

## RESEARCH

# International Bank for Reconstruction and Development

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## Note

The International Bank for Reconstruction and Development (IBRD) regularly issues notes under its October 1997 Global Debt Issuance Facility. The face amounts of these notes generally range from US\$10 million to as much as US\$4 billion (or the equivalent in other currencies). Standard & Poor's Ratings Services' practice is not to issue separate rating letters for small issues under the facility.

However, as of the date of this report, Standard & Poor's has rated IBRD's Global Debt Issuance Facility 'AAA', and any unsubordinated notes issued thereunder carry the same rating. Standard & Poor's maintains annual surveillance on facility notes.

**Issuer Credit Rating**

*Foreign Currency*  
 AAA/Stable/A-1+

## Major Rating Factors

**Strengths:**

- Strong capital position and adequate liquidity;
- Prudent financial management and policies; and
- Strong membership support, including expected treatment as a preferred creditor.

## Rationale

IBRD, which commenced operations in 1946, is the oldest, largest, and most-membered multilateral development finance institution (MDFI). It is the keystone of the World Bank Group, which also includes the International Development Association (IDA; not rated), the Multilateral Guarantee Agency (not rated), and the International Finance Corporation (IFC; 'AAA' [all institutional ratings herein are foreign currency issuer credit ratings as of Dec. 15, 2006]). The bank's staff and its operational policies are shared with IDA, which does not borrow in the capital markets and is not rated; references to the World Bank often mean IBRD, not IBRD and IDA together. IBRD is legally and financially independent of other group members and has no responsibility for their obligations.

The bank's total assets at fiscal year-end 2006 (June 30, 2006) were US\$212.3 billion, by far the largest among MDFIs. Of this amount, US\$103.0 billion was loans. In addition, IBRD had off-balance-sheet country exposure of US\$995 million in the form of outstanding guarantees. Reported shareholders' equity was US\$36.5 billion.

IBRD's loan and guarantee portfolios have historically performed extraordinarily well, and during fiscal 2006 the credit risk embedded in those portfolios continued the decline begun during fiscal 2003. This allowed IBRD to release US\$724 million of accumulated provisions for losses on loans and guarantees, bringing the total down to US\$2.3 billion at fiscal year-end 2006.

The bank's accumulated provisions for losses were buttressed by US\$34.0 billion in shareholders' equity (adjusted for receivables from members and currency holdings subject to restrictions) at fiscal year-end 2006. In addition, IBRD had US\$178.2 billion in subscribed callable capital from its members, US\$79.3 billion of it from countries rated 'AAA' by Standard & Poor's. Accordingly, IBRD's provisions for losses plus its adjusted shareholders' equity (narrow risk-bearing capacity) were nearly 35% of its outstanding loans and guarantees at fiscal year-end 2006, while its provisions for losses, adjusted shareholders' equity, and 'AAA' callable capital (broad risk-bearing capacity) were more than 111% of its outstanding loans and guarantees.

IBRD's shareholders' equity is usually bolstered by allocations from its net income. However, the bank's net income according to U.S. generally accepted accounting principles (U.S. GAAP) was negative US\$2.4 billion during fiscal 2006, in contrast to the positive US\$3.2 billion of fiscal 2005. This loss was the result of a decision by IBRD not to employ hedge accounting for its derivative exposure and the resulting asymmetrical treatment of offsetting transactions required by Financial Accounting Standard (FAS) 133; in addition, it reflects transfers to IDA and other development-related entities now treated as part of net income. Accordingly, the reported loss is misleading from a credit perspective and not a matter of concern to Standard & Poor's. By contrast, IBRD's operating income during fiscal 2006 was a positive US\$1,740 million, an increase from the US\$1,320 million one year earlier. On a current value basis, which reflects the value of all of IBRD's financial instruments and incorporates all the effects of interest rate changes (and upon which IBRD management focuses), fiscal 2006 net income was US\$640 million, up from US\$402 million one year earlier.

The bank's liquidity, having increased to its highest level in recent years at fiscal year-end 2004, fell modestly during fiscal 2006 for the second year in a row; however, it remains adequate, particularly in light of the bank's strong market access.

## Outlook

The stable outlook reflects the bank's strong capital position (especially with the inclusion of its 'AAA' callable capital) and its adequate liquidity. IBRD is in a position to increase its lending substantially and to play an enhanced role in the development efforts of its borrowing members while maintaining its 'AAA' rating.

## Membership, Governance, and Organization

The bank began operation in 1946 with fewer than 50 members; by fiscal year-end 2003, membership had increased to its current 184 countries—by far the largest of any MDFI (except for its affiliates, IFC and IDA). The Republic of Montenegro ('BB'; all country ratings herein are long-term foreign currency sovereign ratings as of Dec. 15, 2006) is applying for membership following its declaration of independence from the Republic of Serbia ('BB-') and Montenegro earlier this year.

IBRD's largest voteholders at fiscal year-end 2006 were the U.S. ('AAA'; 16.4% of voting power); Japan ('AA-'; 7.9%); the Federal Republic of Germany ('AAA'; 4.5%); the Republic of France ('AAA'; 4.3%); the U.K. ('AAA'; 4.3%); and Canada ('AAA'), the People's Republic of China ('A'), the Republic of India ('BB+'), the Republic of Italy ('A+'), the Russian Federation ('BBB+'), and the Kingdom of Saudi Arabia ('A+'), 2.8% each. Member countries not eligible to borrow from IBRD or IDA at fiscal year-end 2006 held 62.5% of total voting power.

Under IBRD's Articles of Agreement (Articles), all powers of the bank are vested in its board of governors, to which each member country may appoint a governor and an alternate and which must meet at least annually. With some specific exceptions, decisions are delegated to the 24 executive directors, one of whom is appointed by each of the five largest shareholders and the others chosen by election by the remaining members; however, three of the elected directors—those for China, Russia, and Saudi Arabia—represent single-country constituencies. Except as expressly provided by the Articles, matters before the boards of governors and directors are decided by a majority of the votes cast.

The chief executive of IBRD is Paul Wolfowitz, who was unanimously elected to a five-year term by the bank's board of executive directors in March 2005. IBRD had a staff of about 8,600 at fiscal year-end 2006, of which about 3,700 were based in Washington, D.C. IBRD has been reallocating staff from its headquarters to its more than 100 overseas offices.

