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The Developmental Role of the International Finance Corporation

By D. L. Khairallah

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I. Introduction

The International Finance Corporation (IFC) (the Corporation) is an international organization created in 1956 by treaty (Articles of Agreement) among its member countries.[1] Its principal purpose is to further economic development in member countries by investing

1. As of September 30, 1995, 168 countries had become members of IFC.

in productive private enterprises.[2] While an affiliate of the World Bank, IFC is an independent legal entity capable of bringing suit and being sued. It has its own funds and staff.

IFC has certain privileges and immunities corresponding to those of the World Bank. According to its Articles of Agreement, property and assets of the Corporation are immune from confiscation, expropriation or any other form of seizure by executive or legislative action. Its assets wheresoever located are immune from all forms of attachment or execution before the delivery of a final judgment against the Corporation.[3]

The IFC, its assets, property and income, and its operations and transactions authorized by the Articles, are immune from all taxation and from all customs duties.

The Governors, Directors, officers and employees of the Corporation are immune from legal process for acts performed by them in their official capacity, except when the Corporation waives such immunity. The Corporation may waive any of the privileges or immunities conferred on it to such extent and upon such conditions as it may determine. The privileges and immunities set forth in the Articles of Agreement are conferred upon the Corporation and not upon enterprises financed by IFC. Such enterprises do not enjoy any special status by reason of the Corporation's investment.

All the powers of IFC are vested in a Board of Governors. Each Governor of the World Bank, appointed by a member of the World Bank which is also a member of the Corporation, is *ex-officio* a Governor of the Corporation. Under the Articles, the Board of Governors may delegate all its powers to a Board of Directors, except for certain fundamental powers, such as admission of members, increase and decrease of capital, amendment of the Articles of Agreement, etc. The Board of Governors has delegated all of its delegable powers, including operating responsibilities, to the Board of Directors. Thus, the Board of Directors is the basic decision making body of the IFC regarding policy making and approval of investments. Day-to-day operations of the Corporation are conducted by IFC's management.

2. Articles of Agreement of the International Finance Corporation, May 25, 1955, 7U.S.T.2197, 264 U.N.T.S.117 (entered into force July 20, 1956) [hereinafter Articles of Agreement], states: "The purpose of the Corporation is to further economic development by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas, thus supplementing the activities of the International Bank for Reconstruction and Development (hereinafter called the Bank). In carrying out this purpose, the Corporation shall:
(i)in association with private investors, assist in financing the establishment, improvement and expansion of productive private enterprises which would contribute to the development of its member countries by making investments, without guarantee of repayment by the member government concerned, in cases where sufficient private capital is not available on reasonable terms;
(ii)seek to bring together investment opportunities, domestic and foreign private capital, and experienced management; and
(iii)seek to stimulate, and to help create conditions conductive to, the flow of private capital, domestic and foreign, into productive investment in member countries.
The Corporation shall be guided in all its decisions by the provisions of this Article."
3. Articles of Agreement, *supra* note 2, art. VI.

II. IFC's Developmental Role

IFC's particular role is to promote development through the private sector in its member countries. With its limited capital, IFC strives to mobilize and not to displace the resources private institutions are willing to invest. In this respect IFC's operations are guided by the three following principles:

A. The Catalytic Principle

This principle has been embedded in IFC's activities from the beginning of its operations. In financing projects, IFC always assumes a minority role so that the bulk of the funding and also the leadership and management responsibility lie with private parties. As a general rule, IFC limits its contribution to 25% of the total cost of a project. This percentage may be exceeded in very special cases.

While conditions vary from one project to another and from one country to another, IFC will limit financing for its own account (whether loan or equity) to the minimum amount that is required to secure satisfactory financing for the project from risk-taking sources. In recent times, IFC has made a considerable effort to intensify its catalytic role. Since the mid-1980's the ratio of IFC's funding to other funding increased from about 1:4 to more than 1:6 on average, especially in Latin America. Mobilization of other sources of funds is both direct (i.e., through participation in IFC loans and underwriting securities issues) and indirect through parallel co-financing by other parties.

B. The Business Partnership Principle

The second developmental principle is that IFC should act as partner of private investors, sharing the risks of investment. IFC's Articles prohibit it from accepting repayment guarantees from a member government.[4] The business partnership principle requires that funds be invested under market disciplines, because funds which are subject to full commercial risk are more likely to be efficiently used. Although its primary goal is not profit but development, IFC does not believe that profitability should be seen as conflicting with its developmental objective but rather as an essential criterion without which development cannot occur. Furthermore, IFC's record as a profit making corporation encourages other private investors to provide financing and promotes IFC's catalytic role. Profits, however, must not be earned by reliance on protection or subsidies or other market distortions. IFC will not invest in projects which are not competitive and beneficial to the national economy of the member country concerned.

