problem. Consultation processes can be lengthy and very difficult. This was a problem we had to overcome, and in the end I think we succeeded in doing so. We also had to recognize that circumstances can change very quickly, especially in the Russian environment. The consortium had to react to several proposals quickly, something that was a very demanding task for us as participants and was true for all the banks in the consortium with us. But I think we managed to respond quickly and to give IFC the support it needed to continue negotiations with the client in this particularly difficult situation.

Cash-flow modeling was another of Dresdner's central competencies and certainly one of the things we always focus on. In this particular case, of course, it was very difficult to keep track of the cash-flow model with changing circumstances, new offers, and extremely volatile paper market. This was a challenge to IFC and to us, but in the end we managed to do so.

The most important point in this transaction was to get the basics done and leave the cash flow modeling as a complementary aspect of the deal. Communication received special attention because this is the most important aspect of a banking consortium: as banks, we are always in negotiations. We had a very good experience with the IFC team in this regard. Communication among the banks and with IFC was always clear and ongoing, so I think this is one of the main success factors and a problem at the same time.

Last, but not least, I should mention the IFC umbrella, given the Russian crisis and the moratorium in 1998. The IFC umbrella regarding transfer and convertibility risk has remained effective, since IFC's loans were explicitly exempted from the moratorium.

To comment briefly on our solutions to the problems: first, we had a dedicated team of workout experts at IFC, and negotiations with the client and all the parties involved were held on a regular basis in Russia. This was very important, and as banks we tried to support this. Most of us have been involved in this deal since the beginning. We did not come from the workout side, but from the structuring side. I think this was also important as a means of supporting the transaction. I have already mentioned the regular flow of information and consultation. There was a period when the project was not formally in default, but was struggling. No one could be sure of where it was going, what it would be worth in a few months, or whether it would improve. This period was especially challenging for information and consultation because everybody was waiting to see what was going to happen. After the formal default was declared regular information was the key to continuing the deal. This period after the formal default lasted for three years, so there was quite a pile of files and many telephone conversations, but we managed to get through it.

The pooling of expertise was another essential ingredient of working together in the banking consortium and with IFC. At Dresdner Bank, as at the other banks, we tried to make available our expertise on documentation and on restructuring, which was certainly well received by IFC. Of course, we had the workout expert in the first row and so constituted a very good team working on this transaction. In the end, as I already mentioned, the advantages of the IFC loan structure—making the loan in the first place plus taking a shareholding in the company—turned out to be the key success factor in this deal. Again, communication proved essential to keeping well informed and keeping track of developments.

Would I personally do any IFC B-loans again? The answer is a clear, "yes."

Francis Hamilton—Senior Adviser, Syndications,
International Finance Corporation

Several lessons can be learned from the way this syndicate was formed and worked. Although it can be risky to draw general conclusions from one case, it would be nice to see some aspects of A. O. Volga repeated in all future problem loans.

The first point to mention is that we had only five B-lenders. It was a homogeneous group: four major German banks and one Austrian bank. The four German banks, as mentioned earlier in this chapter, were all familiar with the German sponsor, and the Austrian bank was there because the major equipment supplier for the A. O. Volga expansion project was an Austrian company.

So they all had good reasons for being lenders, and shared with IFC some sense of responsibility for the project because of the commercial basis for their loans. When things went wrong, especially with respect to the performance of the major German sponsor, the banks did feel, if not directly responsible, at least involved in and familiar with the problems. In other words, while disappointed by the performance of the sponsor, the banks were not about to go to IFC and ask why it had landed them in this transaction with a dubious company. All the lenders had gone in with open eyes, believing that the sponsors were going to perform very well.

Second, regarding communications, IFC is confident that the degree, frequency, and level of our communications with the B-loan participants were satisfactory. Communication was, of course, much easier because of this homogeneous group of just five B-lenders, all of them in Europe. We issued detailed monthly progress reports, and with innumerable telephone conversations and regular meetings there was a good flow of information from IFC.

Third, at no stage did any of our B-lenders feel tempted to dump the loan (on the secondary market), or to jeopardize IFC's restructuring efforts through independent moves. They all understood our approach, even if they did not necessarily agree with our every action. Indeed, strong bonds developed between us, based on personal as well as institutional familiarity.

Fourth, of the five B-loan participants, two (Dresdner and WestLB) had significantly larger participations than the others. I would like to pay

a special tribute to the support and cooperation we received from these two, particularly Dresdner, which acted as agent for the escrow account as well as being the largest individual participant.

As in any complex restructuring, there were a few small areas of the documentation to which some of the lenders paid more attention than others. Dresdner had an excellent eye for all the details, and indeed pointed out, for example, some minor miscalculations in the cash-flow projections. It was gratifying for IFC to be dealing with co-lenders who shared our objectives and who understood every aspect of the transaction.

As lenders, we were also lucky. You have to be lucky—and you have to be able to take advantage of it. All in all, the A. O. Volga restructuring experience was not one we would we would choose to relive, but it had many good features.

CHAPTER 19

(continued)

Part (b): Tuntex Petrochemical Thailand

Eric Jourdanet
Senior Investment Officer, Oil, Gas, and Chemicals Department, International Finance Corporation

Alma Ourazalinova
Participations Officer, Syndications and International Securities, International Finance Corporation

Vera Reusens
Senior Manager, Global Export and Project Finance, Fortis Bank

Eric Jourdanet—Senior Investment Officer, Oil, Gas, and Chemicals Department, International Finance Corporation

The Tuntex Petrochemical Thailand (TPT) transaction provides a number of important lessons from the commercial bank perspective. The initial project was to construct and operate Thailand's first purified terephthalic acid (PTA) plant, with a capacity of 350,000 tons per year and a cost of about US$355 million. The plant was completed within budget and began commercial operations in October 1995, four months ahead of schedule. Design capacity is now 420,000 tons per year of PTA, including investments implemented in 1996.

The plant was built at a competitive capital cost and is today an efficient PTA producer, most of its sales being in the Thai domestic market. The company is part of the Tuntex Group of Taiwan, China, which was

founded and is controlled by Mr. Y. H. Chen. Tuntex Group activities include textiles, real estate, and petrochemicals, and the Group has various investments in Thailand. As it later turned out, sponsorship was one of the main problems encountered in this project.

In 1994 the International Finance Corporation (IFC) provided the company with financing, including an A-loan of US$17 million, and a B-loan of US$137.5 million. Sixteen participant banks were involved. As part of the financing plan Thai banks provided long-term loans of US$17.5 million and a revolving working capital facility for 750 million baht, which at the time was equivalent to about US$30 million. The lenders shared security consisting of a mortgage on the assets, contract assignments, and a pledge of the shares of the company.

Repayments of the B-loan and Thai bank loan started in March 1997, and repayment of the A-loan in March 1998. The repayment schedule was fairly skewed until 2001, with the bulk of the debt to be repaid in 1999, 2000, and 2001. However, the Asian economic crisis and the baht devaluation in late 1997 adversely affected both the company and the sponsors, and caused cash generation, profit generation, and the overall financial structure to deteriorate sharply.

Polyester and PTA markets in the region became very depressed. The conversion ratio between PTA and paraxylene (PX), which is an important barometer for cash generation, fell from about US$300 per ton in 1995 to US$270 per ton in 1996 and 1997. It then fell further, to US$192 per ton in 1998 and about US$130 per ton in the first quarter of 1999—a huge drop in margin. Since then, fortunately, the margin has stabilized at about US$200 per ton.

The working capital situation also contributed to the liquidity shortfall. It so happened that the PX price had gone up significantly just before the crisis, putting a strain on the company's liquidity. Then, because of the baht devaluation in 1997, the working capital facility was effectively devalued from US$30 million to US$20 million, so the two effects accumulated and pushed Tuntex into a liquidity crisis.

The company could not pay principal in March 1999, and the sponsors were not able to provide the required extra cash that was still available under the project support agreement. IFC was then mandated to work on a debt restructuring based on the concept of fair burden sharing among the company, its sponsors, and the creditors. The debt restructuring doc-

umentation was finally signed in August 2000, and it became effective in March 2001. We received the first interest payment under the new schedule at that time, so the loan is now fully current.

With that background, I would like to elaborate on a few interesting terms and conditions of this transaction. Of the US$117 million of outstanding debt, US$86 million of the A-loan, B-loan, and Thai bank loan have been rescheduled. The company now has the capacity to repay its total debt over five years, commencing in March 2001. The working capital facility provided by the Thai banks as part of the restructuring remains in place, and indeed has been increased to US$30 million equivalent, as was intended when we originally financed the project in 1994.

The first interesting feature of this transaction is the increasing spreads. The nonrescheduled part of the loan maintains the same spread, meaning 182.5 basis points (bp) for the A-loan, and 175 bp for the B-loan. As far as the rescheduled maturities are concerned, that is, for the bulk of the loan, the new spread will be the London interbank offered rate (LIBOR) plus 375 bp, which represents a significant increase of 200 bp. The spread on these rescheduled maturities can decrease in future, however, in line with a sequence of events linked to the provision of sponsor support and an excess cash flow sweep.

As part of the transaction, a flat front-end fee of 50 bp was paid by the company on the total rescheduled amount of the A-loan, B-loan, and Thai bank loan.

As mentioned above, the new higher interest spread can be reduced again, depending on sponsor support and payments from excess cash flow. One reason for this is that the sponsors were unable to provide immediately the US$29 million of sponsor support requested. They were granted time to do so, but nonpayment according to the new schedule will be an event of default. Sponsor support injections, once made, will be used to repay the loan in inverse order of maturities, and the spread will decrease by 50 bp on the first such injection and by 25 bp on the second.

The second interesting feature of this transaction, with regard to sponsor support, is that it was secured as far as possible by an asset owned directly by Mr. Y. H. Chen. His intention was to dispose of a valuable piece of real estate in California, of which he was the indirect partial owner. Ownership, however, was by means of a complicated cascade of holding companies, belonging to different jurisdictions and with Mr. Chen a

minority shareholder at each level. In effect, his holding was about 10 percent of the property, and had a total value of about US$20 million.

To ensure that if and when the land was sold the proceeds would be used as sponsor support for Tuntex, we therefore set up a legal structure involving a flow-of-funds agreement, together with a personal guarantee from Mr. Chen for up to the US$29 million of sponsor support, and triggered by the sale of the land in question.

This restructuring also has an interesting cash-sweep mechanism. While normal loan repayments will be made out of sponsor support and cash flow, the cash-sweep mechanism will prepay the rescheduled installments on a pro rata basis, and will also trigger spread reductions of 50 bp and 25 bp.

So in practice we start from a spread of 375 bp, reduced by 50 bp when we receive the first US$12 million of sponsor support. It is then further reduced by 50 bp on receipt of US$22 million of cash-flow sweep. Another reduction of 25 bp comes with the next US$12 million of sponsor support, and yet another of 25 bp with the next US$22 million of excess cash flow. The sequence is designed as an incentive for the company and the sponsor to provide the promised support, to repay the lenders, and indeed to benefit from any prepayments.

These cumulative spread reductions can lead to a minimum spread of 225 bp—which is still, however, 50 bp above the initial nonrestructured spread. Moreover, on the basis of conservative PTA margins, the company should now be able to repay the loans in full on a stand-alone basis. This is important, since in the end it remains questionable whether the sponsors will be able to come up with substantial amounts of support money.

The final payment date for the B-loan was extended from September 2001 to September 2004, which is compensated for by a significant increase in the spread plus the 50 bp front-end fee. The B-loan spread was increased from 175 to 375 bp and applied retroactively from March 1999, meaning that while the restructuring became effective in March 2001 the spread increase was backdated to the first default in March 1999.

The restructuring also, of course, allows us to share in the upside of good market conditions through the cash-sweep mechanism. Finally, it is also pari passu, in that it applies equally to a Thai bank loan with the same conditions as ours, and that we share security pari passu with the Thai bank for the new working capital it provides as part of the transaction.

The restructuring took about two years to complete, and encountered

two main problems. One had to do with fair burden sharing, which in this case meant bringing the sponsors to the negotiating table and getting them to agree to reasonable terms. The second problem had to do with keeping to a reasonable time horizon for closure.

The first problem reflected the fact that the sponsors were themselves in serious financial difficulties, given their involvement in crisis-hit sectors such as real estate in Taiwan, China, and textiles in Southeast Asia. After detailed due diligence on the sponsors, we found that they were unable in the short term to provide any sponsor support and were actually in a worse condition than Tuntex Petrochemicals itself. Even so, we had to find a way to get them to the negotiating table and make them share part of the restructuring burden.

Timing also became an issue, because of the slow process of understanding negotiating positions, reaching agreements, and getting agreements implemented. In addition, there was no real incentive for the company to reach agreements quickly. While in default it was paying interest only, and no principal, and was subject only to a 1 percent late payment penalty.