## Accounting Principles And Balance Sheet

IBRD's financial statements are prepared according to U.S. GAAP. Until fiscal 2006, the bank's financial statements also satisfied the requirements of International Financial Reporting Standards (IFRS). However, effective July 1, 2005, the bank ceased reporting in accord with IFRS, reportedly to allow it to evaluate an amendment to International Accounting Standard No. 39, "Financial Instruments: Recognition and Measurement, The Fair Value Option." Of particular concern was whether refinements to its loan valuation model would permit application of the fair value option to such financial assets. However, because of a change in its auditor's interpretation of a revised Accounting Standard No. 32, it is also likely that IBRD's fiscal 2006 IFRS financial statements would have been qualified (see "Accounting for Capital in Multilateral Institutions," RatingsDirect, May 16, 2006).

Table 1 summarizes IBRD's balance sheet and key off-balance-sheet items. From a credit perspective, the most interesting features at fiscal year-end 2006 were 1) the continuing reduction in the size of the bank's

loan portfolio to a level more than 15% below that of four years earlier; 2) the continuing reduction in the size of the accumulated provision for loan losses; and 3) the reduction in reported shareholders' equity during fiscal 2006.

**Table 1****IBRD Summary Balance-Sheet And Off-Balance-Sheet Items**

(Mil. US\$)	--Year ended June 30--				
	2006	2005	2004	2003	2002
<b>Assets</b>					
Due from banks, of which:	758	1,177	1,803	1,929	1,083
Currencies subject to restrictions	693	672	665	670	668
Investments, trading and purchased under resale agreements	25,826	27,444	31,986	28,128	26,076
Total loans outstanding	103,004	104,401	109,610	116,240	121,589
Accumulated provision for loan losses	(2,296)	(3,009)	(3,505)	(4,045)	(5,053)
Nonnegotiable, noninterest-bearing demand obligations on account of subscribed capital	1,766	1,836	1,790	1,794	1,632
Receivable to maintain value of currency holdings on account of subscribed capital	40	72	113	166	355
Receivable from currency and interest-rate swaps	78,483	85,889	83,022	81,343	76,719
Other assets	4,745	4,198	4,091	4,797	5,393
Total assets	212,326	222,008	228,910	230,352	227,794
<b>Liabilities</b>					
Short-term borrowings	7,280	3,217	3,146	3,432	4,918
Medium and long term borrowings, of which:	88,555	98,080	104,920	105,122	105,345
Maturing during next fiscal year	14,676	15,617	19,881	12,266	17,498
Payable to maintain value of currency holdings on account of subscribed capital	90	83	92	64	61
Payable for currency and interest-rate swaps	74,877	77,742	80,231	77,451	78,579
Other liabilities	5,050	4,298	5,058	6,365	6,578
Total liabilities	175,852	183,420	193,447	192,434	195,481
<b>Shareholders' equity</b>					
Subscribed shares less uncalled portion of subscriptions	11,483	11,483	11,483	11,478	11,476
Amounts to maintain value of currency holdings	52	46	(73)	(331)	(641)
Paid-in capital	11,535	11,529	11,410	11,147	10,835
Other shareholders' equity	24,939	27,059	24,053	26,771	21,478
Total shareholders' equity	36,474	38,588	35,463	37,918	32,313
<b>Memo items:</b>					
Principal amounts of outstanding guarantees*	995	1,157	1,218	1,254	1,574
Undisbursed balance of effective loans	25,856	23,922	24,771	27,094	29,719

\*Maximum potential amount of undiscounted future payments that IBRD could be required to make under its guarantees.

**Risk**

For analytical purposes, IBRD's activities may be broken into 1) treasury activities, which result in holdings of cash and deposits, investments, and risk-management products; and 2) development activities, which result in loans and off-balance-sheet obligations for guarantees (together, the bank's development-related exposure, or DRE).

**Treasury activities**

IBRD does not look to its treasury activities as a source of significant income for the bank; rather, they are intended to fund the bank in a conservative yet cost-effective manner and ensure that it will be able to meet its obligations. Consequently, IBRD's treasury-related credit and interest- and exchange-rate risk are all maintained at modest levels.

**Credit risk.** Securities held by IBRD are high-quality debt instruments issued by government agencies, banks, and corporate entities (91% of the total at fiscal year-end 2006, net of collateral held) and sovereign governments (9%). Twenty-nine percent of these assets were rated 'AAA'; 54%, 'AA'; and 17%, 'A'. The counterparty credit risk resulting from IBRD's use of derivatives is contained by dealing with highly rated

counterparties, using legally enforceable close-out netting agreements, and obtaining collateral.

**Interest-rate risk.** Interest-rate risk arises in two principal ways:

- From the interest-rate sensitivity of the net spread between what IBRD earns on its interest-earning assets and the cost of the borrowings that fund those assets. The interest-rate sensitivity of the net spread historically has been mitigated by most of IBRD's loans being cost-pass-through loans. The interest-rate risk on noncost-pass-through loans is mitigated by the use of interest-rate swaps to closely align the rate sensitivity of these loans with that of their funding.
- From the interest-rate sensitivity of the income earned from the portion of interest-earning assets funded by equity; lower interest rates translate into lower contributions to income. IBRD does not, as a matter of policy, seek to manage its income from year to year and does not seek to mitigate changes in net income resulting from changes in the level of interest rates.

Interest-rate risk also arises from a variety of other factors, such as differences in timing between the contractual maturity or repricing of IBRD's assets, liabilities, and derivative financial instruments. As an example, portions of the nearly US\$2.1 billion, US\$2.7 billion, and US\$4.6 billion in loan prepayments during fiscal years 2006, 2005, and 2004, respectively, were funded with relatively high-cost, long-term debt. However, to mitigate its exposure to mismatches in LIBOR reset dates between assets and liabilities, IBRD occasionally executes overlay interest-rate swaps.