C. The Additionality Principle

IFC's Articles provide that "The Corporation shall not undertake any financing for which in its opinion sufficient private capital could be obtained on reasonable terms".[5] The general principle, which lies behind this provision in the Articles, is whenever IFC participates in a project, it should be to support the private sector and not to substitute for it,

4. *Supra* note 2, art, I.
5. Articles of Agreement, *supra* note 2, art III, § (i).

making a special contribution which adds to or complements the role of market operations. This contribution by IFC may take various forms. The general point, is the IFC, as a business partner, must play a special role and not merely duplicate what other private parties can do and are willing to do. An essential role for IFC is to assist its partners, at the stage of project appraisal, to measure and manage risk so as to enable projects to proceed which, absent IFC, would either be marginal or would not go forward.

III. Coordination with World Bank on Private Sector Development

As a member of the World Bank Group, IFC shares with IBRD the same fundamental objective of fostering development of its member countries. The two institutions coordinate their overall investment objectives to ensure the effective employment of the World Bank Group's finite financial resources.

Operational interaction between IBRD and IFC in private sector development takes place primarily in four areas:

A. Direct lending to the Private Sector

Generally, IFC will be the preferred vehicle for lending to projects that can be appropriately financed on market terms without government financing or a guarantee. The World Bank lending would be judicated where the scale of operations is such that IFC financing, coupled with other mobilized funds would not be sufficient and the member government is prepared to provide the required loan guarantee. In the latter case the Bank may proceed with or without IFC.

B. Financial Sector Development

It is in the domestic financial sector that the activities of the World Bank and IFC are most closely inter-linked. The World Bank will usually take the lead on initiatives emphasizing financial sector reforms while IFC will take the lead on specific advisory and institution-building efforts. Advice on the creation of specialized financial institutions or the development of securities markets is an example.

C. Lending through Financial Intermediaries

Where financial support and institutional advice can be provided without major governmental involvement, IFC plays the lead role. When success is dependent on significant policy changes, IBRD would be expected to play the lead role.

D. Privatization

Both the Bank and IFC have a significant role to play in the privatization process. Generally, the Bank provides advice on broad policy aspects, strategic and institutional issues of privatization and on the design of privatization programs. IFC, on the other hand, deploys its investment experience and knowledge of local conditions in structuring and advising on specific privatization transactions.

IV. Eligibility for IFC Investment

A. Eligibility of Countries

Decisions as to which countries IFC can invest in are governed by the following criteria:

1. The country where the project will have its principal economic impact must be a member of IFC.

2. Normally, the member country recipient of the IFC investment[6] must be a developing country. However, IFC can invest in enterprises located or incorporated in developed countries, provided that the benefits of the investment will accrue predominantly in a developing member country or countries.

3. Because IFC is a multilateral development institution, it is prepared to operate in countries where foreign investors may be unwilling to make investments. However, IFC will not invest in situations where overall economic conditions and the financial and legal environment are such that the project is unlikely to succeed. In making an investment decision, the Corporation takes into account the economic circumstances in the country concerned and the policies of the government as they affect private enterprises, including the recipient of the proposed IFC investment. Particular attention is given to policies relating to protection, the foreign exchange and trade regimes, the exchange rate, price controls, taxation, the direction and pace of economic liberalization and the protection of private ownership. IFC will not proceed with an investment where economic circumstances or the policies of the host government are likely to place the servicing or the recovery of its investment at significant risk.

4. IFC will invest only in countries where the Corporation's privileges and immunities referred to above have been made effective under the laws of the investee country.

B. Eligibility of Enterprises

IFC invests in productive private enterprises. Selected proposals must meet the basic tests associated with IFC's role; that is, the investments must, on the basis of careful analysis and judgment, be likely to earn a satisfactory return and be of benefit to the economy of the country. Besides these general criteria, the following considerations apply to the Corporation's investments:

1. *Member Government's Right to Object*

The Articles of Agreement provide that "the Corporation shall not finance an enterprise in the territories of any member if the member objects to such financing."[7]

6. The term "IFC investment" is used to designate loans, guarantees, equity and quasi-equity investments as well as underwritings and intermediation of financial risk management instruments (swaps, options, etc.) activities.
7. *See* Articles of Agreement, *supra* note 2, art. III, § 3(ii).

Accordingly, before any investment is approved, the member government concerned must be advised of the proposed investment and given an opportunity to object.

