Issue 02 | May 2009

Donor dynamics

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Welcome

Welcome to the second issue of *Donor dynamics*, our magazine for development agencies and banks including The World Bank Group. Ernst & Young hope that you will find it a useful source of ideas and inspiration as we share our experience across many projects, industry sectors and geographic regions where we work together.

Over the past 15 years, we have worked on thousands of projects across Africa, Latin America, Asia and Europe – finding new challenges and developing advice and recommendations in sectors as diverse as financial services, utilities, infrastructure and public services. This magazine is a vehicle for communicating the hard-won lessons and ideas for improvements those projects have generated – both from our perspective and yours. These are lessons which are particularly valuable in emerging markets, some of the most difficult and testing environments in which we do business.

In this issue

A wide range of issues are currently facing developing and emerging markets across the world. Not least is the recent financial crisis which has and will continue to impact economic growth and development. We consider the impacts of the financial crisis on the developing and emerging markets in an extended emerging markets forecast. This section includes donor insight from Jean-Marie Masse, Head of Business Development in Global Financial Markets for the International Finance Corporation (IFC) and the World Bank's Luigi Passamonti, who heads up the World Bank Convergence program which promotes financial sector modernization in Southeast Europe through public-private sector cooperation. We examine the challenges people in Tanzania are facing in accessing financial services, and also investigate the increase in lending by donors to finance clean energy projects.

In our main feature, we draw together the key concerns, issues and areas for development within the Auditor General offices across Africa. We share the results from our survey which was sent to several African auditor general offices. In a separate article, we explore the path to good governance in developing countries, including some commentary from Djordjija Petkoski, Lead Enterprise Structuring Specialist and Head of Private Sector Development team at the World Bank Institute Governance Team.

We also present our "aid map" which summarizes the key trends in aid flows from selected multinational, bilateral, regional and private development agencies.

What do you think?

We received some great feedback for the first issue of *Donor dynamics* and are looking forward to including your ideas in future issues. This will include exploring regional integration, public-private financial sector modernization in Southeast Europe, and Audit Assurance for donor-funded programs.

We continue to welcome any further comments on this magazine, including your thoughts and perspectives on the ideas presented. Please also send us suggestions for any other topics you would like to see covered in future issues.

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Please email your thoughts on *Donor dynamics* to one of our donor community coordinators:

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> **"A wide range of issues are currently facing developing and emerging markets across the world. Not least, the recent financial crisis has and will continue to impact economic growth and development in these regions."**
>
> **Jean-Michel Paillès, Ernst & Young**

Donor insight: investments

Jean-Marie Masse, Head of Business Development, Global Financial Markets for the IFC, the private sector arm of The World Bank Group, says: "At the moment, we are seeing a lot of banks in emerging markets with vast needs for new finance. Over recent years, these banks have increased borrowings because interest rates were relatively low, but now those borrowings are coming due. This means that (unless they can borrow new funds) banks will have to sell assets to repay their loans. And as banks' balance sheets are stretched, there is less cash to lend to core activities such as MSMEs and retail lending. This is a major dislocation. While stopping new lending could improve a bank's liquidity position in the short term, it will ultimately lead to an increase in non-performing loans and enormous strain being placed on a particular country's banking sector and its clients.

"That's why more and more institutions are contacting the IFC to see how our investment activities can help. On the financial sector investment side of the IFC, we work in three main ways. First, we provide financial institutions that have operations in emerging markets with financing (equity, quasi-equity, loans, structured finance, trade finance) to help support their operations. Second, we partner with institutions to enter less developed markets, and take equity stakes in their new operations. Finally, we invest in private equity funds active in emerging markets.

"The main needs at present seem to be in Eastern Europe and Latin America, but I expect them to spread across the globe. We are observing an increase in the number of deals and the value per deal – an average IFC deal used to be US$30m, but now it is multiples of that, given the enormous refinancing needs that banks in emerging markets face as developed country banks reduce their exposures.