**Exchange-rate risk.** To minimize exchange-rate risk, IBRD uses swaps to match the currency of its borrowing obligations to the currency of its assets. In addition, IBRD seeks to minimize the exchange-rate sensitivity of the ratio of its equity to its loans by periodically aligning the currency composition of its equity to that of its outstanding loans.

In sum, IBRD has in place policies and practices that minimize the credit and interest- and exchange-rate risk resulting from its treasury activities. Accordingly, the vast bulk of the risk in IBRD's activities comes from its development activities.

### Development activities

**Borrower eligibility.** Under its Articles, IBRD may lend directly, guarantee, or participate in loans to any member country or political subdivision thereof, as well as to any business, industrial, or agricultural enterprise in a member's territories. However, when the member itself is not the borrower, its central bank or similar agency acceptable to IBRD must fully guarantee payment of principal, interest, and other charges on the loan (although IBRD may lend to IFC without a guarantee, and its loans to the Caribbean Development Bank ['AAA'] are guaranteed by the governments of the countries that are recipients of the loans funded by IBRD). IBRD's Articles call upon the bank to "pay due regard to the prospects that the borrower...will be in a position to meet its obligations under the loan...." They also require that "the Bank shall act prudently in the interests of...the members as a whole."

Of the bank's 184 members at the start of fiscal 2007, 146 were, in principle, eligible to borrow from IBRD or IDA (including those currently ineligible because of arrears). Of these, 64 were eligible to borrow only from IBRD; 15 were eligible to borrow from both IBRD and IDA; and 67 were eligible to borrow only from IDA. Included among the 80 countries with IBRD loans outstanding at fiscal year-end 2006 were six countries now classified as IDA only, which together had US\$1.4 billion in IBRD loans.

**Types of lending.** IBRD's Articles state that, except in special circumstances, loans or guarantees must be for specific construction or development projects. IBRD has interpreted its Articles as permitting rapidly disbursing loans that have also served as macroeconomic support.

In practice, IBRD's lending generally falls into one of two categories: investment or development policy lending. A third category, enclave lending, includes infrequently made loans for large foreign-exchange-earning projects that meet certain criteria in countries ordinarily eligible only for IDA loans. The last enclave loan was approved in during fiscal 2000, in the amount of US\$93 million. At fiscal year-end 2006, US\$124 million in enclave loans was outstanding, a decrease from US\$138 million one year earlier.

Historically, most IBRD loans have been made for investment projects or programs. As shown in table 2, investment lending (including enclave loans) accounted for 36%-69% of new commitments and 57%-58% of outstanding loans over the past five years.

**Table 2**

IBRD Loans, By Type

(Mil. US\$, unless indicated otherwise)	--Year ended June 30--				
	2006	2005	2004	2003	2002
<b>Investment lending*</b>					
New commitments	9,229¶	9,347§	6,592	7,044	4,068
% total commitments	65.3	68.7	59.7	62.7	35.5
Gross disbursements	6,427	6,117	5,761	6,437	6,583
% total disbursements	54.3	62.9	57.0	54.0	58.5
Outstanding loans at year-end	58,805	60,506	63,251	66,569	70,551
% total outstanding loans	57.1	58.0	57.7	57.3	58.0
<b>Development policy lending: excluding Special Development Policy loans</b>					
New commitments	4,906	4,264	4,453	3,684	6,183
% total commitments	34.7	31.3	40.3	32.8	54.0
Gross disbursements	5,406	3,555	4,348	4,840	3,773
% total disbursements	45.7	36.3	43.0	40.6	33.5
Outstanding loans at year-end	41,253	39,933	41,342	41,217	39,533
% total outstanding loans	40.0	38.2	37.7	35.5	32.5
<b>Development policy lending: Special Development Policy loans</b>					
New commitments	0	0	0	503	1,200
% new commitments	0	0	0	4.5	10.5
Gross disbursements	0	50	0	644	900
% gross disbursements	0	0.5	0	5.4	8.0
Outstanding loans at year-end	2,946	3,962	5,017	8,454	11,505
% outstanding loans	2.9	3.8	4.6	7.3	9.5

\*Includes enclave loans. ¶FY06 Investment lending commitment includes guarantee commitment of US\$60 million. §FY05 Investment lending commitment includes guarantee facility of US\$200 million and guarantee commitment of US\$77 million.

During fiscal years 1998 and 1999, IBRD approved US\$7 billion in rapid-disbursing loans to the Republic of Korea ('A') under "nonstandard terms". IBRD subsequently introduced special structural and sector adjustment loans, now called special development policy loans, as part of a broad financial support package for borrowing countries undergoing financial stress. These loans have a five-year final maturity, a three-year grace period, and carry pricing above that of other loans. Over the past five years, total development policy lending, including the loans on nonstandard terms and special development policy loans, accounted for 31%-64% of new commitments and 42%-43% of outstanding loans. There have been no new commitments for special development policy loans during the past three years.

**Loan pricing.** IBRD generally does not vary its loan pricing among its borrowing member countries. However, in contrast to the current contractual terms for new standard loans (those for which the invitation to negotiate was issued after July 31, 1998)—a spread of 75 basis points (bps) over IBRD's sub-LIBOR cost of funding, a front-end fee of 100 bps, and a commitment fee of 75 bps per annum—the terms for special development policy loans are a spread of 400 bps over LIBOR, a front-end fee of 100 bps, and a commitment fee of 75 bps per annum.

However, in practice, IBRD's pricing on its standard loans is lower. Since fiscal 1992, IBRD has waived a portion of the interest charges for those borrowers that have paid all principal, interest, and other charges in full within 30 calendar days of their due dates during the preceding six months. The interest waiver on new loans has been 25 bps per annum since standard pricing was increased during fiscal 1999 (to augment IBRD's risk-bearing capacity). The waiver on old loans, which carry a lower spread of 50 bps over IBRD's average cost of funding those loans, is currently 5 bps. Both waivers will remain at these levels during fiscal 2007. Interest-rate waivers reduced IBRD's net income by US\$138 million in fiscal 2006 and US\$125 million in fiscal 2005. Interest-rate waivers do not apply to special development policy loans.

Similarly, IBRD has waived 50 bps of its commitment fee since fiscal 1990 for those countries satisfying the above criteria. Commitment-fee waivers reduced IBRD's net income by US\$128 million in fiscal 2006 and US\$125 million in fiscal 2005. Commitment-fee waivers do not apply to special development policy loans.

