Center for Global Development

Why Congress Should Authorize the IFC Capital Increase

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In May 2018, the shareholders of the International Finance Corporation (IFC)—the private sector arm of the World Bank—agreed to increase its paid-in capital by $5.5 billion as part of the $13 billion capital increase for the World Bank Group (WBG). The capital increase is the first since 1992 and would more than triple IFC capital. The US administration agreed to the increase but declined to contribute to the additional capital. But for the increase to take effect, Congress must authorize it. Thus far, it has not done so. Why?

By the numbers alone, this is a great deal for the American people. No new US taxpayer dollars will go to the IFC, but under the terms of the deal the US remains the largest shareholder and the only country with veto power over the most important voting decisions. As with any multilateral financial institution, the capital the US has contributed in the past has been multiplied many times over by other shareholders and translated into much larger financial flows to developing countries: a total cumulative paid-in capital contribution of $569 million by the US has—combined with the capital contributions of other countries and capital additions from IFC retained earnings—supported total cumulative IFC finance commitments of $200 billion.

But some in Congress are asking, Why make the IFC bigger? Is that the most effective use of development capital? Would developing countries be better served by putting the $5.5 billion into the parts of the World Bank that lend to governments rather than the private sector?

The argument for enlarging the IFC rests on three propositions:

- Promoting private investment and job creation is essential for growth and poverty reduction, including in low-income countries. But high risks and market failures prevent the private sector from investing in projects that would accelerate development and poverty reduction. So development finance institutions, like the IFC, are needed to bear and mitigate some of the risk and help clear away investment obstacles. The IFC needs more capital to boost its contribution to funding achievement of the Sustainable Development Goals (SDGs).
- The IFC is changing the way it selects investments to place greater emphasis on development impact, for the direct beneficiaries and for building growing and well-functioning markets.

- The IFC's financing mobilizes significant amounts of private investment—beyond its own commitments—which multiplies the impact of US and other aid dollars and promotes broader growth, jobs, and poverty reduction.

But critics stress that the IFC should change some of the ways it is doing business as part of the capital increase:

- In particular, the IFC is being asked to increase the share of its operations in poor and fragile/conflicted-affected countries. As part of the deal the IFC agreed to increase its commitments in International Development Association (IDA) countries (the world's poorest) and fragile and conflict-affected states (FCS) to 40 percent of its portfolio by FY30. That is a very ambitious goal for an institution that is also instructed by its shareholders to maintains its triple-A rating and profitability.

- Many call for more transparency in IFC operations. When the IFC offers incentives for private investment, it must be fully transparent and accountable for the size of, and rationale for, the subsidies. This is to guard against private sector companies exploiting the IFC to get subsidies that are either too large in relation to the impact/benefit or that are unnecessary because the private sector would have invested without them.

So, do the arguments for enlarging the IFC hold water? And is the IFC willing to adapt to meet these formidable challenges? Let's examine each of the five points above in turn.

1. Should promoting private investment in developing countries be an aid priority?

Development assistance has traditionally focused on increasing public funding for social services and infrastructure. Such spending supports poverty reduction and achievement of the SDGs. But the evidence also suggests that rising labor income is both the essential and most sustainable driver of poverty reduction. As noted in the 2013 World Development Report on jobs, for most countries, changes in labor earnings are the largest contributor to poverty reduction. Especially in low-income countries, there is too little private investment to generate jobs or increased income for the bottom 40 percent of the population. The IFC, working with other parts of the WBG, can play a catalytic role in overcoming investment hurdles—through risk sharing, reducing capital costs in underdeveloped capital markets, supporting new technologies and business models, and clearing away the policy and regulatory obstacles to market development. But why does it need more money? To do this effectively, the IFC must have enough capital to expand its operations beyond safe markets to more difficult environments and sectors, and it must stretch its risk tolerance in all markets.