Of course, going for liquidation was always an option, but the company knew, as we did, that this would not have been in the interest of the lenders. Liquidation was particularly disadvantageous in that we also knew that the company had the ability to pay its debts over time on a stand-alone basis.

I believe that this transaction was good for the lenders, who now have a performing loan on a commercial basis. It was also good for the company and the sponsors, who have emerged from default and have recovered the flexibility needed to manage their own business. The burdens have been fairly shared.

It was certainly key to establish the principles and goals of the negotiation very early in the process, but once we had done that it took time to reach closure. IFC had to push to maintain the momentum of the negotiations, but at the same time to avoid lowering our demands or weakening our position, and to steer away from counterproductive conflict. Fortunately, we were able to keep an active dialogue going with all the parties, and in the end this delivered results.

Alma Ourazalinova—Participations Officer, Syndications and International Securities, International Finance Corporation

I would like to outline briefly how IFC worked with its loan participants on the Tuntex transaction. As Eric Jourdanet has mentioned, the financing

for this project was provided by a diverse group of participants: 24 percent by Thai banks and 76 percent by the IFC A- and B-loans. There were 16 participant banks under our umbrella: 11 from Taiwan, China, four Japanese or other Asian, and one European (Fortis Bank). As a result, we had to work with a group of participants in different time zones and with different internal approval procedures. Moreover, in this case the B-loan was unusually important—it accounted for 66 percent of the overall financing and about 80 percent of the long-term debt provided to the company.

As usual, IFC took a leadership role in the project, acting as lender of record for both A- and B-loans. While sometimes, particularly when there are other senior lenders involved, an informal lenders committee works on a restructuring, in this particular case IFC managed the process on behalf of the participants. We set up a team of specialists to conduct extensive and rapid due diligence at the outset, prepared information on Tuntex specifically tailored for the B-loan banks, drafted a term sheet, and negotiated with the sponsors a restructuring package within a framework agreed on with the participants. We therefore needed to agree with the B-lenders on the restructuring package early in the process.

The principle of pari passu treatment of all lenders was preserved. Since repayment of the B-loans originally began one year earlier than for the A-loan, the new repayment schedule provides a longer average life for the A-loan, and the spread increase for the B-loan, of 200 bp, is higher than for the A-loan (178 bp). Also, since the deferred principal amount on the A-loan is much less than on the B-loan, the 50 bp front-end fee brought in only US$85,000 for IFC, in contrast with US$345,000 for the participants.

As a restructuring progresses IFC normally is the primary source of information for the B-loan participants. Therefore, it is important that we consult with, and where necessary get consent from, the participants, as early in the process as possible. A timely flow of information in both directions speeds up the approval process and improves the quality of the final restructuring package. IFC should be aware from an early stage of the participants' bottom line on the key issues.

Vera Reusens—Senior Manager, Global Export and Project Finance, Fortis Bank

Tuntex Petrochemical Thailand (TPT) has always been one of my favorite files. I am the head of the monitoring and intensive care division of the export project financing department of Fortis Bank, which is based

in Brussels. We have about 50 project finance transactions in emerging markets in our portfolio, and the Tuntex file is one I have been giving to every trainee coming to my department as a showcase of how to analyze the original written Information Memorandum of 1993, and to compare it with reality. Perhaps the best place to begin is to explain the merits of the transaction and why Fortis entered into it.

It had all the positive characteristics of a well-structured project finance. The market analysis showed an increasing trend in world PTA consumption, and demand in excess of PTA production capacity. The government of Thailand was aiming to reduce petrochemical imports and integrate its domestic industry by setting up a new industrial zone in Map Ta Phut, Rayong Province. There was high PTA demand from the Thai textile industry, and local supply of all raw materials.

The key to understanding this business was not too difficult. You have PX on the one hand, and the product PTA on the other, so the key to the business is the conversion rate or conversion margin between the PX and the PTA. Historically, from research carried out by a petrochemicals consultancy firm, the conversion margin has been around US$300, which indicated very strong potential profitability.

The project finance itself was well structured. We had an engineering, procurement, and construction (EPC) contract with a fixed-price lump sum, and normal technology. The sponsor provided both precompletion and postcompletion support. There was a very balanced debt-equity ratio, and the tenor was okay, with a three-year construction schedule and then five years for repayment. There was an off-take agreement, a raw material supply agreement, standard covenants, a pledge of shares, share retention obligation, and mortgage on all the assets. In a word, it was a textbook example of how project finance should be structured. In addition, IFC was present, with its sector know-how and its B-loan umbrella, and the loan pricing was good. Nowadays one would probably consider 175 bp to be fairly low, but at that time (1993–94) it was decent remuneration.

As Alma Ourazalinova indicated, the syndicate, too, was rather interesting, consisting entirely of Asian banks plus just one European bank. Fortis Bank was there because of our presence in Fortis Bank–Hong Kong, China, which had a good relationship with the sponsors, the Tuntex Group.

In hindsight, one can now see the weaknesses of the 1993 transaction: they were, principally, our over-reliance on Tuntex companies in the bor-

rowing structure as well as the EPC contract and the off-take agreement. The Tuntex (Thailand) Public Company, Limited (TTC), the main shareholder of our borrower, was also the off-taker, and that created a somewhat difficult situation. Another issue was the transparency of the Tuntex Group. There were no consolidated figures, and we did not know that it had exposure to illiquid real estate business in Taiwan, China, besides being involved in an integrated business from PTA to polyester production, to yarn, and finally to textile products.

As the history of the case shows, there have been many breaches of covenants. Tuntex was a Chinese-run family group, and I think its management did not understand the requirements of a project finance structure led by an institution such as IFC. In several instances we learned after the event of breaches of covenant that had to be retroactively waived. For the credit committee of a commercial bank, it is not very pleasant to be asked for a retroactive waiver seven months after the breach of covenant actually occurred. Since then, more time has been spent monitoring the files, and IFC did a fine job of bringing things back on track when going through the restructure.

When the Asia crisis broke in mid-1997 I told my credit department that it did not have to worry because Tuntex was a completely dollar-based company. Both PTA and PX were always quoted in dollar equivalents, so I was not too worried about Tuntex's performance. By the end of 1997, however, we could see a large exchange loss due to the devaluation of the Thai baht. Furthermore, we could see very low cash flow from operations because of the accumulation of trade receivables, the reason being that TTC, one of the main shareholders in TPT and the off-taker of 50 percent of its production, was not actually paying for its purchases, and had stretched receivables over six months. In other words, our borrower TPT made the sales and had good revenues but it did not collect; so we were indirectly financing TTC, the main shareholder, which was not a very healthy situation.

By then TTC itself was having difficulties. In fact, the textile industry as a whole was suffering because of the Asian recession. There was less demand, and since TTC was vertically integrated, it was of course an important off-taker from our company. This had been an important advantage at the beginning of the financing, but after the Asian crisis it became more of a problem.

When in March 1999 the first payment default occurred, we began a restructuring which we assumed would take around six months to negotiate. The business outlook was now poor, although, technically speaking, the company had always performed well. That is true, as far as we know, because as a B-lender we had no direct contact with the company. In any case, it appears to have been a victim of the whole recession, and I do not think we can say there was poor management. When the sponsors were called on to perform on their support commitments, they too defaulted. They were in the same troubled situation as TPT. The textile business was poor, and, as mentioned earlier, the other sponsor in Taiwan, China, had illiquid real estate interests and was going through its own restructuring.

After the initial default we received preliminary financial projections from IFC, which then reported to us every month about the progress of the negotiations and what the main problems were. That was good. On the other hand, we were not very close to the details of the negotiation. In September 1999 the second principal installment defaulted, and in November the B-loan participants were confronted with the results of the negotiation, in the form of a first presentation of the rescheduling term sheet already negotiated with the company. Then an Information Memorandum was circulated in March 2000. We approved the rescheduling plan; the signing took place in August 2000, and it took until 2001 to make the restructuring effective. As early as September 2000, however, the first sponsor support commitment in the restructuring had already fallen due and had to be waived, because the sponsors were unable to meet it.

The restructuring needs to be looked at from two perspectives. First, I think the negotiation process was rather long: it took two years. Why was that? IFC spent considerable time finding out whether the sponsors were truly unable to support the company. There was a special audit, which took quite some time, especially to investigate the issue of the California land assets that Mr. Chen offered in support of his obligations as a sponsor. It took a long time to find out whether we could firm this into the deal. In the end we did not get proper security on this land, just a personal guarantee from Mr. Chen and a flow-of-funds agreement whereby any proceeds from the land sale will flow back and be injected into the company. But all that took time to work out, as did a problem with the pledge of shares that had actually surfaced much earlier in the process.

Fortunately, communication between IFC and the B-loan participants was good. Although we were not involved in the preparation of the rescheduling proposal and there was no consultation prior to the negotiation, I think that was the result of being efficient. It was a rather complicated participant group with the banks from Taiwan, China, and the Japanese banks and us, and I believe that for efficiency reasons it was much better for one party to take the lead in the restructuring. However, that meant we were sheltered from the details of the negotiation with the borrower, the sponsors, and the Thai banks. This way of working has both advantages and disadvantages. At one point the company tried to communicate directly with the B-loan participants and to elicit our sympathy because they were unhappy with IFC. That put us in a bit of a difficult position because we did not want to cause friction between IFC and the B-loan participants.

However, IFC and the participants did have different views about the duration of the A-loan and the B-loan under the rescheduling. Under the original structure, when the B-loan was repaid, half of the A-loan would still be outstanding. In the first rescheduling plan, the A-loan was shortened, and we had an exchange of views with IFC on this. Eventually IFC agreed to revise its proposal and provide more of a balance between the durations of the A-loan and the B-loans before and after the restructuring. Effectiveness then took a long time to achieve, because IFC tried to get the best deal for the lenders on security.

I think the revised new schedule is fair and balanced. We extended the maturity from September 2001 to 2004, gave two years grace, and the old 2001 repayment schedule was reduced by 50 percent, so all in all it was very reasonable.

The excess cash capture, or the cash-sweep mechanism, is an excellent gimmick. The banks share the advantage of any business improvement if it comes faster than anticipated. There was a margin increase, which was good and reflected the increased risk of a Thai company in financial difficulties. One could question the retroactive application of the margin increase, but it is true that while in default the company was only paying a 1 percent interest penalty while the restructuring may cost it more.

IFC focused much attention on the sponsors and on their support commitment, with a margin reduction depending on both payment of sponsor support and prepayment from available cash. However, this is a

concept that I find a little bit unusual. If the company manages to prepay, why should it not get a margin reduction? Why should it first have to wait for the sponsors to meet their obligations before the margin decrease applies?

It's a matter of how you look at things, of course. One can be in favor of both attitudes. In any case, we know that the sponsors are in dire straits, and one can even wonder whether it would not be better for any available sponsor support to just go to TTC, which is the main shareholder in our borrower and the main off-taker of the products. If TTC has financial problems, it has an immediate effect on our borrower. Therefore while it seems logical and proper to insist on sponsor support for our company, in this case I might wonder whether it is going to help improve TTC's situation.

Hence the main issue now is still the conversion margin and TTC's situation with regard to trade receivables. There is now a covenant that they cannot exceed 90 days, and that is a good measure, but I would like to see some reporting on the monitoring of this covenant, which we have not seen up to now.

Nonetheless, I think IFC did a good job in restructuring this transaction. With this diversified group of B-loan banks, it was probably necessary to take something of an authoritarian position to avoid too many discussions, and get straight to the point of the restructuring.

CHAPTER 20

Investing in Environmental Projects

Louis Boorstin
Manager, Environmental Markets Group,
International Finance Corporation

Brooks Browne
President, Environmental Enterprises Assistance Fund

James D. Westfield
Managing Consultant, PA Consulting Group

Louis Boorstin—Manager, Environmental Markets Group, International Finance Corporation

In this presentation we look at two ways to support environmental projects. One is to finance projects that involve specific environmental benefits—such as renewable energy, organic agriculture, clean water, or waste management. The other is to look at any project being financed, and ask whether there are opportunities to improve its environmental aspects and, thereby, its profitability. The objective here is to make more money through cleaner production.

A little over a year ago, according to a survey by the *Economist,* more than half of the people in developing countries felt that their health was being harmed significantly by pollution and other environmental problems. This is an issue that goes to the heart of the people that the International Finance Corporation (IFC) is in business to assist, people who live in developing countries, particularly the poor people in those countries.

These people face two types of environmental problems. One is what I would call local problems, which pose immediate and serious problems

for the inhabitants of developing countries. Local problems, in turn, can be divided into two types of problems. The first is local indoor and outdoor pollution, whether it is contaminated drinking water, untreated wastewater, or air pollution (in many parts of the world people burn fuels in their homes that cause enormous health problems). The second is degradation of natural resources that people rely on for their livelihood, whether agricultural land, forests, or fisheries.