In a departure from its prior practice, IBRD's executive directors approved a 50-basis-point waiver of its

front-end fee in August 2004, to apply to loans presented to the board on or after March 1, 2004, and during fiscal 2005. The waiver of front-end fees was increased to 75 bps in August 2005, and to 100 bps in August 2006 for loans presented to the board between August 10, 2006, and the date on which the board approves a front-end fee waiver for fiscal 2008.

**Loan maturities.** IBRD's historical focus has been on medium- and long-term lending, with maturities for standard loans typically ranging from 15 years to as long as 25 years (with grace periods of three to eight years for repayment of principal). The weighted average maturity of the loan portfolio was 5.30 years at fiscal year-end 2006, up slightly from the 5.17 years at fiscal year-end 2005.

**Guarantees.** IBRD's Articles permit it to issue guarantees, as well as to make loans. However, IBRD has made only limited use of its ability to issue guarantees, which have not exceeded 1.4% of outstanding loans in recent years. At fiscal year-end 2006, loan guarantees totaled US\$995 million, continuing the downward trend from US\$1.6 billion at fiscal year-end 2000. Countries eligible to borrow from the bank are also eligible for IBRD's guarantee program. The same country creditworthiness and project evaluation criteria apply, and each guarantee requires the counterguarantee of the member country government. However, in exceptional cases guarantees may also be offered for loans for foreign-exchange-generating projects in countries ordinarily eligible to borrow only from IDA.

**Exposure limits and concentration.** Under its Articles (as applied), the total of IBRD's direct loans outstanding net of loan-loss provisions, callable guarantees, and loan participations (of which it has none) is limited to 100% of its subscribed capital, reserves, and surplus (the statutory lending limit). This ratio has gradually declined in recent years, falling to 47% at fiscal year-end 2006 from 57% at fiscal year-end 2000. IBRD thus could more than double its outstanding net loans and guarantees and remain within the limit established by its Articles.

For management purposes, IBRD closely monitors its equity-to-loans ratio, which is calculated on both a reported and a current-value basis. These calculations show a consistent increase in these ratios, to 32.96% and 32.44%, respectively, at fiscal year-end 2006, from 31.45% and 30.83%, respectively, at fiscal year-end 2005, and from 21.51% and 21.43%, respectively, at fiscal year-end 2001.

Although IBRD had loans outstanding to 80 countries at fiscal year-end 2006, the amounts of these loans vary widely. Under policies approved in 1997, outstanding loans plus the present value of guarantees for any single country are limited to the lower of: 1) 10% of subscribed capital, reserves, and unallocated surplus (the equitable access limit), which was US\$21.6 billion at fiscal year-end 2006; or 2) a limit determined by stress testing IBRD's income-generating capacity and risk-bearing capital (the single-borrower limit), which is US\$14.5 billion for fiscal 2007, unchanged from the previous year.

As shown in table 3, China was closest to the single-borrower limit at fiscal year-end 2005; however, its outstanding loans and guarantees of US\$11.3 billion were more than US\$3.2 billion below the single-borrower limit.

**Table 3**

**IBRD Loan And Guarantee Portfolio Country Concentration**

	--Year ended June 30--				
	2006	2005	2004	2003	2002
<b>Largest country exposures/ratings</b>					
<b>Largest</b>	China/A-	China/BBB+	China/BBB+	China/BBB	China/BBB
Outstanding loans and guarantees (mil. US\$)	11,289	11,103	10,857	10,958	11,897
% total loans and guarantees	10.9	10.5	9.8	9.3	9.7
% narrow risk-bearing capacity	31.1	28.4	29.8	27.8	34.2
<b>Second largest</b>	Brazil/BB	Mexico/BBB	Mexico/BBB-	Mexico/BBB-	Indonesia/SD
Outstanding loans and guarantees (mil. US\$)	9,515	9,070	10,169	10,669	11,123
% total loans and guarantees	9.1	8.6	9.2	9.1	9.0
% narrow risk-bearing capacity	26.2	23.2	27.9	27.1	32.0
<b>Third largest</b>	Mexico/BBB	Indonesia/B+	Indonesia/B	Indonesia/B	Mexico/BBB-
Outstanding loans and guarantees (mil. US\$)	9,173	8,386	9,213	10,269	10,745
% total loans and guarantees	8.8	7.9	8.3	8.8	8.7

% narrow risk-bearing capacity	25.3	21.5	25.3	26.1	30.9
Fourth largest	Indonesia/B+	Brazil/BB-	Brazil/B+	Brazil/B+	Argentina/SD
Outstanding loans and guarantees (mil. US\$)	7,551	8,056	8,372	8,659	8,742
% total loans and guarantees	7.3	7.6	7.6	7.4	7.1
% narrow risk-bearing capacity	20.8	20.6	23.0	22.0	25.2
Fifth largest	Argentina/B	Argentina/B-	Argentina/SD	Argentina/SD	Brazil/B+
Outstanding loans and guarantees (mil. US\$)	6,615	7,195	7,551	7,923	8,104
% total loans and guarantees	6.4	6.8	6.8	6.8	6.6
% narrow risk-bearing capacity	18.2	18.4	20.7	20.1	23.3
Largest two country exposures (mil. US\$)	20,804	20,173	21,026	21,627	23,020
% total loans and guarantees	20.0	19.1	19.0	18.4	18.7
% narrow risk-bearing capacity	57.3	51.7	57.7	55.0	66.2
Largest three country exposures (mil. US\$)	29,977	28,559	30,239	31,896	33,765
% total loans and guarantees	28.8	27.1	27.3	27.2	27.5
% narrow risk-bearing capacity	82.6	73.2	83.0	81.0	97.2
Largest four country exposures (mil. US\$)	37,528	36,615	38,611	40,555	42,507
% total loans and guarantees	36.1	34.7	34.9	34.6	34.6
% narrow risk-bearing capacity	103.4	93.8	106.0	103.0	122.3
Largest five country exposures (mil. US\$)	44,143	43,810	46,162	48,478	50,611
% total loans and guarantees	42.4	41.5	41.7	41.3	41.1
% narrow risk-bearing capacity	121.7	112.2	126.8	123.2	145.6
<b>Memo items:</b>					
Total loans and guarantees (mil. US\$)	103,999	105,558	110,828	117,494	123,163
Narrow risk-bearing capacity (mil. US\$)	36,282	39,030	36,415	39,357	34,752