2. Does the IFC prioritize development impact in its investment decisions?

Judging development impact is not easy, even in traditional development areas like health and education. It is even more difficult for interventions in the private sector. Impact has many dimensions and requires a lot of data gathering both before investment decisions are made and after investment execution. There are lots of questions about how much impact can be attributed to a given investment, and measuring the impact of a series of transactions on market development is even more complex. In fact, just a few years ago, the IFC's results measurement system itself was failing to provide a strong comprehensive basis for assessing impact. The ex ante system for predicting impact as a basis for deciding whether to invest was a particular problem.

But in the last few years, the organization invested heavily in what can fairly be called the gold standard of measurement systems for incorporating impact into investment decisions. In 2017, it launched the Anticipated Impact Measurement and Monitoring System. AIMM measures ex ante (expected) impact across multiple dimensions, on beneficiaries and on markets—their competitiveness, resilience, integration, inclusiveness, and sustainability. In 2019, the IFC went a step further and established quantitative targets for impact scores for its portfolio of forthcoming investments.

AIMM scores offer as objective a measure of ex ante impact as you will find. The IFC publishes AIMM scores for FCS and IDA countries, for each region, and by sector. Importantly, AIMM scores for FCS and IDA countries are slightly above the average for all committed projects, indicating that the IFC is not sacrificing expected development impact for the sake of boosting commitments in difficult markets. And the IFC's system seems to be meeting a market test—when JPMorgan recently decided to create its own internal development finance institution, it chose to model its measurement system after the IFC's. Similarly, the US government's own Development Finance Corporation based its new approach to measuring the projected impact of its projects closely on the AIMM system. More investment in measurement will be needed as experience with AIMM grows, but that too argues for a larger capital base to fund such operations.

What about post-investment results measurement? Based on the findings of the World Bank's Independent Evaluation Group (IEG), we know that older IFC projects (2010-2014) had weak results for development outcomes. An IEG deep dive into more recent (2012-2016) blended finance projects (combining concessional and commercial finance) shows considerable improvement. The projects (a new dairy, a leasing operation for an agricultural food cooperative, a production plant for specialty food products for relief agencies, and a fund for affordable green housing) all achieved commercial sustainability, and all realized economic benefits for beneficiaries and for broader market development. The IEG found that in all cases, the economic benefits significantly exceeded the cost of the subsidies.

What did not go so well for this sample of projects? IFC's returns were described as "inadequate" in all cases. And, beyond the blended finance subsidies, the IFC had high costs in the form of advisory services to firms, farmers, cooperatives, and other market actors relevant to the transactions. This finding points up the difficult impact/profitability balancing act that the IFC will have to manage going forward.

More broadly, the IFC deserves recognition for leadership in environmental, social, and governance (ESG) safeguards. Its ESG standards are also a gold standard: almost every development finance institution has adopted them.

3. Does IFC investment mobilize more private investment?

In fiscal years 2018 and 2019, IFC investments mobilized $1.8 in private investment for every dollar it committed on its own balance sheet. That means it is multiplying the impact of its own investments. If we want to fill SDG financing gaps, the ratio will need to be higher; proposals for boosting the ratio require more risk taking and more capital. We have proposed elsewhere that the IFC and other development finance institutions need something like the Stretch Fund to help them take more risk and stretch their capital, mobilization, and development impact.

But thus far, the IFC's mobilization record in IDA countries (those eligible for concessional assistance from the World Bank) is promising. It is using its concessional capital sparingly and catalytically. So far, the IDA Private Sector Window (IDA PSW), established to allocate part of IDA's resources as concessional capital for private investments, has committed about $300 million in concessional funds. These funds, along with about $800 million in IFC non-concessional finance and guarantees from the World Banks' Multilateral Investment Guarantee Agency, are projected to mobilize an additional $1.5 billion in private investment in IDA countries. The ratio of concessional IDA finance to estimated private investment mobilized therefore is 1 to 5.

4. Can and will the IFC expand its operations in low-income countries and fragile states?

As you might expect in these early days, we see progress in the form of growth of IFC's pipeline of projects (pre-approval) in IDA and FCS countries, rather than growth in actual investment commitments. The IDA PSW supported growth in the pipeline of 24 percent from December 2016 to December 2019 to $5.2 billion. The PSW is clearly a driver of this growth: one out of every five dollars of pipeline value in IDA and FCS countries in December 2019 has PSW support.