Second, in the longer run the developing countries are clearly threatened by some global issues, such as climate change and the loss of biological diversity.

Why is IFC, which is a development finance institution, particularly interested in these issues? I think the answer goes back to our mission statement, which says, "We are in business to improve people's lives and to reduce poverty."

IFC has the ability, through its investments—just as all financial institutions do—to "improve people's lives," by addressing the local environmental problems by investing in projects that provide benefits (cleaner air, water, and land), and to invest in projects that help to protect natural resources. We also invest in projects that address global environmental issues, whether it is global warming or the loss of biodiversity.

The second goal mentioned by the mission statement is "to reduce poverty." It is very important to understand that environmental projects have not only environmental benefits—they have very clear economic benefits. In the near term, these economic benefits typically are related to increased competitiveness and productivity in the companies, owing to more efficient use of natural resources. In the longer term these benefits are related to more sustainable economic growth, because these benefits lead to making the basis of production more sustainable.

These are the opportunities that IFC sees in the area of the environment. That means preventing pollution instead of dealing with it at the end of the pipe. It means looking at a company, doing an audit of the company, and saying, "How can we help this company become more efficient?" The projects undertaken here are not typical capital investment projects. They often require a combination of services, including consulting services, and smaller capital investments. I think there are also some interesting opportunities for commercial banks in the environment.

The second area of involvement is that we undertake environmental

projects, which could be everything from projects to improve drinking water, which we have carried out from Argentina to the Philippines, or renewable energy technologies, such as projects with geothermal, or biomass, or wind power.

The third area of involvement is what I would call environmental initiatives. To a large extent we are in an odd business, and this is the business of "pushing the market." This is again in keeping with our developmental role, of trying to find opportunities where we think the market is going to be in a couple of years and helping to accelerate those opportunities, either by identifying technologies such as photovoltaics for solar power, or new business models that we think are going to become important in the future, and trying to make them happen a little sooner.

One of the things that we have discovered about investing in environmental projects is that they have a number of barriers. It is important to understand these if we are to help banks or financial institutions address the problems that arise in projects. These often relate to the size of the project. For example, a renewable energy project will often be smaller than a mainstream power project. Often, they have longer lead times because it takes more time to understand the project and to understand the sponsors. Sometimes we deal with less experienced sponsors.

There are technology issues—we often have a problem of a high ratio of capital cost to operating cost. If one is interested in investing in a wind power project, say, virtually the whole cost of the project is up front, because it is in the equipment; the fuel to run that project is free. The fuel, of course, is the wind. There are some operating and maintenance costs, but those are actually lower than one would typically find for a fossil-fuel-fired plant.

So these are some of the challenges that we need to surmount, and it is one of the reasons that the group I lead exists, which is to help address these challenges. A second set of challenges, which are a little harder to deal with and on which we sometimes collaborate with our colleagues at the World Bank, can be called distortion barriers. The difficulty here is that sometimes the projects we are looking at are not competing on a level playing field with conventional projects. A classic example of that would be a wind project that is trying to compete with a coal-fired plant. But that coal-fired plant is selling power at a price that does not completely reflect the cost of producing that power, whether because the coal mine does not have sufficient allowances for reclamation or whether there is not enough

allowance for the particulate air pollution or the greenhouse gas emissions. These are real problems. What we end up sometimes doing is providing cross-subsidies that serve to counteract these problems. More often than not, though, what we try to do is find countries and provinces of countries where the playing field is level.

Sometimes we also run into an odd problem in this area, one that comes out of the best of intentions but often has a perverse impact: namely, many bilateral and even some multilateral lenders may provide concessional funding. We cannot compete with that, because we provide commercial rate funding. We have often run into situations where we wonder why they are providing the concessional funding, because as far as we can figure out, it is not needed.

In what sectors does IFC operate?

- The environmental services sectors are, first, *water supply* and *wastewater management*; we have several billion dollars' worth of investments in these areas.

- *Solid waste management* is an area in which IFC has a keen interest. Having said that, I will add that IFC has never invested in a solid waste management project. We have a few advisory assignments in this area, and some good projects in our pipeline, but for a variety of reasons we have not yet managed to invest.

- *Pollution abatement technologies and services* is an area where we have not done that much, but would like to do more.

- As for *renewable energy*, we have some biomass, geothermal, and a number of small-scale hydroelectric projects. We have just approved our first wind-power project, and we have done a number of energy efficiency projects. Energy efficiency is an interesting area; in most of IFC's projects, where we go into existing companies and provide improvements for those companies, we are actually providing several energy efficiency benefits. We do not measure those benefits, unfortunately. If we go into an old cement plant, though, or a chemical factory, or a factory performing another industrial process, and we upgrade and expand it, typically one of the things we do is to provide a vast improvement in energy use, because it is such an important part of the production. If that step is not taken,

the firm is not competitive. We have also invested in upgrading transmission and distribution lines, in the manufacturing of efficient light bulbs, and even in some investments in energy service companies, which provide demand-side benefits.

- *Sustainable agriculture and forestry*: We have done a few projects here.
- *Ecotourism*: We are beginning to look at projects in areas such as fuel cells and fuel-efficient vehicles.

One example of our environmental projects is Aguas Argentinas, which is actually two separate investments for IFC in a US$4 billion water and wastewater concession in Buenos Aires; and a project with an intermediary company, Energía Global, which invests in renewable energy ventures in Central America.

A terrific project in our agribusiness department is in Ecuador. This is the first banana grower in Latin America to be certified by a nongovernmental organization (NGO) as ecofriendly. The same NGO that provided the certification recently gave an award to Chiquita Banana, which has also just achieved the same ecofriendly status.

Another project, a cement project in Estonia, goes back almost 10 years. That was a case where we went into an existing plant, upgraded it substantially, and actually achieved a 98 percent reduction in its emissions.

Another area of involvement in the environment is in projects funded by the Global Environment Facility (GEF). This is a pool of funds that IFC can access, for projects that address climate change and loss of biodiversity. GEF funds can be used both as investment capital and as grants, and as anything in between.

We are not particularly fond of using grants, but we have used the funds in a number of different areas to help support interesting projects through guarantees. One is the Hungary Energy Efficiency Project, which started out with a US$5 million GEF guarantee. Recently, in February 2001, IFC approved a co-guaranteed facility of US$12 million, making it a US$17 million project. What is exciting about this project is that we are working with a variety of financial intermediaries in Hungary. We are providing a partial risk guarantee to them when they make loans for energy efficiency improvements. Our expectation is that this US$17 million will catalyze US$90 million worth of loans from these financial institutions in

Hungary. In fact, most of that US$17 million will never be spent. We will get most of it back, because I think they are going to make good investments, and they are not going to call the guarantees.

The Small- and Medium-Size Enterprise Program is another project funded by GEF that has done everything from sustainable forestry in Costa Rica to efficient lighting in the Arab Republic of Egypt, to a project that addresses solar energy in several countries.

The last topic I would like to mention very briefly is one that has had front-page coverage recently: the Kyoto Protocol. The reason IFC is interested in this is not that IFC, as a financial institution, has obligations under the Kyoto Protocol. We do not. Those obligations are for countries. We are interested in this because we see it as a new source of financing for projects, and a very interesting source of financing. What we like about it is that if we can find companies that are interested in buying these greenhouse gas emission reduction credits our clients get funding. They are paid for these emission reduction credits, but they do not have to pay money back. All they have to do is provide these certificates that say, "We have reduced greenhouse gas emissions." From a company's point of view, that is a great deal. They get money in, and all they have to do is give out a piece of paper. So, to be very frank, that is why we are interested in it. From the perspective of our developmental role we are interested in it because we see this as a way to help the developing countries gain access to cleaner technologies and to have our developed-country members, the members of the Organisation for Economic Co-operation and Development, reduce the cost of complying with their obligations.

Brooks Browne—President, Environmental Enterprises Assistance Fund

I would like to present a slightly different perspective. While there are many good emotional, quality-of-life issues and other benefits to mention in the context of the environment, there is also money to be made in the environment. I want to talk about the profit-drivers to making money in environmental sectors, which is the focus of the organization I work for, Environmental Enterprises Assistance Fund.

Environmental Enterprises is an NGO. We are staffed by a private equity and venture capital people. Our program is designed to address capital markets–obstacles that prevent the private sector from getting more involved in environmentally beneficial activities. So we focus largely on the three pillars of environmental activity: climate change, biological

diversity, and clean technology. The vehicle that we use to address capital markets–barriers is private equity funds, so we deal in equity and quasi-equity types of investment instruments.

Our first fund is a US$10 million private equity fund in Central America. We had some private capital investors, but most of the capital came from multilateral and bilateral investors. We have been investing in a variety of small hydroelectric and biomass projects, energy deals, and some pollution abatement in Central America. There is a large amount of coffee, and a lesser amount of garment manufacturing in these countries, so we have also done wastewater treatment there. On the organic side, we have financed organic pepper, organic broccoli, and sustainable forestry. These are all private sector businesses. Some make money, some lose money. The premise is, at the end of the day you can show the investment world that environmentally beneficial businesses do not just make you feel good, but they can also make money.

Terra Capital is one of our flagship products, and IFC has been very supportive of it. It funds only the biodiversity sectors. We are about one-third invested. We still have private capital in this fund available to invest in good companies, and I am very excited about this, because I think there is real money to be made, for example in organic agriculture.

The Renewable Energy and Energy Efficiency Fund (REEF) is also supported by IFC as a lead investor. We have substantial private capital in this fund from NUON, which is a major Dutch utility; Alliant, which is a U.S. utility; and John Hancock Insurance, a U.S. insurance company. We are still fund-raising for the REEF, and we hope it will grow to US$80 million very shortly.

Finally, we have raised US$29 million for another IFC-led fund, which will invest in off-grid rural electrification. Together with that fund we have created a foundation to provide business development services. This is a healthy element of private capital in this fund from institutions such as Rabobank, Astro Power, and Calvert.

Most of us started thinking about the environment in the mid- to late-1980s, when we saw lawsuits against polluters, and even financial institutions started getting sued when the businesses they financed were poor performers in an environmental sense. Today we are seeing a great deal more environmental awareness, both in the developing and the developed countries. Interestingly, environmental investing 10 years ago was mostly on pollution-abatement technologies and abatement-service companies, and on things such as the privatization of water companies. We are now

seeing declining rates of return in some of these sectors. Pollution-abatement technology deals are still out there, but in the current capital markets they are often regarded in the same light as telecommunications or Internet investments. There is a great deal more caution now. At the same time, there are good business opportunities in some nontraditional sectors, such as organic food processing and environmentally friendly consumer products distribution companies. As a result, the capital markets are investing in businesses that are supplying these industries, and there are some incredible margin opportunities, depending on the industry. If you are a first mover in a new market or in a new supply arena, that enables you to stake out a strong position, and it locks up profit margin.

Technology improvements that are now occurring are also making an impact. It does not make sense to do business the old-fashioned way any more, with only end-of-pipe solutions. You can save money and make money by integrating efficiency into your basic production process.

We are also seeing changes in larger, well-managed companies. Some Fortune 100 companies are quietly undertaking environmental investing through their divisions or subsidiaries. There are barriers to entry, however, which in fact favor environmentally focused companies, whether it is organic certification; energy generation or distribution concessions; or proprietary technologies.

As fund managers we can provide value added to our investees. In our organic agriculture investing, we know who the buyers are. We know who the certifiers are. We recently went to Biofach, which is the major organics trade show in Germany, and introduced one of our investee companies, a producer of organic sesame seed oil, to potential new customers from Japan and Switzerland. So we can make important connections for our investee companies.

In our business we do take some earlier-stage risks, because in the developing world people involved in these environmental sectors are often from smaller companies. Although the smaller companies have the higher risk they also represent the greater value added opportunity, which means that an investor can make more money at this level. One does need to be aware of the risks, however. These usually have to do with technology, with the classic small business problems, and with government policy shifts. If the investment is in the power sector in Brazil or in India, for instance, the regulatory process may still be evolving.

We must remember, too, that access to capital faces an education challenge. Many bankers think that biomass power is actually a farming business, for example in sugar or rice production. It is not—it is altogether different: it uses agricultural waste as a fuel source for power generation. The leaders in the banking world can help some of their colleagues better understand that difference. I hope that bankers will also recognize that the environment is a good business opportunity, and not just something that needs to be dealt with to reduce their risk.

James D. Westfield—Managing Consultant, PA Consulting Group

I want to talk about clean production and pollution prevention, primarily in the developing world. A lot has been done in this field in Europe and in the United States, but I think there is a substantial market and a real opportunity in the developing world.