Other measures of country concentration are countries' shares of total outstanding DRE; and, more meaningfully from a credit perspective, countries' outstanding DRE relative to IBRD's narrow risk-bearing capacity (see "Capital and Risk-Bearing Capacity," below). These measures for IBRD's five countries of largest exposure and for the two, three, four, and five largest country exposures together are also shown in table 3. IBRD's five countries of largest exposure have remained the same over the past five years, although their rankings have changed, and their share of IBRD's total loans and guarantees has increased slightly, to 42.4% of the total from 41.1% four years earlier. While China was the country of largest exposure during each of the past five years, accounting for 10.9% of total exposure at fiscal year-end 2006, the absolute size of exposure only to Federative Republic of Brazil ('BB') was higher than that of four years earlier.

The bank's narrow risk-bearing capacity declined during fiscal years 2006 and 2004 as a result of large reported losses on a U.S. GAAP basis. However, at fiscal year-end 2006, the outstanding DRE of the five countries of largest exposure was 121.7% of narrow risk-bearing capacity, well below the 145.6% at fiscal year-end 2002.

**Portfolio quality and provisioning.** The performance of IBRD's loans historically has been much better than that of loans of commercial lenders, and in its 60 years of operation the bank has never written off a loan (although, since IBRD does not charge interest on interest, past-due obligations involve economic losses for the bank even without write-offs). This reflects the preferred creditor treatment that borrowing member countries have usually accorded IBRD, generally remaining current on their loans and, on those occasions when they have gone into arrears, eventually repaying principal and interest in full. The strong performance of IBRD's loan portfolio also reflects three other factors:

- Only 79 of IBRD's 145 developing-country members were eligible to borrow from the bank as of July 1, 2006 (including 15 that were eligible for a blend of lending from IBRD and IDA), with the 66 poorest and least-creditworthy members restricted to borrowing from IDA;
- Nonperforming loans to some countries have been removed from IBRD's balance sheet by, in effect, moving them to IDA; and

- Under very special and extreme circumstances, the bank overrode its policy and rescheduled loans for three members.

However, its borrowers have sometimes been late—occasionally very late—in meeting their obligations. Table 4 shows the 20 countries that have had arrears of six months or more in payments to IBRD (been in nonaccrual status) at the end of a fiscal year (Cote d'Ivoire [not rated] and the Republic of the Congo [not rated] went into nonaccrual status on two separate occasions). Of these 20 countries, only four were in nonaccrual status at fiscal year-end 2006: Republic of Liberia (not rated), with loan principal of US\$150 million outstanding and past due principal, interest, and charges totaling US\$405 million; Zimbabwe (not rated), with principal outstanding of US\$442 million and past dues of US\$353 million; Republic of Seychelles ('B'), with principal outstanding of US\$2 million and past dues of US\$1 million; and Cote d'Ivoire, with principal outstanding of US\$444 million and past dues of US\$241 million. Nine of the countries that have gone into nonaccrual status with IBRD may no longer borrow from the bank, but are restricted to borrowing only from IDA.

Historically, IBRD has been very reluctant to reschedule all of its loans to a sovereign and has done so only three times: for the People's Republic of Bangladesh (not rated) in 1975; for Bosnia and Herzegovina (not rated) in fiscal 1996; and for Serbia and Montenegro in fiscal 2002. The criteria approved in connection with the rescheduling of Bosnia and Herzegovina's loans (which would also have qualified Bangladesh's rescheduling) limit eligibility for reschedulings to countries that:

- Have emerged from a current or former member of IBRD;
- Are assuming responsibility for a share of the debt of such member;
- Have limited ability to service their debt and impaired creditworthiness due to a major armed conflict in their territories involving extensive destruction of physical assets; and
- Would realize a significant improvement in their repayment capacity, assuming appropriate supportive measures were taken.

**Table 4**

**IBRD Member Countries With Obligations Past Due For More Than Six Months At Fiscal Year-End**

<b>Country</b>	<b>Entry into nonaccrual status</b>	<b>Elimination of past-due obligations</b>
Nicaragua*	December-84	Fiscal 1992
Guyana*	December-86	Fiscal 1990
Syria	February-87	Fiscal 2003
Liberia*	June-87	Still in nonaccrual status
Peru	August-87	Fiscal 1993
Sierra Leone*	August-87	Fiscal 1992
Zambia*	August-87	Fiscal 1991
Panama	May-88	Fiscal 1992
Honduras*	April-89	Fiscal 1990
Guatemala	July-90	Fiscal 1993
Iraq	December-90	Fiscal 2005
Congo, Republic of*	September-91	Fiscal 1994
Bosnia and Herzegovina	September-92	Fiscal 1996
Macedonia	September-92	Fiscal 1994
Serbia and Montenegro (formerly Federal Republic of Yugoslavia)	September-92	Fiscal 2002
Congo, Democratic Republic of (formerly Zaire)*	November-93	Fiscal 2003
Sudan*	January-94	Fiscal 2000
Congo, Republic of*	November-97	Fiscal 2002
Zimbabwe	October-00	Still in nonaccrual status
Cote d'Ivoire*	March-01	Fiscal 2002
Seychelles	August-02	Still in nonaccrual status
Cote d'Ivoire*	November-04	Still in nonaccrual status

\*Eligible to borrow only from IDA as of July 1, 2006.

Table 5 provides information on the quality of IBRD's loan and guarantee portfolio. The first section of the table shows the breakdown of IBRD's loan and guarantee exposure by rating groupings (confidential credit assessments are used to allocate countries for which no public rating is available, but at fiscal year-end

2006 more than 97% of IBRD's DRE was to countries with public ratings from Standard & Poor's). Changes in the percentage of loans and guarantees in various rating groupings primarily reflect changes in country ratings, since the share of DRE to a country usually changes only slowly. During fiscal 2006, the principal changes resulted from Standard & Poor's raising its long-term foreign currency sovereign credit rating on China (to 'A-' from 'BBB+'); Brazil (to 'BB' from 'BB-'); the Republic of Argentina (to 'B' from 'B-'); and Russia (to 'BBB' from 'BBB-'); in addition, Standard & Poor's long-term foreign currency sovereign credit ratings on 14 other countries with loans or guarantees from IBRD were raised; only one borrower, the Republic of Hungary, had the rating lowered (to 'BBB+' from 'A-').