2. *Private Ownership*

IFC normally invests in enterprises which are privately owned and managed. However, some element of public ownership does not, in itself, disqualify an enterprise from consideration for an IFC investment. Participation in the ownership of an enterprise by the government of the host country, whether directly or through government-controlled agencies, can be accepted where this is necessary in the circumstances of the country concerned, provided that the investment is satisfactory in other respects and provided further that the enterprise is subject to normal commercial and corporate law and operates without close governmental control. Situations in which IFC might consider financing enterprises with significant ownership or participation by the host government include:

a. Financial institutions which act as vehicles to reach local private entrepreneurs, especially in the small and medium-scale enterprise sector;

b. Enterprises being privatized, in which governments would clearly wish to see more active private sector involvement in ownership and control, but where private investors able and willing to participate cannot be found immediately; and

c. Joint ventures between governments and foreign investors, located in countries where the local private sector is not able to provide capital for the venture and where one or both of the parties wish to have IFC's presence as a confidence-enhancing factor in dealing with the other.

3. *Local Participation*

Companies in which IFC invests should preferably include local participation in the shareholding. There is no general rule as to the appropriate balance between local and foreign shareholders. IFC invests frequently in enterprises fully owned by local shareholders. Wherever possible, IFC avoids investing alongside foreign shareholders only; but if no local shareholder can be found, full foreign ownership can be accepted if the investment is otherwise satisfactory and has economic importance for the host country.

4. *Sectors*

IFC may invest in enterprises in any activity, including agriculture, manufacturing, infrastructure, extractive industries, energy, tourism and other service industries, as long as the investment will be of benefit to the economy of the host country. As a general rule, IFC will not finance the production of alcoholic beverages and tobacco products, the manufacture of arms, the entertainment or gaming industry or real estate development.

5. *Legal Form and Internal Control*

Enterprises in which IFC invests must be in satisfactory legal form and have adequate

accounting and cost control arrangements. When the Corporation invests in equity, IFC must have limited liability, and the preference is for legal entities structured in such a manner as to facilitate divestment. In the case of a loan investment, IFC requires that the life of the investee enterprise exceed that of the loan by a prudent margin of safety. Prior to investing, the Corporation reviews in depth the accounting and cost control systems which the investee company has in place or, in the case of new ventures, proposes to install. It will invest only where these systems meet its standards of quality and where the investee company agrees to having its accounts audited annually by independent accountants acceptable to the Corporation, and to give IFC access to its books and accounts.

V. Project and Corporate Finance

Most of IFC's work focuses on *project finance* - where the lender looks to the project's cash flows to repay the debt, and to the project's assets for security. It is also known as "structured financing" because it requires structuring the debt and equity such that the project's cash flows are adequate to service the debt. Often the riskier the project's cash flows, the more equity is required.

Project sponsors (equity holders) seek project finance because it means the project can be funded off their balance sheet. Self-standing projects, with no guarantees given by the sponsors (or government) to lenders for the project, are known as *non-recourse.* In practice most projects have limited recourse financing, where sponsors commit to provide contingent financial support above their up-front equity commitment, to give lenders extra comfort. The focus is usually on the construction and startup period, which is generally the riskiest time in the life of projects. For example, a sponsor might undertake to finance cost overruns during construction until the project passes specific operating and financial completion tests.

In some projects, *government agencies* purchase a project's output directly. Lenders therefore look to both sponsors and the government to provide credit enhancement. Thus, in addition to sponsors covering traditional project risks such as cost overruns, lenders might require a take-or-pay contract from the state-owned agency purchasing the project's output, or government assurances of compensation if future changes in government policy affect its viability.

With *corporate financing,* although finance may be ostensibly provided for a project, lenders look to the cash flow and assets of the whole company to service the debt and provide security. Key elements include the existence and quality of a company's financial track record, the viability of its expansion plans and country conditions.

In fiscal year 1994, IFC approved 52 projects in 13 countries in Latin America and the Caribbean. By June 30, 1994, the Corporation's committed portfolio included loans and investments for 261 companies in 24 countries.

VI. Investment Criteria

Most of the Corporation's investments involve the financing of specific projects or investment programs, either for the establishment of new productive enterprises or the expansion or rehabilitation of existing ones. IFC also provides financing and advice for corporate development and restructuring programs with a view to strengthening the overall productive base or financial structure of the enterprise.

A. Profitability and Developmental Impact

The Corporation needs to be satisfied from an economic standpoint that the project possesses sufficient comparative advantages to have a good chance of success. In assessing a proposal, IFC verifies that project concept, technology, sponsors and management are sound; that a market exists for the project's products or services; and that the project cost is reasonable and the financing plan adequate. The project must have good prospects of meeting all its financial obligations and generating adequate surpluses to sustain its long-term viability. Its financial merits should be demonstrated by quantitative analysis of the projected cost structure, operating and financial results, and other key data.