There are at least four basic requirements for clean production. To begin with, the industry needs to fully understand pollution and how to prevent it. Normal industrial people do not look at pollution in this way. They look at more production-oriented processes, and obviously they look at efficiency. There has to be some knowledge about pollution prevention, though.

A second requirement for clean production is technical capability. People need to know and be proficient in technologies and approaches that can help them. Banking, and even the government, has few such technical experts. So there has to be a cadre of people with those capabilities.

There also have to be government incentives and regulations covering clean production. Countries should be able to say to an industry, or to an entity, "If you meet certain requirements, you do not have to have secondary treatment. If you can change your production process, you can recycle and reclaim, we will accept that." That is already happening in a number of places.

Many industries and entities in developing countries are small, and they do not have a history of borrowing. Or if they do, the borrowing is under different circumstances. So, financing has to be available and tailored to the local scene, and that is the fourth requirement for clean production.

Furthermore, the company itself, and individuals in the company, have to want to pursue clean production. They have to understand that clean production can be a viable alternative.

Lack of financing is a barrier for a number of reasons, especially when potential borrowers have a history of credit problems. Many potential borrowers in developing countries have not borrowed before, so they cannot go to the bank and exhibit. Although they may have some collateral, a bank or a financier is going to want something in case the loan does not work. Borrowers also lack experience in designing and in justifying these projects. So there has to be some technical help available. The bank has to understand this, because many environmental projects do not generate a new revenue stream. This is not like going into an industry and putting in a new production line or adding products that yield a revenue stream to which a potential borrower can point.

At the same time, clean production and pollution prevention initiatives can save a great deal of money. They also have a great payback period, but they do not generate new revenue. This often concerns bankers—and I have dealt with this in many countries—because they cannot see where the revenue is coming from, even though it can be shown that a project saves money.

Because banks themselves lack experience in this area they tend to be hesitant about financing such projects. They neither entail the traditional technologies that banks deal with, nor do they entail traditional types of projects. I am talking primarily about industry, about new industry, not old industry. Even if production from new industrial plants in Southeast Asia over the next five years will only be one-time greater—a very conservative estimate—then what is on the ground now represents a tremendous opportunity. Helping new industry adopt cleaner production is not only beneficial, but also financially viable, especially among the new industries that are buying old technology. Many are going to Europe and buying old bottling plants, or old canning plants. There are opportunities to add clean production or pollution prevention initiatives to the new plants being built using that old technology. What makes this technically easier and often less costly is that it is not necessary to stop production, because everything is being designed and put in before the plant begins operating. Furthermore, it produces quicker paybacks.

In the past, established industry received most of the attention, partly because many existing industries have been under government scrutiny or have been ordered to clean up. You can meet most or all of the requirements for end-of-pipe by clean production. The benefit is that clean pro-

duction provides savings. Waste treatment does not. Waste treatment is a cost, and it is a continuing cost. It does not produce any savings, just additional cost. It frequently does not improve the quality of the product, or manufacturing efficiency.

A manufacturing industry can benefit from efficiency upgrades, cost control requirements, and clean technology, however. Many technologies, in fact, improve the product and minimize seconds and rejects. Where a company needs investment capital, a bank or financing institution has leverage if it understands what the technologies can do.

Another point about existing industries is that they usually have a credit history, collateral, and borrowing experience, so they are easier to work with than other industries that do not have this history and experience, or that are smaller.

Now I want to present some case study data that we have collected, primarily out of Latin America, from actual implementation of clean technology products. The first two cases were very large industries in Latin America.

The first case involves an inorganic chemical industry in Mexico that decided to modify its combustion process, reduce natural gas consumption, and reduce volatile organic compound emissions. Hence the case has both an environmental and economic dimension. The natural gas consumption was reduced substantially. We helped the plants modify their phosphoric acid processing operations. Again, the project led to savings in natural gas and volatile organic compound emissions, and it improved product quality. The modification in gas emission and handling had several important effects. There were savings in energy and volatile organic compound emissions. Data collected over several years after the projects were implemented indicate that the investment was very small, less than US$50,000, yet in the first year savings amounted to almost US$450,000—that means it had a 750 percent payback. Although this is not typical, by any means, it has happened in many places, and this was a very good example. Some results have not been quite so spectacular. The important thing is they experienced reductions. The financing here was not great, but the returns were significant.

In a second case, in the organic pharmaceutical industry, there were three major applications of process modification for bromine addition, for toluene. The company reduced toluene use and volatile organic carbon emissions. The total expenditure was something like US$30,000 to

US$40,000 for capital, which does not include the company's personnel cost. This capital cost was primarily for technology. This is the kind of money they could have borrowed or spent from capital—and the return on capital was, again, about 800 percent, so the savings were substantial.

In a third case, again in Latin America but this time in sugar processing, a company spent about US$1.6 million, and its subsequent annual savings were about a third of that amount. So this had a three-year payback period. Again, this project was financed by borrowing, and the company had a history of borrowing.

The first case was not financed by borrowing, by the way, because the company had capital on hand, but the second was financed by borrowing from commercial banks, as was the third.

In Ecuador we worked with the government to develop programs, and regulations, to help encourage clean-technology pollution-prevention options. The government recognized clean production as an alternative to end-of-pipe treatment. A wide variety of industries were involved. We went into 16 kinds of plants, including car assembly plants; many of them were small, but some were larger. In these plants we identified anywhere from a few to more than 40 pollution-prevention clean-technology options. In a tanning plant, for instance, we identified 42 options, for a total investment cost of about US$297,000. In almost all of these cases the companies borrowed and invested the money, and then enjoyed the annual savings. In one case the average payback was 10 months—a full return on investment in just10 months. This is documented information, based on annual expenditures before and after investing.

We have developed a rule-of-thumb in working with banks and governments on these projects: if you can get an annual return amounting to one-third of what you invest, that is reasonable in financing terms. Then you can go longer or you can go shorter. We also found, in Latin America, that if financial institutions can see a three-year return on their investment—and they can understand the financial benefits, the processing-manufacturing benefits, and the environmental benefits—they are willing to consider funding these projects. The fact that not one loan failed in Ecuador indicates that these kinds of projects actually work, and they produce reasonable savings.

SECTION VI

Innovations

CHAPTER 21

The B-Loan Website

Andy McCartney
Managing Director, eHatchery, LLC

James Smouse
Project Manager, B-Loan Website,
International Finance Corporation

As part of our effort to continue improving the International Finance Corporation's (IFC's) collaboration with the financial community, the Syndications and International Securities Department is establishing a B-loan market website to add liquidity and efficiency to IFC's B-loans. We are creating an online meeting place to facilitate the introduction of willing sellers of B-loan participations to willing buyers who meet IFC's criteria for participation in the B-loan program. Actual trading of B-loans does not occur on the site.

We expect the website to enable qualified B-loan participants to:

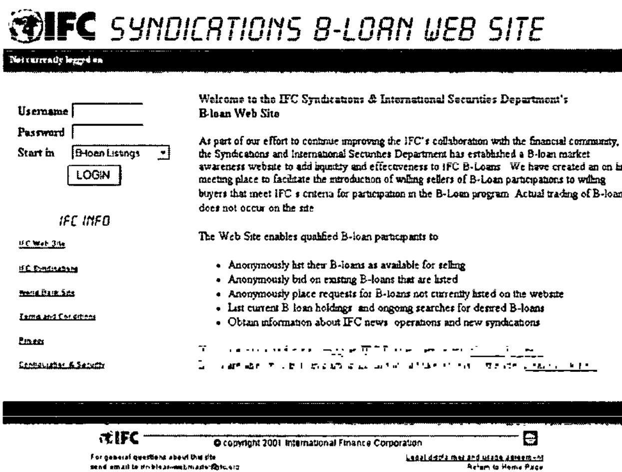
- Anonymously list their B-loans as available for selling.
- Anonymously bid on existing B-loans that are listed.
- Anonymously place requests to purchase B-loans not currently listed for sale on the website.
- Access current B-loan holdings of their financial institutions.
- Obtain information about IFC news, operations, and upcoming syndications.

We expect to launch the website in the third or fourth quarter of 2001, with an announcement to IFC's existing B-loan participants, as well as to

other financial institutions prescreened by IFC and interested in developing their B-loan portfolios. We will preregister existing participants and invite prospective participants to register on the website. Approved parties will then be given a username and a password to access the website. As is already the case, individual buyers and sellers will be responsible for completing due diligence, negotiating terms and conditions, concluding the sale, and submitting the appropriate documentation to IFC off-line. A few sample pages from the website follow.

Public Home Page

The home page will be available to all authorized, unauthorized, and prospective users. The exact design of the home page will be determined at a later stage, but essentially the content and functionality will include an introduction to IFC syndications and the B-loan website; links to IFC, the World Bank, and other relevant websites; new participant and user registration information; login fields; and start page. Successful logins will be presented with a website disclaimer and confidentiality agreement that must be accepted in order for the user to proceed.



B-Loan Listings Page

We expect two primary pages to represent the B-loan marketplace: "IFC B-Loan Listings"and "My B-Loan Activity." From the IFC B-loan listings page a user can access a list of all B-loans outstanding and B-Loans that are for sale, plus any participant requests for assets to purchase.[1]

My B-loan Activity | B-loan Listings | IFC Information | IFC New Business | Preferences

IFC

Logged on as Jamie Simone, First International Bank

IFC B-loan Listings

Listing Type	Status	Borrower (click for terms)	Country	Facility	Amount for sale	Maturity	Margin	Ask%	Best Bid	All-in Yield on ask
Currently available B-loan offers										
Offer	Open	ABC Manufacturing	Mexico	$30m A $32m B	$8m	6/15/09	LIBOR +2.875%	100%		LIBOR +3.96%
Offer	Open	Autokola	Czech Republic	DM 22m A DM 30m B	DM 8.[illegible]m	2/15/08	LIBOR +1.325%	Par		LIBOR +1.325%
Offer	Open - 2 bids	Banamex	Mexico	$44.3m A1 $55.7m A2 $94.7m B	$8.2m	6/15/02	LIBOR +0.875%	96%	93%	LIBOR +0.952%
Offer	Open	Caribbean Ispat	Trinidad & Tobago	$20m A $50m B	$5m	2/15/05	LIBOR +2.25%	99%		LIBOR +2.40%
Offer	Due Diligence	Comsigua	Venezuela	$25m A $135m B	$10m	3/15/07	LIBOR +2.5%	Par	99%	LIBOR +2.5%
Offer	Open	Corimon	Venezuela	$25m A $138m B	$12m	3/15/07	LIBOR +2.5%	98%		LIBOR +2.08%
Offer	Open	DLF Cement	India	$11m A $17m B	$7m	1/15/02	LIBOR +4.5%	97%		LIBOR +4.72%
Offer	Open	Jingyang Cement	China	$28m A $70m B	$6m	7/15/08	LIBOR +2%	Par		LIBOR +2%
Offer	Open 1 bid	Globo Cabo	Brazil	$35m A $80m B	$10m	10/15/02	LIBOR +2.75%	98%	97%	LIBOR +2.85%
Offer	Open	Lojas Americanas	Brazil	$20m A $20m B	$5m	5/15/02	LIBOR +3%	101%		LIBOR +2.875%

All Participant requests for B-loans

Listing Type	Status	Borrower	Country	Sector	Amount for purchase	Maturity	Margin Range	Ask%	Best Bid	All-in Yield on ask
Request	Active	Banco Hipotecario	Argentina		$20m		LIBOR +1% to +2%			
Request	Active		Brazil	Steel	$15-20m		LIBOR +2% to +4%			
Request	Active			Oil, Gas & Chemicals	$5-10m		LIBOR +3% to +6%			

Activity: Posted within 30 days | Listing: Only offered B loans | Region: All regions

Post an Offer   Post a Request

IFC

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For general questions about this site send email to ifc bloanwebmaster@ifc.org

Legal disclaimer and usage agreement

Return to Home Page

[1]The assets listed in all screenshots are fictitious and are shown here for demonstration purposes only They do not represent offers to buy or sell IFC B-loans.

Viewing the Term Sheet and Making a Bid

When a user selects the borrower name from "B-Loan Listings," a confidentiality agreement page will appear relating to the asset that has been selected.

If that agreement is accepted, a term sheet page will be displayed, as shown here. Functions available from the term sheet page are expected to be:

- The ability to make a bid.
- The ability to post a public or private anonymous e-mail to the seller.
- "Set an alert" enables an alert to be sent to that bidder's e-mail address when the ask price changes to a predetermined amount.