**Table 5****IBRD Development-Related Exposure Quality And Accumulated Provisions For Losses**

(Mil. US\$, unless otherwise indicated)	--Year ended June 30--				
	2006	2005	2004	2003	2002
<b>Distribution of loans and guarantees by rating category (%)</b>					
A- and above	15.0	5.1	5.2	6.0	1.3
BBB+ to BBB-	22.8	31.2	27.4	25.8	32.3
BB+ to BB-	40.5	37.4	24.9	26.4	25.9
B+ to B-	19.3	24.2	31.9	31.0	21.0
CCC+ to SD	2.4	2.2	10.6	10.8	19.6
Index of credit quality of development-related exposure	6.5	7.1	9.9	10.4	12.2
<b>Past-due loans and provisioning</b>					
Loan write-offs	0	0	0	0	0
Principal on nonaccrual loans	1,038	3,543	3,188	3,012	2,755
Principal payments past due on nonaccrual loans	577	459	365	319	336
Interest and charges past due	423	370	363	310	313
Accumulated provision for nonaccrual loans	816	1,431	1,342	1,269	1,523
As a % of principal on nonaccrual loans	78.6	40.4	42.1	42.1	55.3
As a % of principal payments past due on nonaccrual loans	141.4	311.8	367.7	397.8	453.3
Accumulated provision for accrual loans	1,480	1,578	2,163	2,776	3,530
As a % of accrual loans	1.5	1.6	2.0	2.5	3.0
Guarantee write-offs	0	0	0	0	0
Accumulated provision for losses on guarantees	11	13	15	24	41
Accumulated provision as a % of outstanding guarantees	1.1	1.1	1.2	1.9	2.6

The index of credit quality of DRE is a summary indicator of the credit risk embedded in IBRD's DRE portfolio. It is constructed by calculating the percentage of the portfolio falling into each rating category and applying an expected default rate to each of these percentages, resulting in a weighted average default rate, which is the index; the higher the index, the greater the credit risk embedded in the portfolio. In applying the default rates, country ratings are generally elevated by three notches to reflect expected preferred creditor treatment (i.e., the default rate applied to 'BB' exposure is that associated with 'BBB' countries). This measure ignores the possibility of recoveries (which have, of course, been typical in the case of IBRD and other MDFIs), and thus is not deemed to be a meaningful indicator of expected losses. This index, which decreased to 6.5 at fiscal year-end 2006 from 7.1 one year earlier and a recent high of 12.2 at fiscal year-end 2002, is consistent with the continuing improvement in the overall quality of IBRD's loan and guarantee portfolio suggested by the breakdown of exposure by rating category.

While IBRD has never had to write off a loan, it nonetheless holds a substantial accumulated provision for potential losses in its loan portfolio. Under the current provisioning policy, loan-loss reserves are calculated as the sum product of IBRD's loan exposure, the borrower's expected default probability, and IBRD's expected loss given default. The parameters used in these calculations require large accumulated provisions for nonaccrual loans. As shown in table 5, the accumulated provision for nonaccrual loans has varied between 40% and 79% of principal over the past five years, the latter percentage applying at fiscal year-end 2006. The accumulated provision for performing loans is much lower, varying between 3.0% and 1.5% over the past five years, the latter percentage also applying to fiscal year-end 2006. Due to the extremely different loss assumptions made for nonaccrual and performing loans, the movement of loans into and out of nonaccrual status has a large effect on the accumulated loan-loss provision, and hence on the provision for losses in IBRD's income statement.

To date, IBRD has never written off a guarantee. Nonetheless, IBRD maintains an accumulated provision for its guarantee exposure, which was 1.1% of such exposure at fiscal year-end 2006.

The bank paid out US\$250 million during fiscal 2003 under its partial guarantee of US\$1.5 billion in zero coupon notes issued by Argentina. That payment triggered a loan in the same amount by IBRD to Argentina; accordingly, if Argentina fails to reimburse IBRD for the bank's payment under its guarantee it would be defaulting on a loan, although the origin of the exposure was a guarantee.

## Capital, Risk-Bearing Capacity, And Capital Adequacy

IBRD's US\$190.8 billion in authorized capital (that which its board of governors has authorized for subscription by members) has been unchanged since fiscal year-end 1998. Of this amount, US\$189.7 billion was subscribed (i.e., claimed by members) at fiscal year-end 2006. However, less than US\$11.5 billion of the subscribed capital was paid-in; the remaining US\$178.2 billion was callable.

**Table 6**

### IBRD Risk-Bearing Capacity

(Mil. US\$)	--Year ended June 30--				
	2006	2005	2004	2003	2002
Authorized capital	190,811	190,811	190,811	190,811	190,811
Subscribed capital	189,718	189,718	189,718	189,567	189,505
Callable capital	178,235	178,235	178,235	178,089	178,029
Paid-in capital, reported	11,483	11,483	11,483	11,478	11,476
Amounts to maintain value of currency holdings	52	46	(73)	(331)	(641)
Retained earnings	24,782	27,171	23,982	27,031	22,227
Accumulated other comprehensive gain (loss)*	157	(112)	71	(260)	(749)
Total shareholders' equity	36,474	38,588	35,463	37,918	32,313
Currencies subject to restrictions	(693)	(672)	(665)	(670)	(668)
Nonnegotiable, noninterest-bearing demand obligations on account of subscribed capital	(1,766)	(1,836)	(1,790)	(1,794)	(1,632)
Amounts to maintain value of currency holdings	(40)	(72)	(113)	(166)	(355)
Adjusted shareholders' equity	33,975	36,008	32,895	35,288	29,658
Accumulated provision for loan losses	2,296	3,009	3,505	4,045	5,053
Accumulated provision for losses on guarantees	11	13	15	24	41
Narrow risk-bearing capacity¶	36,282	39,030	36,415	39,357	34,752
Callable capital from 'AAA' rated member countries	79,281	79,281	76,110	74,414	66,575
Broad risk-bearing capacity§	115,563	118,311	112,525	113,771	101,327

\*Consists of the effects of FAS 133 and currency translation adjustments. ¶Adjusted shareholders' equity plus accumulated provision for loan losses and losses on guarantees. §Narrow risk-bearing capacity plus 'AAA' callable capital.