To address this demand, IFC, in addition to its regular activities, is mobilizing funding from investors that have liquidity, including channelling capital where it is needed. This fund mobilization activity is boosted by special initiatives undertaken by the IFC to answer the crisis. One example is the nearly US$5b – of which US$1b has been invested by the IFC – IFC-managed global private equity fund (the Bank Recapitalization Fund) designed to invest in emerging markets; this project was approved by the IFC board in December 2008.

"Several countries in Western Europe (e.g., France, Ireland, the UK and the Netherlands) have come up with plans to pump liquidity into their domestic banking systems. I feel strongly that Eastern Europe needs the same treatment. Governments, the EU and donors need to work together to help Eastern European banks manage their liabilities, as most of their borrowings are due during the first half of 2009.

A chance for market reform?

Public-private collaboration for modernization

One of the main ways in which emerging economies can navigate through the current crisis is by redoubling efforts to improve their regulation and modernize their financial sectors.

To help emerging countries do this, the World Bank is running the Convergence Program, which promotes financial sector modernization in Southeast Europe through public-private sector cooperation. The World Bank's Luigi Passamonti, who heads up the program, says it is designed to be a catalyst to involve market participants in the identification and design of market-building reforms.

Reforms might include harmonizing a country's accounting standards with international ones; reforming bankruptcy laws; improving IT infrastructure; or setting up a banking ombudsman. "Such reforms are crucial because, ultimately, they give borrowers like SMEs and marginal borrowers access to capital, making the system more inclusive and multiplying the opportunities for entrepreneurship," says Mr Passamonti.

Under a build-operate-transfer model, the Convergence Program helps authorities and market participants to set up and operate a partnership (called a special projects initiative (SPI)), which enables the pursuit of an analytical and broad-based modernization program. Luigi says: "This collaborative way of working maximizes the chances of success as, at the end of the process, any proposal has already been extensively reviewed and honed by both the public and private sectors."

The Convergence Program has already had a number of successes across Romania and Albania. SPI Romania has mobilized 120 financial sector experts from 17 public institutions and 16 banks, which work together in identifying regulatory and institutional solutions for the sector's most pressing modernization requirements. "One of the big successes is the fact that, in less than a year, electronic settlement of cheque processing has been introduced – which means that cheque clearing has been reduced from 25 days to two days," says Mr Passamonti. "This has long been needed, but as no one organization had the mandate to lead the way, it had not been achieved."

In Albania, a recent success was the project undertaken to streamline the auction process for foreclosed assets.

"This is important because if this situation of liquidity need is not addressed, we could see more cases of bank nationalization to avert runs on deposits – a recent example is Bank Parex in Latvia. In fact, the past decade in Eastern Europe has been about promoting privatization and moving away from state-owned institutions, and the current crisis could undo the progress privatization has achieved in modernizing some emerging markets' financial sectors.