My B-loan Activity | B-loan Listings | IFC Information | IFC New Business | Preferences

IFC

B-loan Term Sheet

Borrower	Total B loan Facility	Margin	Maturity	Amount for sale	Bid %	Ask %
ABC Manufacturing	USD 32M B loan	LIBOR + 3 875%	05/15/09	USD 8M	no bid	99%

Email Correspondence | Send Email to Seller | Set Price Alert | Make Bid | Bid Help

Seller	
[illegible]	23 May 2001, 01 01 PM
[illegible]	Commercial Bank
[illegible]	BBB+/A2
Asset Termsheet	
[illegible]	USD32,000,000 B-loan Facility
[illegible]	ABC Manufacturing
[illegible]	Widen Libwa Corporation
[illegible]	1 September 2000
[illegible]	Clean with Negative Pledge
[illegible]	Maximum Debt to Equity is 1 25 1 00 Current Ratio 1 1 times Interest Coverage Ratio 1 25 times
[illegible]	U S Dollar
[illegible]	USD 8,000,000
[illegible]	USD 32,000,000
[illegible]	05/15/09
Interest	LIBOR + 3 875%
[illegible]	Project Finance - construction of new factory
[illegible]	In equal semi-annual installments beginning 5/15/02
[illegible]	Yes, on interest payment date only
[illegible]	17 50 bps
[illegible]	No minimum specified
[illegible]	English
[illegible]	Mexico
[illegible]	Manufacturing
Offer and Settlement Terms	
Ask price	99%
[illegible]	52.5 bps payable by Seller on Settlement Date
[illegible]	Settled without accrued interest
[illegible]	None
Transfer fee	USD 2000 payable by Buyer
[illegible]	Payable by Buyer
[illegible]	Assignment Form (from Participation Agreement)
[illegible]	To be prepared by the Seller
[illegible]	Yes
[illegible]	Yes
[illegible]	IFC Agreement
[illegible]	This transaction is subject to the negotiation of mutually acceptable documentation This transaction is subject to the granting of IFC consent required under the terms of the Participation Agreement This transaction is subject to a satisfactory legal review by the Buyer of the sufficiency of the Credit Documentation

IFC

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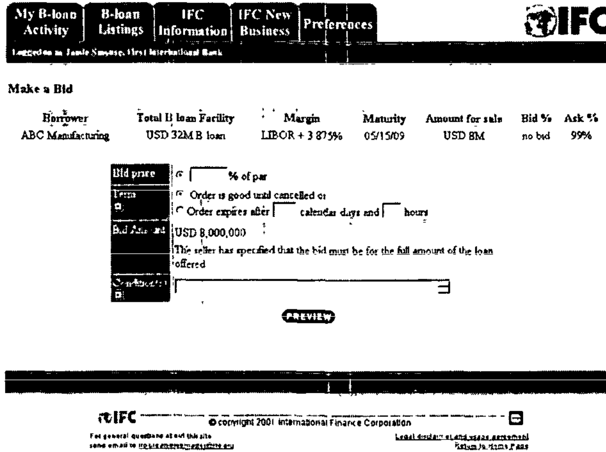
When the "Make a Bid" link is selected, a bid page will appear that enables bid information to be entered. This information is determined to be:

- Bid price
- Term
- Bid amount
- Conditions.



A preview and password confirmation page will appear after the completion of the bid page and an e-mail will be sent to the seller, the bidder, and IFC. We expect that it will also be possible to edit and delete bids from this page.

If the bid price matches the offer price, then anonymity will be lifted with an e-mail notification to the buyer and seller, at which point they can begin negotiations and due diligence offline and seek IFC's consent for the assignment. The loan will be removed from the B-loan listings page. If the bid price is below the offer price, the loan will remain listed (while the seller determines whether to accept the bid by amending its ask price accordingly).

My B-Loan Activity Page

The second page that we expect will complete the B-loan marketplace is "My B-Loan Activity." This page is customized to list items specific to the logged-on user or institution. The "My B-Loan Activity" page will display all B-loans held by the participant, plus any current bids, offers, requests, and searches for that participant. The following screenshot is a prototype that shows the proposed content and functionality of this page.

My B-loan Activity | B-loan Listings | IFC Information | IFC New Business | Preferences — IFC

Logged on as Jamie Smouse, First International Bank

My B loan Activity

Listing Type	Status	Borrower (Click for Term)	Country	Facility	Amount	B loan Maturity	Margin	Bid%	Ask%	All in Yield on ask
My B-loans										
Holder		Banamex	Mexico	$52m A $40m B	$15m held	6/15/06				
Holder		Cemtigua	Venezuela	$25m A $135m B	$10m held	3/15/07				
Holder		DLF Cement	India	$11m A $17m B	$13m held	1/15/04				
Holder		GVN Americas	Venezuela	$40m A $40m B	$20m held	7/15/06				
Holder		Globo Cabo	Brazil	$35m A $80m B	$10m held	10/15/02				
My Bids										
Bid	Bid sent to seller	ABC Manufacturing	Mexico	$30m A $32m B	$8m	5/15/09	LIBOR +3.875%	98%	99%	LIBOR +3.99%
Bid	Accepted Awaiting Consent	Autobola	Czech Republic	DM 22m A DM 36m B	DM 0.5m	2/15/06	LIBOR +1.325%	Par	Par	LIBOR +1.325%
My Offers										
Offer	Open	Globo Cabo	Brazil	$35m A $80m B	$10m	10/15/02	LIBOR +2.75%		Par	LIBOR +2.75%
Offer	Active Bid	Cemtigua	Venezuela	$25m A $135m B	$10m	3/15/07	LIBOR +2.5%	98%	99%	LIBOR +2.7%
My Searches										
Search1 Match	Open offer	ABC Hospital	Mexico	$20m A $14m B	$14m	4/15/2009	LIBOR +3.875%		99%	LIBOR +3.98%
Search1 Match	Open offer	Banamex	Mexico	$44.3m A1 $55.7m A2 $94.7m B	$8.2m	6/15/02	LIBOR +0.875%		99%	LIBOR +0.92%
Brazil Search Match	Open offer	Lojas Americanas	Brazil	$28m A $20m B	$5m	5/15/02	LIBOR +3%		98%	LIBOR +0.34%

My Requests (Indicative Bids)

Listing Type	Status	Borrower	Country	Sector	Amount for sale	B loan Maturity	Margin	Bid%	Ask%	All in Yield on ask
Request	Active	Banco Hipotecario	Argentina		$20m		LIBOR +1% to +2%			
Request	Active		Brazil	Steel	$15-20m		LIBOR +2% to +4%			

Activity [For Jamie Smouse ▾] Post an Offer Post a Request Create Search & Alert

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For general questions about this site send email to [illegible]

Legal disclaimer and usage agreement

Return to Home Page

Posting an Offer

An offer can be posted from the "My B-Loan Activity" page. The seller will select the B-loan it would like to sell from the list of the user's holdings. This will open a term sheet that will be automatically populated with important information about the loan, including borrower name, sector, margin, maturity schedule, covenants, and so forth. The seller must review the term sheet information and update any incorrect fields.

After the user has accepted or updated the term sheet information a second page will allow the user to enter price and terms of its offer. A preview and password confirmation page will appear after the offer and settlement terms page, and an e-mail will be sent to both the seller and to IFC that an offer has been sent for posting to the website. IFC will have the opportunity to review the term sheet before it is posted live on the website.

NOTE: IFC must grant its consent prior to the offer if a seller is offering a participation in a B-loan with the following characteristics:

- A partial sale of its participation
- Before full disbursement of the B-loan
- Projects in advanced stages of restructuring.

IFC Information

This tab will contain IFC news and content, and links to other online-related content. IFC will continuously update both the content and structure of this page.

New Business

This tab will contain announcements of new syndications when they are launched, press releases on syndications that have closed, and the latest monthly syndications pipeline. Each announcement will have specific e-mail contact links.

Preferences

This page will allow users to update their personal settings in a number of areas relating to website operations. Exact preferences requirements will be confirmed at a later design stage, but to date the following settings have been identified:

- Registration information from the B-loan website registration page
- Geographic region(s) that the user would like to specify as a filter for asset listings and alerts
- Set alerts and contact e-mail addresses
- Change of password
- Creation of login identification for that institution.

Contact Information

For further information on IFC's B-loan sales website, please feel free to contact Mr. James Smouse with your comments or questions.

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CHAPTER 22

Investing in Education: NIIT Student Loan Program

Guy Ellena
Technical Manager, Health and Education Department,
International Finance Corporation

C. N. (Madhu) Madhusudan
President, Strategic Alliances, National Institute of Information
Technology (USA), Inc.

Nicholas Vickery
Investment Officer, Financial Markets, South Asia Department,
International Finance Corporation

Guy Ellena—Technical Manager, Health and Education Department, International Finance Corporation

We would like to discuss the first large-scale student loan program in India, undertaken by the International Finance Corporation (IFC) in collaboration with Citibank and the National Institute of Information Technology (NIIT), one of the leading education and training organizations in India. Through this project IFC is playing a pioneering role in the launch of a new financial asset class in India—student loans.

Let me first give the general background for IFC's interest in education financing. Education is a topic that bankers usually do not discuss much, despite its enormous importance to human resources. A few years ago we began making a case for IFC and private involvement in this sector, as well as in health, both of which are traditionally public-dominated sectors.

The global market for education—encompassing everything from public and private kindergarten to higher education, specialized training, and corporate training—is unbalanced. Overall, it amounts to about US$2.2 trillion, and about 5 percent of the labor force worldwide is involved in education. About one-third of this US$2.2 trillion is spent in the United States alone, however, and only 15 to 20 percent is spent in the developing world.

Another important factor for bankers to consider is the demand for education. When one looks at the size of a population and its education needs from primary through tertiary levels, China, India, and Latin America clearly have very high needs. Unfortunately, public expenditures on education are very low compared with demand. That is why a case can be made for financing private education, although many people continue to view private education as something for rich people. That view is based on truth to some extent, especially in the most developed countries, which usually have a strong and well developed public education system, and in which one has to elect to go to private education. Levels of real private expenditures on education do not always coincide with the economic status of a country, however. Exact figures are difficult to pinpoint, of course, because much private expenditure is not recorded. In any case, the results can be surprising, especially at the higher levels of education, which should, by the way, include vocational training.

To take a few examples: private expenditures account for 57 percent of education resources in Uganda, while Chile has a well-regulated public-private mix. Cameroon, China, and Ghana have just experienced a huge expansion of private education in a short period. China alone has established 500 new tertiary institutions over a period of only four years. Cameroon, which has moderate resources and a large population, has seven universities, and 25 colleges applying for accreditation. Even in countries where one would have expected the public sector to do more, many students are receiving private education. In the Philippines, for example, 86 percent of students in higher education are in private education, and in the Dominican Republic the figure is 71 percent. In Côte d'Ivoire, which has a public-oriented tradition, 100 percent of professional training today is de facto privately provided. In The Gambia 44 percent of the training market is private.

In view of their developing and emerging economies many of our client countries are in dire need of trained professionals: lawyers, account-

ants, teachers, dentists, doctors, nurses, and the like. Although private education in developing countries does serve the rich, it is also increasingly serving the middle- and lower-middle-classes; although it is certainly more of a challenge, in some areas it is also reaching the poorest populations. Demand-side financing mechanisms, such as student loan schemes, can help the private sector expand its service to the poorest populations. A conducive regulatory framework is a precondition for any widespread private sector response, and we do find that in many of our client countries this framework is underdeveloped but changing rapidly. That makes our task more challenging.

Because of these changes, especially the increased demand for education, large for-profit educational institutions are starting to look at developing countries. They are expanding their markets by moving toward countries where the demand, the needs, and the financing mechanisms are sufficiently established to convince their shareholders that there is business to do there. So far, in many countries good education is available to the wealthy classes and, to some extent, to the lowest classes; a growing middle-class that has high expectations of social mobility still has limited access to quality education today, however.

That increased demand from the middle-classes is what we think is driving private investments. A number of developing-country public institutions have reacted to their bad financial situations by introducing tuition fees for students who can afford to pay, and in some cases this has translated into improved quality of education.

To return to IFC, its first investment in this sector was only in 1995 in a chain of primary and secondary schools in Pakistan. Then in 1999 IFC's corporate strategy group launched a global study that began with a brief paper entitled "Investing in Private Education in Developing Countries," which outlined the broad objectives and rationale for IFC to become involved in the social sectors.

In April 2000 IFC established the Global Practice Group for Social Sectors, which is the group within IFC charged with health and education. That group presented a revised IFC strategy to the board of directors, emphasizing the need to mobilize private resource flows in the development of particular businesses. IFC expects that, in getting involved with educational institutions, it is going to advance managerial efficiency and to help those institutions expand to serve larger markets. In addition,

these investments will directly contribute to building much-needed human capital, which is one of the most important drivers for economic growth and poverty reduction.