IFC considers investments only in enterprises and projects that contribute to the economic development of its developing member countries. Such projects are usually found in sectors and industries where because of location, availability of raw materials, size of market and availability of labor at competitive rates, production can occur at cost levels which are comparable to the delivered cost of similar products from efficient producers worldwide.

In addition to the qualitative aspects of a project's contribution to a borrowing member country's developmental objectives, it is necessary to ensure that an enterprise financed by IFC meets minimum standards of efficiency as measured by the economic rate of return, the financial rate of return and other relevant indicators. Projects financed by IFC must also generate satisfactory economic rates of return which are calculated by adjusting for the effects of distortions on market prices, and valuing project costs and benefits at economic or opportunity costs to the economy. Financial profitability is a requisite of IFC's going forward with private sector investment, but is not in itself an adequate indicator of a project's efficiency. Thus, IFC does not invest in projects that are dependent for their financial viability, on subsidies or protection.

Where IFC invests in projects or companies that have substantial or majority (and on occasion 100 per cent) foreign ownership, it is also necessary to determine that the project is not only efficient, but also that adequate economic benefits are retained within the economy, after foreign capital flows (both debt and equity) have been accounted for.

B. Environmental Considerations

Assessment of environmental impact is an integral part of IFC's project processing cycle. As part of the World Bank Group, IFC's policy is that all operations be carried out in an environmentally sound manner and that projects meet the highest environmental standards. Compliance with such standards would also serve to limit potential liability of the project company and its shareholders for claims arising out of environmental issues.

All projects undergo an environmental assessment process to ensure that they are fully consistent with the appropriate World Bank guidelines and standards.

The environmental assessment process is designed to ensure that:

(i) an environmental due diligence is applied to each investment project;
(ii) environmental issues are addressed early enough in the project cycle to consider technology and site alternatives, mitigation measures and efficiency improvements;
(iii) there is adequate public participation and disclosure of environmental information; and
(iv) all significant environmental issues must be satisfactorily addressed prior to Board decision.

The five steps of the environmental review process are: project screening, issuance of environmental information requirements, environmental review, consultation and disclosure, and project supervision.

C. FOREIGN EXCHANGE

1. *Repatriation Rights*

IFC invests only when it is satisfied that appropriate arrangements exist for repatriation of debt service, dividends, equity capital and capital gains. In cases where a country's laws or practices do not provide adequate protection in this area, IFC seeks special undertakings, of the type frequently obtained by private investors, from the member government concerned.

2. *Off-Shore Retention Rights*

In general, the Corporation seeks to structure its investments without utilizing off-shore retention accounts. However, where the host country has suffered a chronic shortage of foreign exchange and there is a high risk that IFC's and others' investments will not be repatriated in a timely manner, the Corporation may seek to incorporate an off-shore retention account structure as part of the security structure for its investment. The Corporation will usually do this where the project is a net foreign exchange earner. Retention accounts are more likely to be utilized in oil and mining ventures, where a commodity subject to an off-take arrangement or exclusive agency for sales is involved.

D. PROCUREMENT POLICY

The funds provided by IFC may be used for foreign exchange or local currency expenditures, to acquire fixed assets, meet working capital requirements or finance intangible assets.

IFC does not require international competitive bidding on its projects. However, IFC expects all procurement contracts to be negotiated on an arms-length basis, and to be in the best financial interest of the client company as distinguished from the sponsor. Where a shareholder of the project company is also a major contractor, the Corporation will be especially vigilant to ensure that the costs incurred by the company are fully in line with the market.

VII. Investment Types and Limits

IFC offers a wide array of financial products which fall into four broad categories: (i) equity and quasi-equity investments; (ii) long term loans; (iii) financial risk management instruments; and (iv) guarantees of investments made by third parties. The terms and conditions of IFC's investments depend on the risks and prospective returns of the venture, as well as on the characteristics of the investment vehicle.

A. EQUITY AND QUASI-EQUITY INVESTMENTS

IFC's ability to provide risk capital sets IFC apart from most other international finan-

cial institutions and is a key element in its role. IFC's equity investment enables IFC to play a stronger financial role, by bringing in other investors with capital or technical know-how, thus facilitating the coming together of major investors and playing the role of a catalyst in promoting new activities and new investment ideas.

IFC's equity investments take a variety of forms including: (a) ordinary or preference shares. In most instances these instruments are denominated in local currency and, consequently, involve foreign exchange risk for the Corporation; (b) underwriting of share issues by client companies, including country funds.

The Corporation also makes quasi-equity investments which range from subordinated loans and income notes (denominated in a convertible currency) to redeemable preferred shares. Quasi-equity instruments are particularly useful where the absence of an organized capital market would hinder the sale of equity investments, or where the foreign exchange risk involved in a straight equity instrument would be excessive.