Reported paid-in capital is, in reality, overstated from a credit perspective, as it implicitly includes the following (as shown on the asset side of the balance sheet at fiscal year-end 2006):

- US\$693 million in currencies subject to restrictions. These are capital subscriptions paid in members' local currencies, which may be used by IBRD for its lending or investing operations only with the consent of the respective members and for administrative purposes. The ability to use these sums to repay borrowings or guarantees in a time of financial stress is uncertain;
- US\$1,766 million in nonnegotiable, noninterest-bearing demand obligations on account of subscribed capital. These are sums owed IBRD for capital subscriptions that are held in bank accounts bearing IBRD's name; however, IBRD's ability to withdraw and convert these sums in a time of financial stress is uncertain; and
- US\$40 million in receivables to maintain the value of currency holdings on account of subscribed capital. These are sums owed IBRD by members whose currencies have depreciated relative to the value of the Special Drawing Right (SDR) on July 1, 1974, which are outstanding for less than two years. IBRD's ability to draw on these sums is also uncertain.

Standard & Poor's deducts these items from shareholders' equity as reported on the balance sheet to get adjusted shareholders' equity, which is used for calculating some ratios and for comparison with other MDFIs, whose capital is similarly adjusted when necessary.

IBRD's paid-in capital is substantially exceeded by its retained earnings, which totaled US\$24.8 billion at fiscal year-end 2006. Another component of shareholders' equity is accumulated other comprehensive income (or loss), which includes currency translation adjustments and the cumulative effects of the change in accounting principle occasioned by the adoption of FAS 133. Under U.S. GAAP, these items are excluded from net income and are directly reflected in shareholders' equity. This adjustment totaled a US\$157 million at fiscal year-end 2006, in contrast to the negative US\$112 million one year earlier.

IBRD's shareholders' equity alone, however, vastly underestimates its financial strength. As shown in table 6, IBRD's shareholders' equity at fiscal year-end 2006 was buttressed by US\$178.2 billion in callable capital. This callable capital is:

- Subject to call only to meet IBRD obligations created by its borrowing or guarantees;
- A several obligation of members (i.e., the failure of a member to meet a capital call does not excuse other members from meeting the call); and
- Subject to repeated calls, up to the limit of each country's subscription to callable capital.

IBRD has very substantial high-quality callable capital. At fiscal year-end 2006, US\$79.3 billion was subscribed by countries rated 'AAA' by Standard & Poor's, including US\$30.0 billion by the U.S., whose subscription has been determined by the U.S. Treasury's general counsel to be a full faith and credit obligation of the U.S. Other 'AAA' rated member countries with large callable capital subscriptions include Germany (US\$8.2 billion); France (US\$7.9 billion); and the U.K. (US\$7.8 billion). Another US\$56.5 billion of callable capital was subscribed by other investment-grade countries, of which Japan's subscription was the largest (US\$14.4 billion).

Since Standard & Poor's ratings on MDFIs assess their willingness and ability to meet their obligations in a timely fashion, one concern regarding callable capital is the timeliness with which member countries could/would meet a capital call, particularly since no 'AAA' rated MDFI has ever issued such a call. This concern is mitigated by the fact that US\$7.7 billion of the U.S. callable capital subscription may be paid by the U.S. secretary of the treasury without any congressional action.

IBRD's last general capital increase was in fiscal 1988, and there are no plans for another increase at present. The bank's management deems existing capital and prospective income adequate to support its current business strategy and the expected demand for its loans. IBRD's shareholders are aware that IBRD's ability to provide support to borrowing countries in the event of a severe international financial crisis is limited by the level of its shareholders' equity.

Table 7 summarizes alternative measures of IBRD's capital adequacy. DRE, which accounts for the vast bulk of the IBRD's credit risk, has been less than half of total assets plus guarantees at each of the last three year-ends, below the percentages of earlier years. Similarly, shareholders' equity (adjusted for assets of uncertain value), which declined to 16.2% of assets similarly adjusted at fiscal year-end 2006 from 16.4% one year earlier, was still well above levels of earlier years.

**Table 7**

**IBRD Capital Adequacy**

(% , unless otherwise indicated)	--Year ended June 30--				
	2006	2005	2004	2003	2002
<b>Balance-sheet based</b>					
DRE/total assets + guarantees	48.8	47.3	48.2	50.7	53.7
Adjusted shareholders' equity/adjusted total assets	16.2	16.4	14.5	15.5	13.2
Narrow risk-bearing capacity/DRE	34.9	37.0	32.9	33.5	28.2
Broad risk-bearing capacity/DRE	111.1	112.1	101.5	96.8	82.3
<b>Embedded risk approach</b>					
Narrow risk-bearing capacity/embedded default risk (x)	5.4	5.2	3.3	3.2	2.3
Broad risk-bearing capacity/embedded default risk (x)	17.1	15.9	10.3	9.4	6.8
<b>Stress-test approach</b>					
Narrow risk-bearing capacity/exposure rated SD to CCC+ (x)	14.3	12.4	3.1	3.1	1.4
Narrow risk-bearing capacity/exposure rated SD to B+ (x)	1.6	1.4	0.8	0.8	0.7
Narrow risk-bearing capacity/exposure rated SD to BB+ (x)	0.6	0.6	0.5	0.5	0.4
Broad risk-bearing capacity/exposure rated SD to CCC+ (x)	45.5	37.7	9.6	9.0	4.2

Broad risk-bearing capacity/exposure rated SD to B+ (x)	5.1	4.1	2.4	2.3	2.0
Broad risk-bearing capacity/exposure rated SD to BB+ (x)	1.8	1.8	1.5	1.4	1.2
Broad risk-bearing capacity/exposure rated SD to BBB+ (x)	1.3	1.2	1.1	1.0	0.8
DRE-Development-related exposure.					