Clearly, IFC does not want to invest in social sectors based on the fact that they are subsidized by other moneymaking sectors. We want to prove that private investments in education can be financially viable, whether they are for-profit or not-for-profit, and we want to build them as a new line of business for IFC. To this end we have approved 29 education projects so far throughout the world. The volume approved is particularly high in Latin America (which amounts to US$88 million of a total US$138 million for IFC's own account), although we have only undertaken nine projects there. At this point, we expect to do 15 projects a year, for an average of US$10 million each. I should also mention that IFC and the World Bank have collaborated in putting together private sector education initiatives, starting with a website service called EdInvest. EdInvest is a website that provides a great deal of information. Initially subsidized, it now must be more self-sustaining by selling its services. It is going to be based with us in IFC to get it much closer to private business, although with a little support from our big sister, the World Bank.

Finally, if private sector education delivery is to grow in the emerging economies, one absolutely essential need is the provision of student loans. Without them, and especially without loans of the type issued under the NIIT Student Loan Program, it will take a long time for the private education sector to address the needs of low- and middle-income families rather than just act as a service provider for the well off.

C. N. (Madhu) Madhusudan—President, Strategic Alliances, National Institute of Information Technology (USA), Inc.

There continues to be a great deal of confusion about how education can be for-profit, or how a developing country can invest in educational infrastructure. To answer such questions one must remember that the key resource on this planet is the sheer number of inhabitants, and that education enables us to convert that resource into an asset.

When our firm, NIIT, started operations in 1982 the idea of combining profit and education was not widely accepted. Education, most people said, belonged in the public sector. There may be a token fee for tuition but everything else is provided by the state. One could not think of profit

in that context. This view was a big obstacle for the growth of NIIT in its first few years.

However, one thing going for us at that time was the demand that was building up with microcomputers entering the marketplace. Traditional educational institutions were not looking at microcomputers, or microprocessor-based computers, as anything of value to them. Most of the higher-end technology institutions were oblivious to what was happening. Meanwhile, the industry was taking off with many computers being delivered to companies, but with no one to educate people in their use. That was the market opportunity we saw.

We asked ourselves how we could address this opportunity. The first step, we realized, was to start bringing some people in and training them on how to use these new computers. That constituted a small market in itself. Then a host of new issues arose pertaining to who actually needed to use a computer. Did one have to be an engineer, a mathematician, or a scientist? This made the confusing situation worse. So we decided to resolve that question first.

Once we identified our market we looked around for a potential audience. We decided that India was a good candidate. The social structure in India was such that after students finish high school, unless they get into an engineering college or a medical school, they are considered a write-off. The size of this community of write-offs is massive, because most people do not get into medical school or engineering school. Yet they have some basic academic qualifications and nothing for which to aspire. This is a sure-fire recipe for a revolution. So we decided to address this audience and enable them to become computer-literate, and then see if they would be employed by industry. That, in a nutshell, is how NIIT got started.

Over the years our company expanded into two "business lines." One of these is Teknowlogy Solutions, which provides software solutions for applications and knowledge management. The second is Learning Solutions, which is the focus of the education loan program.

Since 1982 NIIT has developed 18 subsidiaries, and now has offices in about 36 countries. We also have 2,800 education centers. One of the key reasons for NIIT's success is access. Traditionally, to attend a particular school one had to relocate to the city where the school operated. With NIIT we just flipped that model around and said that it was not necessary to relocate, because there will be an NIIT education center nearby.

Scalability and access are indeed two keys to the success of such programs. Hence our mission was to take a computer education center and deliver it to everybody's home, or at least into everybody's neighborhood. How was this done?

Over the years we have hired about 2,000 software professionals and 700 instructors. First we had to decide what kind of instructors to put into our education system. The basic premise that drew us in one direction rather than another was the fact that we had to impart skills. This could be done by going either to a traditional professor or academician and listening to lectures on a subject, or by going to someone who had developed systems and could provide real-life hands-on experience. That made us recruit instructors who were practitioners, not professors. This gives us a way of bootstrapping experienced talent into the training system, which is usually a bottleneck for the traditional university system.

When we started in 1982 we opened two education centers, one in Bombay and one in Delhi, and by the time we opened our third one, which was in Madras, we were fairly exhausted because it takes time to drum up business, and the cash-flow needs were high. At that rate, it was going to take us forever to build even 20 education centers. The first radical shift in our thinking was to find a way to scale this up without being limited by our own speed and resources.

We decided to look into how we could network and partner with like-minded people and get them to be our engines of growth and reach. That "licensing" or "business partnership" approach has worked extremely well and in fact has helped us expand into a strong 2,800-center network.

In the early days we began working in parallel with a group called the Performance Management Group at the University of Michigan, Ann Arbor. The driving factor for this group was the fact that during a recession the first expense that companies cut is training. When they asked themselves why this happened the only answer they could come up with was that a return on investment was not visible in the case of training. They then created a whole set of instructional design models aimed at measuring impact, which we started using. Subsequently we created our own instructional research and development facility, which has now become a large business in its own right, with multimedia and "e-learning" programs.

In 1989 the American Council on Education visited NIIT to look at all our instructional development activity, that is, to look at how NIIT edu-

cation was actually managed in education centers. Its representatives performed an evaluation of our courses and operations. They were so impressed that they decided to establish credit recommendations that would allow NIIT students to take NIIT courses and have the credits transferred when they joined the next-level programs at American universities. That action strengthened our own conviction of the value of what we were doing. By 1992 we had moved on to converting all our courses, which are of many different kinds, into one structure, almost like a university structure. That was the start of the program called GNIIT.

Subsequently, Microsoft approached us to seek our assistance with its computer education in India that takes place under the certified education center model. Under its model of certified education Microsoft certifies a provider to impart Microsoft education. This has been popular in many countries, but in India they were just starting. So Microsoft came to us and asked if they could use our education network for training people on Microsoft products. Now, we are Microsoft's premier education training provider.

In 1996 we started using e-learning, or the Netvarsity here, and TechEdge, which is basically web-delivered learning services. Next, we launched the web-centric curriculum, the iGNIIT, which is actually the flagship of the loan program. Since then we have added newer topics. Our success can be attributed in part to the fact that we are based on the hospital and medical school model. One of the problems with traditional education is that its goal is mainly to grant a degree, and rarely is there any communication between industry and academics. By contrast, our system operates on the premise that software development requirements should drive the training. It is oriented toward real life and current technology, and it has absolutely no traditional academic constraints. As a result, those who come out of the training system are actually practitioners. They do not need another finishing school to be able to find a job. I think that is the core strength of this model.

Over the years NIIT has established itself as a very large training company. It is now among the top 50 such companies of the world, having trained 1.5 million students. At any point in time, on any given day, about 350,000 students will walk into NIIT education centers. Unlike a traditional education system, this one is managed like a production system. Under this concept, education is managed as a manufacturing process.

The focus is on efficiency, and thus on issues such as learning effectiveness, capacity utilization, or instructor utilization, which is what makes it possible to manage the system as a business.

One of our key objectives is to provide retraining because technology changes so quickly. A second objective is to help meet the global shortage of information technology (IT) skills among working professionals. A third is just to make people computer literate. Our goals and our methods are the force behind what is truly a success story in the field of education.

Nicholas Vickery—Investment Officer, Financial Markets, South Asia Department, International Finance Corporation

The impetus for the loan program that was developed with NIIT was IFC's desire to finance students with potential, but without the resources needed to gain access to higher education. The program we subsequently developed in India has two key features. It is the first private sector student loan program in India that works without subsidies and without any government intervention. The other key feature is its innovative financial structure, which has made it possible to share the risk among Citibank, IFC, and NIIT using the techniques of securitization in order to lower the costs for the students.

So where does one start in order to develop education finance? We identified a sector in a country where there was potential. This turned out to be IT, which today is one of the most powerful instruments of change in India. The software industry has grown from US$150 million eight years ago to US$4 billion last year. It is one of the fastest-growing foreign exchange earners in the country. As a result, IT education is one of the fastest-growing segments of education, with 700,000 students enrolled every year in IT programs in India. Yet there is still a global shortage of IT engineers. Last year, this global shortage was estimated at 1 million students. Even with the slowdown in the IT sector this year, there is still a shortage of between 500,000 and 750,000 students globally.

Within the sector we identified NIIT as the best partner for providing IT education. Among the courses offered by NIIT we identified iGNIIT as the flagship program. It is a three-year program that is completed in parallel with a university degree. During the first three years, when the student is still studying in a university, he or she is concurrently taking computer courses. At the end of three years the student is awarded a university degree

and a certificate in IT. This training is followed by practical experience consisting of one year spent working for a company and earning a stipend. This is why the recruitment opportunities for graduates of iGNIIT are so high, and why we chose this program as the one we wanted to finance.

Although there is a pressing need for IT education in India it is not covered by the traditional financial sector. When we looked at the availability of student finance in India we saw that very few institutions offer student loans. Those that do often reserve it for the elitist programs, such as those at the Indian Institutes of Technology and Indian Institutes of Management, which basically do not target what we refer to as the lower-middle-class, which is the core market that we are targeting. In addition, these finance programs are mainly based on collateral lending, which means that the families have to show they already have the revenues or they have to pledge the amount that they are borrowing. Hence only the people who could have afforded the loans at the outset are able to gain access to these funds. The reason for this is that student financing is still considered a risky activity, in view of the high default rates in student loan programs around the world.

IFC's approach to student finance was to find the best possible partner in unsecured consumer lending and apply the methodology of unsecured consumer lending to student financing. We identified Citibank, which has had a presence of nearly 100 years in India and has the best collection rates in consumer lending in India today. With these three partners—NIIT providing the best of IT education, Citibank providing its lending expertise for consumer finance, and IFC providing the ability to structure and share the risk—we were able to produce a student loan program of nearly US$100 million. The first step was to develop a student loan that matched the needs of the students. We developed a seven-year loan that covers 90 percent of the program costs of iGNIIT. It has a fixed rate of 16 percent, which is approximately as low as you can get in consumer finance in India, with mortgages at around 15 percent and unsecured consumer loans at 21 percent.

We based the repayment on the student's earning capacity, and took a new approach to student finance where we decided that we were going to use the techniques of project finance. That meant treating education as an investment that leads to future earnings as a way to model our approach to education finance.

During the first three years, when the student is still in school and not generating income, we kept the payment as low as possible. The payment then is about 1,000 rupees (or US$25) per month, which means that families who are earning US$100 a month can afford the student loan. In the last four years the student makes equal monthly installments of about 4,000 rupees per month, which will enable him to repay the overall cost. These 4,000 rupees correspond to 25 to 40 percent of the expected earnings of the student, so we have based the loan structure on his future repayment abilities and future earning capacity.

Under the program's structure, Citibank will be underwriting and servicing the student loans. The first level of losses will be grouped into what is called a junior tranche, so Citibank and NIIT will take the first losses jointly. The second level of losses, called the mezzanine tranche, will be covered by IFC. And Citibank will take the third level of losses, called the senior tranche. Instead of taking a traditional approach and sharing risk proportionately (as we have done in loan syndications, for instance), we have taken a sequential approach to risk sharing. That means the losses come first to the junior tranche, then to the mezzanine tranche, and then to the senior tranche.

To size these different tranches we had to make some assumptions about how much we expected to lose on student loans. This was difficult to do because of the lack of historical data on student loans in India. We decided to base it on Citibank's approach to consumer finance, using a methodology that was approximately the same. In this way, we estimated that the losses on student loans would be about 7 to 8 percent of disbursements. We validated this through our due diligence, but also through Standard & Poor's risk assessment.

As a result we were able to size the junior tranche at 11 percent. This is 1.5 times the expected loss and is the risk equivalent to equity. The second level of losses, which is taken by IFC, is the mezzanine tranche, sized at 10 percent. Because the mezzanine tranche benefits from the risk coverage of the junior tranche, which basically means that the expected losses are covered 1.5 times before they reach the mezzanine tranche, we were able to get a risk assessment of BBB– by Standard & Poor's on this mezzanine charge. Because of the junior and the mezzanine tranches, which together cover 2.5 times the expected loss, we were able to get a risk equivalent of AA– for the senior tranche.

Through this structure we have transformed 80 percent of the program into a risk-free program. One direct benefit is that we were able to scale up the program from one that was going to be US$4 million, according to Citibank's risk appetite initially, to a program that today is nearly US$100 million. The second direct benefit was that we were able to lower the cost to the student to 16 percent a year. This covers the cost of funds of 12 percent, administrative costs of 1.2 percent, annual losses of 1.3 percent, and an investor margin of 1.5 percent. If we had not been able to differentiate the risks between the tranches for the junior investor, the mezzanine investor, and the senior investor we would not have been able to reach such a low level of pricing.