By making equity investments, IFC assumes responsibility of ownership, but is constitutionally prevented from assuming responsibility for management of companies in which it invests. It may, however, exercise an oversight or a support role by nominating a member of the Board of Directors; where there is a clear need for assistance by IFC.

IFC is enjoined by its Articles to revolve its funds. Thus, the Corporation typically sells its equity interest as soon as the investment has matured. Where the prospects for divestment of its equity investment are dim, however, IFC resorts to redeemable quasi-equity instruments or put agreements.

B. LOANS

1. *Main Lending Instruments*

In most cases IFC makes senior loans. As a general rule IFC's loans must rank on a par, regarding security and debt service, with other senior loans. The Corporation may, however, make subordinated loans to enterprises meeting its investment criteria, but unable to raise sufficient equity capital for their projects. This option is considered mainly where IFC straight equity investment is not feasible or advisable. Subordinated loans are usually priced to reflect the higher risk they entail compared with senior loans, unless they have conversion features or profit participation with upside potential. There is no standard set of subordination provisions; loans may be subordinated on current basis or only in liquidation, or both.

2. *Loan Types*

IFC offers variable rate loans (carrying interest rate set in terms of a spread over the six-month London Interbank Offered Rate (LIBOR) for the relevant currency). It also offers fixed rate loans denominated in U.S. dollars, deutsche marks, French francs, Japanese yen, pounds sterling and Swiss francs. IFC may make stand-by loans, usually where use of funds is expected in later years following utilization of first tranche loans. Such loans are approved with deferment of currency or rate option and carry an availability fee of 1/4% p.a., charged in U.S. dollars, until currency and rate basis are chosen.

3. *Loan Options*

Options available to the borrower are: the choice from among various convertible currencies, of interest rate basis (e.g., fixed or floating), of deferred rate setting, of currency conversion features, and of interest rate caps and collars. The borrower alone must take the responsibility for the choice of financing. IFC offers a once-only conversion option from a variable to fixed interest rate, provided that the appropriate hedge can be obtained in the marketplace. The variable rate loan borrower may also exercise a one-time option to change the currency denomination of the loan, provided the Corporation is able to arrange funding on the proposed loan conversion date.

4. *Lending Decisions*

In making a loan, IFC gives great importance to the creditworthiness of the borrower; reliance on security, guarantees and financial support agreements are of secondary importance relative to the borrower's ability to service the loan. The main consideration is the adequacy of projected cash flows to meet the financial obligations with a reasonable margin of safety.

With respect to pricing the loan, interest rates are set with reference to the macro-economic risk in the country, the commercial risk of the project, the creditworthiness of the borrower and, wherever possible, the terms available from alternate market-sources.

As to maturities and prepayment, IFC loans are generally for terms of 7 to 12 years with a grace period appropriate to the project's needs. The loans that are not convertible into equity are prepayable. The variable rate loans are prepaid without charge; while prepayment of fixed rate loans entail a premium to compensate IFC for the cost of redeploying prepaid funds.

5. *Financial Fees*

IFC charges commitment fees of 1% p.a. on undisbursed balance of all fixed rate loans and a 1/2% p.a. for variable rate loans. It also charges typically 1% front-end fee on both fixed and variable rate loans. This fee partially compensates IFC for costs associated with loan processing and other fees are charged on a case-by-case basis.

6. *Loan Security*

In making a senior loan to a specific project vehicle, IFC, as a rule, seeks security interest in fixed assets or a guarantee adequate to cover its loan exposure. Only where establishing physical security is not practical or legally feasible is the Corporation prepared to rely on "negative pledge". Where co-lenders have requested security on the project assets, IFC accepts to share security with co-lenders on a *pari-passu* basis through security sharing agreements. But where the co-lenders have requested non-project related security, or a third-party guarantee, the Corporation may seek a compensating enhancement of its security interest in the project. However, IFC does not seek specific security against political risk.

VIII. Guarantees by IFC

Guarantees are special purpose instruments which give IFC flexibility to respond to private sector needs that could not be met with direct IFC equity or loan investments. IFC provides several types of guarantees:

(i) Guarantees for debt instruments which cover debt service for loans, bond issues, commercial papers facilities or revolving credits; and

(ii) Guarantees for trade obligations involving non-lending situations to back-up a client's performance (e.g., guarantees of bids and performance bonds).

IFC guarantees typically cover commercial, as well as non-commercial risks, and projects involving IFC guarantees are appraised, processed and supervised in the same manner as those involving direct investments. The beneficiaries of IFC debt guarantees may be local or foreign financial institutions, commercial firms or individual investors.