The fiscal year 2018 share of IFC commitments in IDA/FCS countries was 21 percent, far from the 40 percent target for 2030. Our CGD colleagues have understandably questioned the feasibility of that target. Indeed, the target was never going to be achievable without deep organizational change that focuses institutional capacity on more risky, underdeveloped markets.

So, what we need to be looking for now is evidence of such change. Already we see that the WBG, and particularly the IFC, is changing its staffing models, launching a major drive to recruit people to work in countries affected by fragility, conflict, and violence. This means many more people who can help find and develop a pipeline of good projects in these difficult countries by undertaking upstream activities both on project development and on the investment climate problems that are stifling private investment. And staff incentives are changing: unlike in the past, experience in fragile and conflict-affected states is now a must in gaining access to senior World Bank positions and promotions.

The imperative of boosting commitments in IDA and FCS countries is also driving a breakdown of siloes within the WBG. To make many more investments commercially sustainable as well as impactful, the WBG is finally starting to bring together all its tools—country diagnostics including barriers to private investment, support for policy and institutional reforms that improve the investment climate, concessional and commercial finance, risk-sharing instruments, and advisory services to mitigate ESG and conflict risks. The slow start of the IDA PSW is driving home the lesson inside the bureaucracy: only by using these instruments in concert can the WBG be successful in high-risk and difficult markets.

5. Are the IFC's subsidies transparent?

Every dollar of subsidy for financing the private sector is a dollar that is not available to offer to governments in IDA countries. So our CGD colleague is right to call for rigor in allocating, measuring, and publishing subsidy data. Up until recently, the IFC, like its peers, did not publish information on subsidy values and shares of total investment value for every transaction. Now it does. And hopefully its peers will follow its lead. An explanation of how the subsidy level or concessionality is calculated and average subsidy shares of project cost can be found here. Across IDA PSW transactions to date, subsidies account on average for 5.9 percent of the total investment cost.

But how do we know whether the IFC is offering larger subsidies than are needed to make private investment possible? We don't, partly because this involves assessing a counterfactual. (A recent piece by CGD colleagues explores a promising theoretical approach to subsidy allocation.) What would help is more use of competitive processes, such as auctions, to require firms to bid for access. But that requires multiple bidders, which in many cases—especially where new technologies, business models, or products are involved—do not exist.

In addition to auctions, there are other ways to offer access to subsidies to multiple firms or financial institutions in order to prevent individual actors from extracting excessive subsidy levels. The IFC does so by offering subsidies through publicly advertised programs that provide access to firms that can meet pre-established conditions. An example is the Small Loan Guarantee Program, which accounts for 35 percent of approved IDA PSW investments. More programs designed in this manner are being developed. Firms must pay a fee to access the subsidy and they must meet prespecified impact criteria to ensure that the subsidy supports the intended impact.

The bottom line: Congress should authorize the IFC capital increase

It would be wonderful if such a transformation could take place overnight. But bureaucratic change takes time and withholding new capital until the perfect union is formed within the WBG dooms the reform to failure. So the case for the US authorization of the IFC capital increase must rest on the change in the IFC's trajectory, not on its having reached its destination. We believe there is enough evidence of that change to move forward, especially in light of the urgency of the SDGs.

Approval must be followed by strong oversight by the United States and other shareholders. The capital increase deal requires that progress toward meeting the IFC and other WBG commitments be independently evaluated five years after agreement was reached. The United States should press the World Bank's Independent Evaluation Group not only to assess progress, but also to offer specific recommendations for improving performance if there are signs that it is not on track. IFC management should commit to implementing those recommendations and any other actions needed to ensure that the commitments are met, and subsidy use is both tightly connected to development impact and efficiently allocated.

Change is rightly being driven by the setting of ambitious targets. The World Bank is going about pursuing the targets in the right way—by making long-term investments in its capacity in IDA and FCS countries to promote both project volume and quality. Other shareholders strongly support the capital increase; further delay risks undermining their willingness to help in advancing US reform proposals. Moving forward with authorization now, while signaling the US intention to hold the IFC accountable, sends the right message of support.

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