We developed a pilot project that was launched in January 2000 by Citibank to see what sort of appetite there would be for this product, and the results today show that it has been a huge success. In the areas where the student loan was provided 80 percent of the students took it up. Furthermore, from a social mobility standpoint we were able to achieve enormous success. Half of the students who took out the loans will be earning an income that is higher than that of their parents, while 30 percent of the students who took out this loan will be earning an income more than double what their parents are making today. Without the student loan program these students would not have had access to education finance and therefore would not have had access to the education provided by NIIT.

PROGRAM OF MEETING
INTERNATIONAL FINANCE CORPORATION PARTICIPANTS MEETING
WASHINGTON, D.C.
JUNE 6–7, 2001

International Finance Corporation (IFC) Headquarters
2121 Pennsylvania Avenue, N.W.
Washington, D.C. 20433

Wednesday, June 6

9:00 a.m.–10:20 a.m.

Opening Session: Welcome and Update on IFC Operations

Mr. Peter L. Woicke, Executive Vice President, IFC, and Managing Director, Private Sector Development, World Bank

Mr. Assaad J. Jabre, Vice President, Operations, IFC

Trends in IFC's Syndicated Loan Program

Ms. Suellen Lambert Lazarus, Director, Syndications and International Securities, IFC

10:45 a.m.–12:00 p.m.

Basel Capital Accord 2: Implications for Lending to Emerging Markets

Speakers: *Mr. Jonathan L. Fiechter*, Senior Deputy Comptroller for International and Economic Affairs, Office of the Comptroller of the Currency

Mr. Frans Cornelissen, Senior Vice President, Head of Country Risk Management, ABN AMRO Bank

Mr. Ernest Napier, Managing Director, Financial Services Group, Standard & Poor's

Mr. Dirk Müller, Partner, Financial Services Consulting, Risk Management, KPMG

Moderator: *Mr. J. Michael Swetye,* Principal Syndications Officer, Syndications and International Securities, IFC

12:00 p.m.–1:00 p.m.

Investing in Sustainability

Speakers: *Mr. Bart Jan Krouwel,* Managing Director, Sustainability and Social Innovation Group, Rabobank Nederland

Dr. Julie Fox Gorte, Senior Environment and Technology Analyst, The Calvert Group

Moderator: *Mr. Bernard E. Sheahan,* Chief Strategist, Operational Strategy Group, IFC

1:15 p.m.–2:45 p.m.

Lunch

Keynote Speaker: *Mr. John T. Olds,* Special Advisor to the Chairman, DBS Bank, Singapore

3:00 p.m.–5:15 p.m.

"Breakout Sessions"

3:00 p.m.–4:00 p.m.

InfrastructureWorld, Inc. Bringing Efficiency, Speed, and Global Reach to the Project Development and Finance Process

Speakers: *Ms. Barbara Laflin Treat,* Managing Director, InfrastructureWorld, Inc.

Mr. Pedro Batalla, Managing Director, Darby Overseas Investments Ltd.

Mr. Declan Duff, Director, Infrastructure Department, IFC

Moderator: *Mr. Matthew Bauer,* Vice President, InfrastructureWorld, Inc.

Projects in Telecom : Where Will the Funding Come From?

Speakers: *Mr. Jan van Bilsen,* Director, Syndicated Debt, Emerging Europe, Middle East and Africa, ABN AMRO Bank

Mr. Scott Sutliff, Vice President of Telecom, Global Project and Structured Finance, Citigroup

Dr. Robert Stuart, President and CEO, InDepth Financial Advisers, LLC

Moderator: *Mr. Mohsen Khalil*, Director, Telecommunications & Internet Technologies Department, IFC

Investing in Education: NIIT Student Loan Program—A Case Study

Speakers: *Mr. C.N. Madhusudan*, President—Strategic Alliances, NIIT (USA), Inc.

Mr. Guy Ellena, Technical Manager, Health and Education Department, IFC

Moderator: *Mr. Nicholas Vickery*, Investment Officer, Financial Markets, South Asia Department, IFC

4:15 p.m.–5:15 p.m.
Corporate Governance: Enhancing Enterprise Value

Speakers: *Mr. Peter C. Clapman*, Senior Vice President and Chief Counsel, Investments, TIAA-CREF

Mr. Peter H. Sullivan, Chairman and CEO, Lombard Investments, Inc.

Mr. Mike Lubrano, Senior Investment Officer, Financial Markets Advisory Department, IFC

Moderator: *Mr. Khaleel Ahmed*, Principal Investment Officer, Syndications and International Securities, IFC

The World Bank Group Risk Mitigation Instruments: PRG/MIGA/IFC

Speakers: *Mr. Peter Jones*, Manager, Finance and Syndications, MIGA

Mr. Dan Hoang, Financial Officer/Derivatives, Treasury Department, IFC

Mr. Michel Wormser, Director, Project Finance and Guarantees Department, World Bank

Moderator: *Ms. Suellen Lambert Lazarus*, Director, Syndications and International Securities, IFC

IFC's Focus on Electricity Distribution

Speakers: *Mr. Jesus Marcos*, International Financing, Union Fenosa

Ms. Sarah Slusser, Vice President, AES Americas

Moderator: *Mr. Francisco A. Tourreilles*, Director, Power Department, IFC

6:15 p.m.–7:15 p.m.
Reception for Participants and IFC Senior Management

Host: *Mr. Peter L. Woicke,* Executive Vice President, IFC, and Managing Director, Private Sector Development, World Bank

7:15 p.m.
Keynote Speaker: *Mr. James D. Wolfensohn*, President, The World Bank Group

Followed by:
Dinner for Participants and IFC Senior Management

Thursday, June 7

9:00 a.m.– 9:45 a.m.

Navigating through Crises

Speaker: *Dr. Miguel A. Kiguel*, President, Banco Hipotecario S.A.; former Chief Advisor to the Minister of the Economy and Undersecretary of Finance, Argentina, and Deputy General Manager for Economics and Finance at the Central Bank of Argentina

Moderator: *Mr. Cesare Calari*, Director, Global Financial Markets Department, IFC

9:45 a.m.–10:45 a.m.

When Things Go Wrong: IFC's Multifaceted Role in Restructurings

A. O. Volga—A Case Study

Speakers: *Ms. Anke Avderung*, Director, Global Debt Origination, Dresdner Kleinwort Wasserstein

Mr. G. K. van der Mandele, Chief Special Operations Officer, IFC

Mr. Francis Hamilton, Senior Advisor, Syndications, IFC

Mr. Andres Hernandorena, Chief Counsel, Legal Department, IFC

Moderator: *Mr. Jyrki I. Koskelo*, Director, Special Operations, IFC

11:00 a.m.–11:30 a.m.

IFC's Portfolio—Results and Trends

Speaker: *Ms. Farida Khambata*, Vice President, Portfolio and Risk Management, IFC

Moderator: *Ms. Mary Elizabeth Ward*, Manager, B-Loan Management Division, IFC

11:30 a.m.–12:00 p.m.

B-Loan Website: Proposal for a New Market Place for Secondary Sales

Presenters: *Mr. Andy McCartney*, Managing Director, eHatchery LLC

Mr. James Smouse, Project Manager, B-Loan Website, IFC

Moderator: *Ms. Suellen Lambert Lazarus*, Director, Syndications and International Securities, IFC

12:00 p.m.–12:40 p.m.

Perspective on Globalization

Closing Speaker: *Mr. Thomas L. Friedman, The New York Times* foreign affairs columnist; and author of *The Lexus and the Olive Tree* and *From Beirut to Jerusalem*

1:00 p.m.–2:30 p.m.

Lunch

Keynote Speaker: *Mr. Horst Köhler,* Managing Director, International Monetary Fund

2:45 p.m.–5:00 p.m.

Seminar: Upcoming Transactions, Recent Restructurings and New Initiatives

2:45 p.m.–3:45 p.m.

Tuntex Petrochemicals: Restructuring Case Study in Thailand

Speakers: *Ms. Vera Reusens*, Senior Manager, Global Export and Project Finance, Fortis Bank

Mr. Eric Jourdanet, Senior Investment Officer, Oil, Gas, and Chemicals Department, IFC

Ms. Alma Ourazalinova, Participations Officer, Syndications and International Securities, IFC

Moderator: *Mr. Rashad-Rudolf Kaldany*, Director, Oil, Gas, and Chemicals Department, IFC

Investing in Power in Central America

Speakers: *Ms. Sarah Slusser*, Vice-President, AES Americas

Mr. Haran Sivam, Senior Investment Officer, Power Department, IFC

Moderator: *Ms. Stefania Berla*, Principal Syndications Officer, Syndications and International Securities, IFC

Banorte: Financing Long Term Leases in Mexico

Speakers: *Mr. Antonio Emilio Ortiz Cobos*, Director General, Corporate Bank, Banorte

Ms. Debra Perry, Financial Specialist, Financial Markets—Latin America, IFC

Moderator: *Ms. Toyin Adeniji*, Syndications Officer, Syndications and International Securities, IFC

4:00 p.m.–5:00 p.m.

Speakers: *Mr. Georg D. Braune*, Senior Vice President, Global Debt, Dresdner Kleinwort Benson

Mr. Dong Liu, Investment Officer, Infrastructure Department, IFC

Mr. François J. Grossas, Principal Syndications Officer, Syndications and International Securities, IFC

Investing in Environmental Projects

Speakers: *Dr. James D. Westfield*, Managing Consultant, PA Consulting Group

Mr. Brooks Browne, President, Environmental Enterprises Assistance Fund

Moderator: *Mr. Louis Boorstin*, Manager, Environmental Markets Group, IFC

Kronospan: Romania and IFC's Regional Strategy

Speakers: *Mr. Christopher Goss*, Principal Investment Officer, *Mr. Georgi Petrov*, Senior Investment Officer, and *Mr. Zahid Yousaf*, Investment Officer, Southern Europe and Central Asia Department, IFC

Moderator: *Mr. J. Michael Swetye*, Principal Syndications Officer, Syndications and International Securities, IFC

List of Attendees

2001 PARTICIPANTS MEETING

June 6–7, 2001

Company	Name	Title
ABB Structured Finance	Mr Glen Matsumoto	Executive Vice President
ABN AMRO Bank	Mr. David Cole	Executive Vice President
ABN AMRO Bank	Mr Frans Cornelissen	Senior Vice President & Head of Country Risk Management
ABN AMRO Bank	Mr Jan van Bilsen	Director, Syndicated Debt
ABN AMRO Bank	Mr. John Neblo	Senior Vice President
ABN AMRO Bank	Mr. Maarten Klessens	Managing Director
ABN AMRO Bank	Mr Ragheed Shanti	Head of Fixed Income Origination
ABN AMRO Bank	Ms. Jill Chen	Vice President
ABN AMRO Bank	Mr. Juan Martin	Vice President and Director
ABN AMRO Bank	Mr. Rui Silva	Group Vice President and Director
Alliance Capital Management Corporation	Mr. Joel Serebransky	Senior Vice President
Allstate Insurance Company	Mr. Ronald Mendel	Senior Portfolio Manager
ANZ Investment Bank	Mr. Chris J. Vermont	Global Head
Arab Banking Corporation	Mr. Lamine Djilani	Assistant General Manager
Banca Nazionale del Lavoro	Mr. Marino Cucca	Deputy General Manager, Head of Corporate & Structured Finance

Banca Nazionale del Lavoro	Mr. Robert Lisi	Vice President
Banco Atlantico, S A	Mr. Jose Miguel Arigita	Commercial Officer
Banco Espirito Santo	Ms. Cristina Ferreira	Vice President
Banco Santander Central Hispano	Mr. Jose Yepez	Vice President
Banco Santander Central Hispano	Mr. Manuel Bramao	Senior Vice President and Head
Banco Santander Central Hispano	Ms. Gema Sacristan	Assistant Vice President
Banco Santander Central Hispano	Mr. Mark Tristant	Vice President (Investment Securities Inc.)
BANESTO	Mr Fernando Malillos	Director
BANESTO	Mr. Javier Rodriguez	Head
BANESTO	Mr. Luis Basagoiti	Executive Vice President and General Manager
Bank Austria AG	Mr. Ingo Bleier	Manager/Head of the Syndications Team
Bank of America	Ms. Audrey Zuck	Vice President
Bank of America Securities LLC	Ms. Anne Predieri	Managing Director
Bank of Tokyo-Mitsubishi, Ltd	Mr Atsumasa Tochisako	Chief Representative
Bank of Tokyo-Mitsubishi, Ltd.	Mr. Hiroshi Azuma	Vice President
Bank of Tokyo-Mitsubishi, Ltd	Mr. Michihiro Enomoto	Vice President
Bank of Tokyo-Mitsubishi, Ltd	Mr. Shinichi Hongo	SVP & Manager
Bankgesellschaft Berlin	Mr. Herc van Wyk	Director
Banque et Caisse d'Epargne de l'Etat Luxembourg	Mr. Guy Seyler	Senior Vice President & Head
Banque Generale du Luxembourg	Mr. Anthony Smith-Meyer	Head of Structured Finance
Banque Generale du Luxembourg	Mr Michele Liebermann	Credit Manager
Barclays Capital	Mr. Arturo Girona	Director
Barclays Capital	Mr Jonathan de la Pasture	Associate Director