The risks and costs of providing guarantees are largely the same as for loans; consequently, the spread over IFC's cost of funds for loan financing is used as a guideline in setting guarantee fees. However, guarantee pricing will also be influenced by the risks covered, maturity and extent of coverage.

Guarantee fees are payable in one of IFC's standard lending currencies even when guaranteed amount is in local currency. The exchange rate on due date usually applies.

The guarantee documentation usually provides that if IFC pays out under the guarantee, it will acquire a claim on the borrower in one of its major lending currencies, bearing interest at the then-prevailing rate regardless of original currency and terms of the debt. The documentation also provides IFC with the right, upon guarantee call, either to pay the overdue amount or to prepay the whole loan. Finally, the policy on repatriation rights and security also apply to loan guarantees.

IX. Loan Syndication

Loan syndications enable the Corporation to mobilize funds otherwise not available to the borrower. They also help diversify the sources of funding and are an important aspect of the Corporation's catalytic role, as they enable it to assist companies with relatively large investment projects to access international financial markets.

Syndications involve arrangements whereby banks and other financial institutions are offered participations in an IFC loan, with the former taking the same risk as IFC on a *pari-passu* basis. IFC, under this arrangement, remains the lender of record and enters into non-recourse participation agreements with participating banks and, in most cases, manages the syndicaton. IFC identifies prospective participants based on its experience in the market and the borrower's relationship with certain banks.

As the lender of record, IFC administers the loan. In general, IFC seeks as much administrative independence as possible, but in a manner that is consistent with its fiduciary duties to the participants and its contractual obligations to the borrower. While it would not waive a condition of disbursement without a participant's consent, IFC would consult with participants with respect to the course of action to be taken subsequent to a material violation of the loan agreement's covenants by the borrower.

When there are participants, the IFC loan agreement normally provides for separate loans. One or more (A Loans) for the account of IFC and one or more for the account of participants (B Loans). The terms and conditions are usually those of Eurocurrency loans. These conditions generally include a floating interest rate frequently tied to the six month London Interbank Offered Rate (LIBOR) for the relevant currency, together with a spread, commitment fee and a front-end fee. IFC charges the borrower syndication fees in line with those prevailing for comparable services in the financial markets concerned (e.g., front-end fees and administration fees). When a partial payment is made on the A and B loans it would be allocated *pro rata* among IFC and the participants including the proceeds of security for the loans. Participants, otherwise, have no recourse to IFC.

Because of the tax immunity conferred on IFC by its member countries in its Articles of Agreement, funds remitted by the borrower are not subject to withholding tax. Where IFC's investments, however, include loan participations, it is IFC's practice to obtain confirmation from the government concerned that its immunities also apply to payments representing that portion of its loan which is for the account of participants.

Private sector banks and financial institutions in good standing are eligible for participation in IFC loans, but not government-owned development finance institutions or export credit agencies. The reason is that IFC will not extend its political risk "umbrella" to institutions that are, to a large extent, established for the purpose of assuming political risk.

X. Risk Management Products

In 1990, IFC introduced Risk Management Products (RMP) to enable companies in developing countries to access financial markets through IFC's intermediation for the purpose of hedging financial risks. The full range of RMPs (interest rate and currency swaps, currency options, etc.) as well as advisory services, operate to assist IFC's clients in identifying particular risks, and in selecting appropriate hedging mechanisms to manage such risks.

International markets are generally limited to clients of high credit quality. Most companies in the developing countries are excluded from accessing these markets usually because of the high country-risk hurdle. Because IFC is able to accept both the credit exposure of the client and the country risk, it performs a crucial role as intermediator between these companies and the market for RMPs. The provision of RMP enables IFC to fulfill its developmental role by bridging the gap between the financial markets and IFC clients and by transferring know-how about new financial products.

In order to help companies confront financial risks emanating from currency and interest rate mismatches between assets and liabilities, currency mismatches between cost and revenue streams and exposure to volatile commodity prices, IFC offers instruments to hedge three broad risk categories: (a) interest rate risk; (b) exchange rate risk; and (c) commodity price risk. The instruments offered by IFC to hedge these risks can be divided into three categories: (i) swaps, (ii) forwards (sale and purchase), and (iii) options (sales and purchases, including caps, floors and collars).

XI. Capital Markets Activities

Assistance in the development of the domestic financial sector in developing member countries is an important IFC function, aiming to increase mobilization of domestic savings and improve their allocation to productive investment. While providing advice and technical

assistance for the development of legal and regulatory framework is one of the main services the World Bank provides to developing member countries, IFC provides advice to member countries on regulatory and fiscal policies, designed to encourage the growth of their capital markets including the legal framework required to implement such policies.