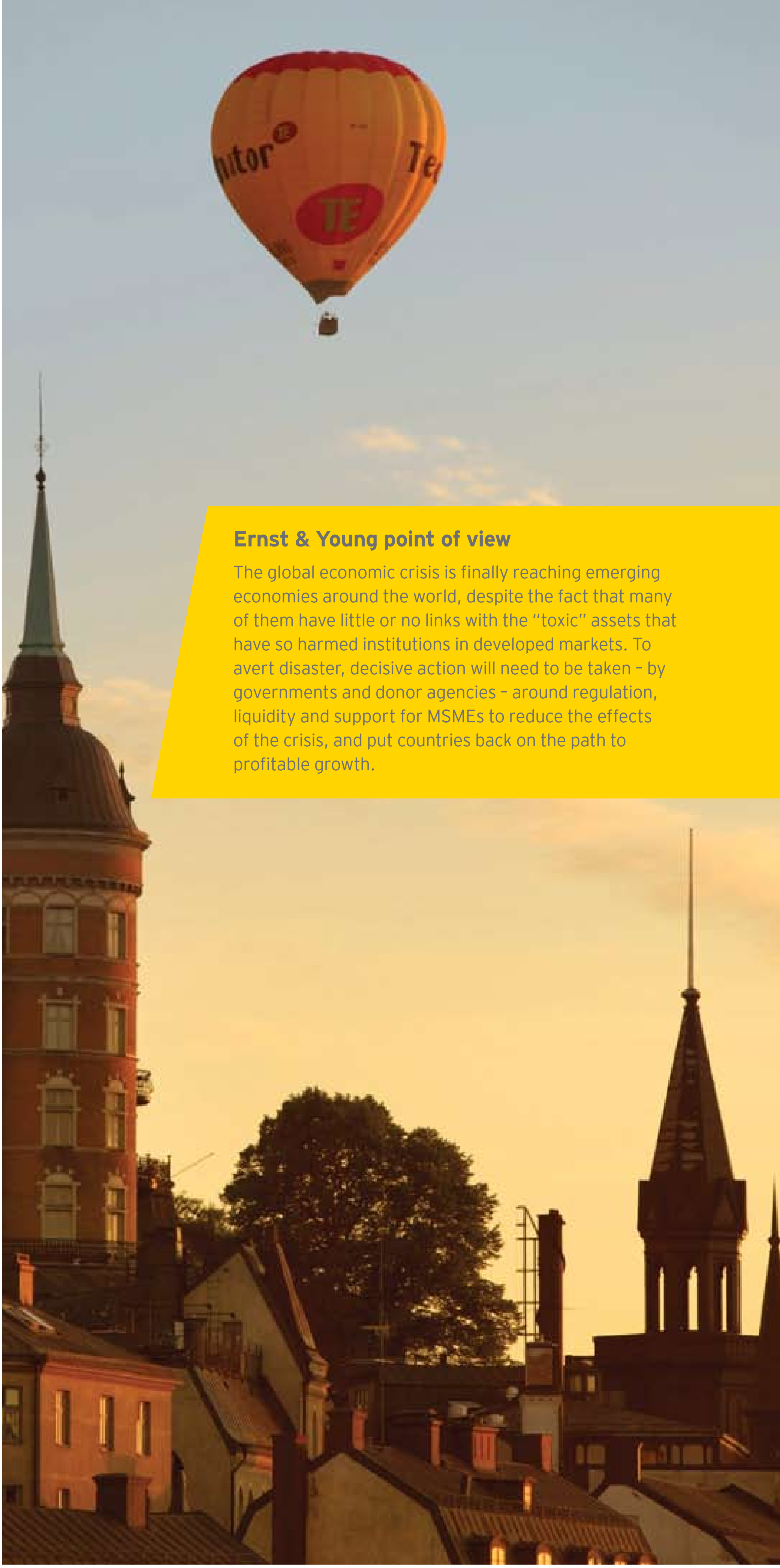
"Overall, it is too soon to tell whether Western banks will start to withdraw from emerging markets. First, I expect to see some consolidation in the Western European banking sector. Such consolidations could lead to overlaps in operations in developing countries, and needs for rationalization/eventual exits from some markets – and bank share prices evolution will be a key factor in these strategic decisions."

For more information about IFC, please visit **www.ifc.org**

The system was reformed in just over six months in 2008, much to the surprise of local market participants. "People in Albania are in disbelief as banks had been trying to do this for years," says Mr Passamonti. "But they weren't being heard as they were not presenting a case based on evidence. They were seen to be complaining, whereas we presented their case in a form that parliament was likely to approve."

He adds: "Overall, the operating costs for Convergence Program activities are just 0.5% of the annual gain they deliver for the banking sector, making them highly rewarding."

For more information about the Convergence Program, please visit **www.spi-romania.eu** and **www.spi-albania.eu.**



Ernst & Young point of view

The global economic crisis is finally reaching emerging economies around the world, despite the fact that many of them have little or no links with the "toxic" assets that have so harmed institutions in developed markets. To avert disaster, decisive action will need to be taken – by governments and donor agencies – around regulation, liquidity and support for MSMEs to reduce the effects of the crisis, and put countries back on the path to profitable growth.

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