Bayerische Landesbank Girozentrale	Mr. Dietmar Rieg	Vice President & Manager
BBVA	Mr. Erich Michel	Vice President
BBVA	Mr Marco Achón	Vice President
BLB International Co.	Mr. Brieuc Le Bigre	President
BNP Paribas	Mr William El Karak	Project Manager
BNP Paribas	Ms Agnes Michel	Head of Multilaterals and Debt Conversion
Caisse Nationale des Caisses d'Epargne	Mr. Yves Kodderitzsche	Director
Caixa Geral de Depositos	Mr Dale Prusinowski	General Manager
Caja Madrid	Ms. Ana Rios	Manager, International Financial Institutions
Caja Madrid	Ms Maria Arenal Bello	Manager, International Financial Institutions Investment Banking
Caja Madrid	Ms. Soledad Romero	Head
CDC IXIS (Caisse des Depots et Consignations)	Ms. Celine Scemama	Vice President
CIC Credit Industriel et Commercial	Mr Lionel Walter	Head of Group
CIC Credit Industriel et Commercial	Mr. Mark Palin	Vice President
Citibank	Ms Selma Storm	Manager
Citibank and Salomon Smith Barney	Mr. John Gilliland	Managing Director
Citibank and Salomon Smith Barney	Mr. Tony Boon	Managing Director
Citigroup Investments Inc	Ms. Denise Duffee	Vice President
Citigroup Investments Inc.	Ms Pamela Westmoreland	Vice President
Credit Agricole Indosuez	Mr Henri de Courtivron	Executive Director
Credit Agricole Indosuez	Mr. Jean-Francois Grandchamp des Raux	Head of Project Finance
Credit Agricole Indosuez	Mr. Patrick Blanchard	Global Head
Credit Agricole Indosuez	Mr. Patrick de Chocqueuse	Managing Director Supranational Institutions

Credit Lyonnais	Mr. Laurent Garaffini	Head of Multisourced Export Finance & Multilateral Cofinancing
Credit Lyonnais	Ms. Karine Legeret	Head of Multilateral Cofinancing-DFS/FI
Credit Suisse First Boston Corporation	Mr Takashi Miyake	Director
Dai-Ichi Kangyo Bank, Ltd.	Mr. Christopher O'Gorman	Assistant General Manager/Head of Project Finance
Dai-Ichi Kangyo Bank, Ltd	Mr. Katsuya Noto	Vice President
Dai-Ichi Kangyo Bank, Ltd.	Mr. Tohru Tonoike	General Manager
Dai-Ichi Kangyo Bank, Ltd.	Mr. Tsunehisa Suita	Deputy General Manager
Darby Overseas Investments, Ltd.	Mr. Robert Graffam	Managing Director
DEG - German Investment and Development Company	Mr. Rolf Grunwald	First Vice President
Delphos International	Mr. William Delphos	Managing Director
Den Norske Bank	Mr. Erik Hammer	Senior Vice President & Head
Deutsche Bank	Dr Dagmar Linder	Relationship Manager
Deutsche VerkehrsBank AG	Dr Christoph Tomas	Vice President
DEXIA	Mr Tim Ononiwu	Vice President
DEXIA	Ms Charlotte Lavit d'Hautefort	Vice President
DEXIA/World Business Inc	Mr Philippe Nouvel	Senior Adviser
Dresdner Bank Lateinamerika AG	Mr Rolf Tessmer	Manager
Dresdner Bank Lateinamerika AG	Ms Stefanie Kuehl	Assistant Manager
Dresdner Bank Luxembourg S.A	Mr. Peter Wanken	Managing Director/Deputy Head Syndications
Dresdner Kleinwort Benson	Dr. Luc Grillet	Head Project Finance

Dresdner Kleinwort Benson	Mr Jon Boles	Regional Head
Embassy of Canada	Mr Stephane Charbonneau	Director
Embassy of France	Mr. Serge Couvreur	Economic & Commercial Counsellor
Erste Bank	Mr Johann Breit	Vice President
European Bank for Reconstruction and Development (EBRD)	Mr. Lorenz Jorgensen	Director, Head of Syndications
First Union Bank	Ms. Nancy Tuomey	Director
Fitch	Mr. Gregory Kabance	Senior Director
Fitch	Ms. Sheila Robinson	Senior Director
FMO	Mr. Klaas Bleeker	Head of Syndications
FMO	Ms. Lidwien Schils	Manager
FMO	Ms. Michele Klaassens	Attorney
Fortis Bank	Mr. Pierre Ceyssens	Manager
Fortis Bank	Ms Vera Reusens	Senior Manager, Global Export and Project Finance
Fuji Bank, Ltd.	Mr. Hitoshi Sejima	Senior Vice President & DGM
Fuji Bank, Ltd	Mr. Tsukasa Takasawa	Vice President & Senior Team Leader
Fuji Bank, Ltd.	Mr. Yasuji Ikawa	General Manager
Fuji Bank, Ltd.	Ms Kanae Iomori	Vice President
HELABA - Landesbank Hessen-Thuringen	Mr. Ulrich Paehler	Senior Vice President & Head
HSBC Securities (USA) Inc.	Mr. Jeffrey Diehl	Managing Director
HSBC Securities (USA) Inc.	Ms. Christine Drury	
HVB Group	Dr. Martin Wuerth	Director
IFPT Management Inc.	Mr. David Creighton	Managing Partner
IFPT Management Inc.	Mr. Oton Tony Iskarpatyoti	Vice President
IFU (The Industrialization Fund for Developing Countries)	Mr. Jorgen Dan Jensen	Deputy Managing Director

IFU (The Industrialization Fund for Developing Countries)	Mr. Jose Ruisanchez	Senior Advisor
IKB Deutsche Industriebank AG	Dr. Frank Schaum	Head of Structured Finance
IKB Deutsche Industriebank AG	Mr. Sy Rotter	IKB Washington Representative
Industrial Bank of Japan, Ltd.	Mr Koichi Hasegawa	Senior Vice President
Industrial Bank of Japan, Ltd.	Mr. Eric Richstein	Consultant
Industrial Bank of Japan, Ltd.	Mr Toshihiko Matsumoto	Senior Vice President/ Division Head
InfrastructureWorld com	Mr Matthew Bauer	Vice President
ING Barings	Mr. Raul Vidal	Vice President
ING Bank	Ms. Elizabeth Wen	Assistant Director/Head, Transactions & Risk Mitigation
ING Barings	Ms. Michele Mangan	Director
Institute of International Finance, Inc	Ms. Joan Kerrigan	Policy Advisor
Institute of International Finance, Inc.	Ms. Sabine Miltner	Deputy Director
Inter-American Development Bank	Mr. Kevin Corrigan	Head, Syndications
Japan Bank for International Cooperation	Mr. Katsuhiko Okazaki	Senior Representative
Japan Bank for International Cooperation	Mr. Takashi Nakamura	Senior Representative
Japan Bank for International Cooperation	Mr. Yo Kikuchi	Representative
JP Morgan Chase	Mr. Fred Schriever III	Associate
JP Morgan Chase	Mr Sergio Saichin	Vice President
JP Morgan Chase	Ms Leigh Paschall	Vice President
JP Morgan Chase	Ms Marguerite Gill	Vice President
Kreditanstalt fur Wiederaufbau	Mr. Holger Apel	Vice President
Landesbank Rheinland-Pfalz	Dr. Herbert Geist	Vice President
Landesbank Schleswig-Holstein	Mr. Klaus-Volker Lenk	Senior Vice President
Lazard Freres and Co. LLC	Mr Ivan Nedds	Vice President
Lyonnaise de Banque	Mr. Spiros Petrou	Head of Syndications
Mediocredito Centrale	Mr. Alessandro Castellano	Managing Director

MIGA (Multilateral Investment Guarantee Agency)	Mr. Peter Jones	Manager
MIGA (Multilateral Investment Guarantee Agency)	Mr Roger Pruneau	Vice President
Mitsubishi International Corporation	Mr Yasuyuki Sugiura	General Manager
Mitsui & Co. (U S.A), Inc.	Mr Bill Bell	International Project Manager
Moody's Investors Service	Ms Maria Muller	Assistant Vice President, Analyst
Moody's Investors Service	Ms. Susan Knapp	Vice President, Senior Credit Officer
Natexis Banques Populaires	Mr. Franck Gault	Vice President
Natexis Banques Populaires	Mr Marc Forissier	Head of Multilateral Institutions
New York Life International	Mr. Jaijit Kumar	Associate
Nord/LB Norddeutsche Landesbank Girozentrale	Mr Bruno Mejean	Senior Vice President
Nordea	Mr. Chip Carstensen	Vice President, Structured Finance
Nordea	Mr. Henrik Brink	Vice President
Orrick, Herrington & Sutcliffe LLP	Ms. Marie-Anne Birken	Partner
Project Finance International	Ms Nicole Gelinas	Latin American Editor
PROPARCO	Mr. Laurent Demey	Senior Investment Officer
PROPARCO	Ms. Nathalie Mignon-Leboucher	Head
PROPARCO	Ms. Stéphanie Leydier	Investment Officer
Provident Investment Management, LLC	Ms. Regina Kane	Senior Investment Officer
Prudential Capital Group	Mr David Nguyen	Associate
Rabobank International	Mr. Inge Skjelfjord	Representative
Rabobank International	Mr. Mark Northway	Executive Director
Rabobank International	Mr. Shafik Gabr	Senior Vice President

RZB Austria	Mr. Heinz Hoedl	Executive Vice President & Head
RZB Finance LLC	Mr. F Dieter Beintrexler	President
RZB Finance LLC	Mr Josef Thullner	Vice President
RZB Finance LLC	Ms. Astrid Wilke	Vice President
Sampo Bank	Mr Jukka Hakkila	Senior Vice President
Sanpaolo IMI Bank	Mr. Alessandro Ermolli	Head
Sanpaolo IMI Bank	Ms. Ilaria Carnevali	Account Officer
Sanwa Bank	Mr. Eiji Nakatani	Vice President
Sanwa International plc	Mr Charles Gundy	Senior Vice President
Sanwa International plc	Mr. Katsuya Tsuboi	Senior Vice President
Scotiabank	Ms Teresa Lee	Senior Manager
Societe Generale	Mr. Laurent Chabot	Director
Societe Generale	Ms. Maria Rosa Garcia Otero	Director
Sovereign Risk Insurance Ltd	Mr Price Lowenstein	President & Chief Executive Officer
Sovereign Risk Insurance Ltd	Ms. Nila Davda	Vice President and Senior Underwriting Officer
Standard & Poor's	Mr Larry Hays	Director, Sovereign Ratings
Standard & Poor's	Ms Rosario Buendia	Managing Director
Standard Chartered Bank	Mr. Gordon Hough	Senior Vice President
Standard Chartered Bank	Mr. Manuel Aravalo	Head
Standard Chartered Bank	Mr Raghunandan Menon	Senior Vice President, Head of Network Banking & Structured Trade
Standard Chartered Bank	Mr. Vibhuti Sharma	Vice President
State Bank of India	Mr. Om Bhatt	Representative
Sumitomo Mitsui Banking Corporation (SMBC)	Mr. William Ginn	Joint General Manager

Sumitomo Mitsui Banking Corporation (SMBC)	Mr. David Gardner	Head
Sumitomo Mitsui Banking Corporation (SMBC)	Mr Yoshio Ogino	Vice President
Swedbank	Mr. Per-Olof Uppeke	Vice President, Project Manager
Taylor-DeJongh, Inc	Mr. Frank Langhammer	Executive Vice President
Taylor-DeJongh, Inc.	Mr. Richard Parry	Executive Vice President
TIAA - CREF	Ms. Niamh Fitzgerald	Managing Director
Transamerica Leasing Inc.	Mr. Michael Cunningham	Vice President
Transamerica Leasing Inc.	Ms. Lori Kielty	Director of Marketing
Vereins- und Westbank AG	Mr. Rudiger Jester	Vice President, International Division
WestLB	Dr Manfred Knoll	Managing Director, Head of Structured Finance
WestLB	Mr. Foster Deibert	Vice President
WestLB	Ms. Carla Jakoby	Regional Head
Zurich Emerging Markets Solutions (ZEMS)	Mr. Daniel Riordan	Executive Vice President and Managing Director

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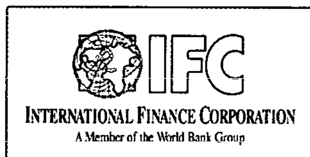

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