IFC fosters capital markets development by supporting local and regional intermediaries to which it provides loan and equity resources. IFC helps channel portfolio investment into emerging markets by promoting country, regional and global investment funds. Finally, IFC helps private issuers of securities based in developing countries to place their offerings in the local and/or international markets. In this capacity IFC plays the role of intermediary between issues, on the one hand, and governmental agencies, institutional investors and market professionals on the other.

A. Financial Intermediaries

The nature of financial intermediaries financed by IFC depends on the needs of the host country. Institutions already financed include: (i) equity finance institutions such as venture capital funds, equity portfolio funds, and debt-to-equity conversion funds; (ii) securities institutions such as brokerage companies and investment/merchant banks; and (iii) financial institutions such as Development Finance Companies (DFC), leasing companies, housing finance companies, and insurance companies.

B. Credit and Agency Lines to Intermediaries

Promoting the development of small and medium sized enterprises in member countries is an important IFC objective. To this end, IFC makes resources available for such enterprises under credit and agency line arrangements with local financial intermediaries. In case of credit lines, the credit risk is borne by the intermediary, which takes the sub-project risk. In case of agency lines, the intermediary channels IFC's funds to the end client for the Corporation's own account for projects satisfying pre-agreed criteria. As part of the agency arrangement, financial intermediaries are required to commit their own funds in parallel with IFC and to supervise the investee company. The selection of the individual projects for IFC's support is delegated to the intermediaries, often subject to review at IFC headquarters.

C. Underwritings

IFC plays an important catalytic role in the underwriting and distribution of both debt and equity securities issued by private sector companies in developing member countries. Once a developing country corporation or fund is ready to come to market, IFC acts as either joint or co-lead underwriter of the offering or as private placement agent. It distributes the underwritten securities to, or privately places the securities with, a very limited number of institutional investors.

XII. Advisory Services

IFC provides a broad range of advisory services to member countries and individual enterprises. This work falls into three general categories:

A. Special advisory services on project structuring and financial packages provided during the appraisal process over and above those performed during investment processing.

B. Transaction oriented financial advisory services provided to member governments, for instance in a privatization context, or to a private sector client. These services include analytical and advisory work done on financial diagnosis, restructuring and packaging of new or existing ventures.

C. Advice to governments on subjects such as Capital Markets development and privatization programs. Foreign Investment Advisory Service (FIAS), a joint venture between IFC and the World Bank, specializes in advising member governments on procedures for the promotion, appraisal and monitoring of foreign direct investments.

For its services, IFC is usually compensated in the form of fees for advisory services rendered. The fees reflect IFC's cost for rendering the services, as well as contribute to IFC's profitability, sometimes through "success" fees.

XIII. Privatization

Whether IFC's client is a government or an enterprise being divested, IFC's comprehensive approach focuses on designing an optimal strategy and on implementing transactions. In assuming its role, IFC assists governments in selecting industries and enterprises that are appropriate for privatization, advise them on the most effective privatization mechanism to adopt and assist them in implementing a model transaction. IFC guides companies through all phases of the privatization process, including forming a corporate vehicle, restructuring, sale of assets and locating foreign strategic partners. For example, the IFC's Privatization and Financial Advisory Group (PFA) advised the Argentine Ministry of Defense in the privatization of Altas Hornos Zapla (AHZ), a steel mill. It assisted in the tender process and marketed AHZ to potential bidders around the world. The contract was awarded to a consortium comprised of an Argentine engineering firm, a French specialty steel maker, and the local subsidiary of an international bank.

XIV. Infrastructure

Increased private investment in infrastructure is today a major, worldwide trend. Many governments are seeking private capital for infrastructure projects which were formerly financed exclusively by the public sector. It is estimated that no less than $2 trillion will be needed during the next ten years to finance infrastructure projects. (Multilateral organizations cannot possibly meet this colossal requirement.)

During fiscal year 1993, the highest proportion of investment inquiries that IFC received was for infrastructure projects, such as telecommunications, power, ports, roads and the like. In July 1992, IFC redeployed assets and staff to support infrastructure projects and set up a separate Infrastructure Department. The Department has three groups staffed by both financial and technical specialists in power, telecommunications, transportation and utilities.

IFC is heavily involved in an extensive program of infrastructure projects in Latin America. In Argentina, IFC approved financing for several infrastructure projects. It will provide a loan and equity financing to Aguas Argentinas, a recently privatized company, to

help finance the initial phase of rehabilitation and expansion of the greater Buenos Aires drinking water and sewerage system. IFC is also helping to finance a project undertaken by Edenor S. A. that will reduce system losses and increase the reliability of the electricity supply for two million customers in the northern half of Buenos Aires.

XV. Some Legal Issues IFC Frequently Encounters

I could not bring this presentation to a conclusion without sharing with this distinguished audience of jurists and bankers IFC's practice with respect to some of the legal issues it encounters. As an international financial institution operating in more than a hundred different jurisdictions representing all major legal systems, IFC is bound to encounter challenges related to the legal and regulatory frameworks of the countries in which it operates. I will limit myself to three areas:

A. Choice of Law and Jurisdiction

In considering a governing law, lawyers in the IFC Legal Department focus on how IFC can enforce its rights effectively, expeditiously and at a reasonable cost - both in tangible (i.e., money) and intangible (i.e., relations with any government concerned, clients and partners) terms. IFC frequently chooses not to include a specific choice of law provision in its loan agreements for the following reasons:

1. Historically its loans were all U.S. dollar loans disbursed and repaid in New York. Therefore, New York Courts would apply New York law if a suit were brought in New York. The same may be said with respect to most jurisdictions which are home of the freely convertible currencies in which IFC lends. In addition, IFC obtains a legal opinion from counsel in the country where the project will be carried out and where the borrower has its assets, to the effect that relevant legal documentations are effective and enforceable under that country's laws.

2. If IFC specified a governing law, it would face the hurdle of proving that law before a judge who can not take judicial notice of such law and who might have no familiarity with it.

3. Having obtained a local counsel's opinion about compatibility and enforceability of relevant investment documentation in the jurisdictions where the borrower has its assets and confirmation that, in the absence of an express choice of law, the judge would apply either local law or a law that would preserve IFC's interests as expressed in its legal documents, there is no need to specify applicable law.

4. The actual circumstances that govern IFC's investments and the legal consequences they generate militate in favor of maintaining maximum flexibility so far as loan documentation is concerned especially that IFC loans are usually secured by mortgages on the borrowers' assets, all of which will be governed by the law of the place where assets are located. Furthermore, when the borrower defaults and an enforcement action is necessary, the borrower is frequently insolvent. In virtually all jurisdictions, local bankruptcy laws are considered to fall in the realm of public policy (ordre public) and will be mandatorily applied.

Other project support documents, such as project support and completion agree-

ments, guarantee and share retention agreements are usually considered separately. Enforceability is again a major consideration in deciding on a choice of law approach. IFC will include an express choice of law provision when the transaction is sophisticated (such as swap and other derivatives) and IFC lawyers are satisfied that the forum will respect the choice of a foreign law. In ancillary documents, such as a parent support agreement, where there is a strong likelihood of an enforcement action taking place in a particular jurisdiction, an express choice of suitable law may be indicated.

With respect to Fora, IFC maintains a flexible posture and usually provides for the choice of a non-exclusive jurisdiction. IFC's Articles of Agreement provide for certain immunities which were referred to previously including limited immunity from jurisdiction, tax immunity and archival immunity. The Corporation expects that such immunities will be respected in its contractual relationships.

B. Security for Loans

As is typical in project finance, security guaranteeing repayment of an IFC loan may take the form of a mortgage on real property, a chattel mortgage or industrial pledge on movables, a floating charge on cash, inventories and other current assets where permitted by law, and/or a pledge of the shares of the project company, usually those of the project's sponsor. In many jurisdictions, especially those that have adopted old French law, a security interest in inventories may not be established, and the concept of a floating charge is not known. The concept of trust, as a legal institution widely practiced in common law jurisdictions, especially in organizing and managing the security interests of the lenders in project finance, is totally unknown to lawyers operating in most civil law jurisdictions. So in designing security for its loans, IFC has to pay careful attention to the legal environment where enforcement is to take place. Frequently establishing security in an escrow account and receipt of proceeds of sale of the borrower's production will be implemented outside the host country.

C. Company Law

Company law plays a crucial role in structuring projects and allocating risks among investors. In collaboration with local counsel, IFC makes sure that the legal vehicle and legal instruments chosen in structuring project finance are compatible with applicable company law. In many civil law jurisdictions, for example, the concept of authorized capital is unknown. Equity capital has to be fully subscribed, if not paid in full. Any capital increase requires the approval of the assembly of shareholders and is valid only after the subscribed capital has been paid in full. An understanding of such rules is crucial where issuance by the project company of stock options or convertible debentures is involved as part of the financial structure of a given project.

Where IFC encounters legal or institutional difficulties that would discourage private investors, it brings the need for change to the attention of the government concerned and if asked, it would help in bringing about the required modifications in the regulatory and institutional framework. IFC's involvement, however, is frequently limited to removal of obstacles that would discourage an investor from participating in project financing in a member country. The World Bank remains the institution that is better equipped to help in advising and implementing major legal reforms. Thus, in addition to its role as investor, IFC carries out its developmental role as a catalyst and institutions builder in the legal area.