Standard & Poor's has two measures of risk-bearing capacity:

- Narrow risk-bearing capacity, equal to the accumulated provision for losses on loans and guarantees plus adjusted shareholders' equity; and
- Broad risk-bearing capacity, equal to narrow risk-bearing capacity plus 'AAA' rated callable capital.

As shown in table 6, narrow risk-bearing capacity fell by US\$2.7 billion during fiscal 2006 after increasing by US\$2.6 billion during fiscal 2005, the consequence of a reported loss under U.S. GAAP accounting. Broad risk-bearing capacity also fell by US\$2.7 billion during fiscal 2006, but it has increased more than narrow risk-bearing capacity in recent years as a consequence of Standard & Poor's upgrading countries to 'AAA' long-term foreign currency sovereign credit ratings, including the Kingdom of Spain during fiscal 2005, the Kingdom of Sweden during fiscal 2004, and the Commonwealth of Australia and Canada during fiscal 2003.

Because of the decline in IBRD's narrow risk-bearing capacity during fiscal 2006, it fell as a percentage of DRE to 34.9% from 37.0% one year earlier, which was by far the highest percentage in recent years. Similarly, broad risk-bearing capacity relative to DRE fell to 111.1% of DRE from 112.1% one year earlier, which was also by far the highest percentage in recent years (this percentage was 82.3% at fiscal year-end 2002). The fact that it exceeds 100% implies that the bank would remain solvent even if all of its loans were deemed worthless and it was required to pay out under all of its outstanding guarantees—as long as there were no losses on IBRD's other assets and all of IBRD's 'AAA' rated members met a capital call. By all of these measures, then, IBRD's capital adequacy at fiscal year-end 2006 was extremely strong by both historical standards and in absolute terms, surpassed only by that of one year earlier.

Two other approaches are also employed in assessing capital adequacy. The embedded-risk approach employs the same methodology used in calculating the index of credit quality of DRE to calculate the dollar amount of default risk in IBRD's loan and guarantee portfolio. It then compares this number to the narrow and broad risk-bearing capacity of the bank. By implicitly assuming a 0% recovery rate, this calculation grossly overestimates the losses that must be covered by the bank's risk-bearing capacity.

Using this approach, IBRD's narrow risk-bearing capacity relative to the default risk in its development-related portfolio has gradually but substantially increased, to 5.4x at fiscal year-end 2006 from 5.2x one year earlier and 2.3x at fiscal year-end 2002. The pattern was similar but more pronounced using broad risk-bearing capacity, with the ratio of broad risk-bearing capacity to default risk increasing to 17.1x at year-end 2006 from 15.9% one year earlier and 6.8x at fiscal year-end 2002.

Another approach (the stress-test approach) assumes that there is a market-driven contagion and that all of the lower-rated countries default with no recoveries. At fiscal year-end 2006, IBRD's narrow risk-bearing capacity would cover the write-off of all loans and guarantees in the 'SD', 'CCC', 'B-', 'B', and 'B+' rating categories and more than 83% of those in the 'BB-' category. Of course, as noted above, since IBRD's broad risk-bearing capacity exceeds its loans and guarantees, by this measure all of IBRD's DRE could be written off without the bank becoming insolvent, assuming its 'AAA' rated members met their commitments to provide callable capital.

All of these measures point to the same conclusion: IBRD is extraordinarily well capitalized by historical as well as absolute standards and positioned to withstand even very large, low-probability shocks. In the absence of a wholesale abandonment of preferred creditor treatment by its borrowers and the failure of its highest-rated shareholders to meet their obligations to provide callable capital, IBRD's current risk profile and risk-bearing capacity can withstand any foreseeable adverse international economic environment.

## Net Income

Because there are no plans for a capital increase from existing members, and because new members will not be a source of significant additional capital, growth in IBRD's risk-bearing capacity will depend almost entirely upon contributions to retained earnings from net income. Table 8 summarizes IBRD's income statement.

**Table 8**

## IBRD Summary Income Statement And Transfers From Net Income And Surplus

(Mil. US\$, unless otherwise indicated)	--At June 30--				
	2006	2005	2004	2003	2002
Interest income on loans funded by equity	1,585	1,298	1,231	1,483	1,714
Interest income on loans funded by debt, net of funding costs	278	291	628	936	848
Total loan interest income, net of funding costs	1,863	1,589	1,859	2,419	2,562
Other loan income	41	63	37	111	98
Release of provisions (provisions) for losses on loans and guarantees	724	502	665	1,300	15
Total loan income, net of funding costs and provisions for losses	2,628	2,154	2,561	3,830	2,675
Investment income, net of funding costs	76	94	22	36	32
Administrative expenses	(1,055)	(1,021)	(934)	(882)	(876)
Contributions to special programs	(173)	(173)	(179)	(156)	(176)
Net other	264	266	226	193	269
Operating income	1,740	1,320	1,696	3,021	1,924
FAS 133-related adjustments	(3,479)	2,511	(4,100)	2,323	854
Board of governors approved transfers	(650)	(642)	(645)	(540)	(402)
Net (loss) income	(2,389)	3,189	(3,049)	4,804	2,376
<b>Memo items:</b>					
Transfers from previous year's unallocated net income and surplus to:					
IDA	400	300	300	300	302
HIPC Initiative Trust Fund	210	240	240	240	100
Low-Income Countries Under Stress Implementation Trust Fund	25	0	25	0	0
Other	15	102	80	0	0
Total transfers	650	642	645	540	402
Current-value operating income	1,012	815	977	1,742	1,957
Current-value net income	640	402	1,129	3,436	2,853
Operating income/average total assets + guarantees (%)	0.80	0.58	0.73	1.31	0.85
Operating income/average adjusted shareholders' equity (%)	5.0	3.8	5.0	9.3	6.8
HIPC-Highly indebted poor country.					

IBRD's operating income on a U.S. GAAP basis increased to US\$1,740 million during fiscal 2006 from US\$1,320 million one year earlier. The principal drivers of operating income are the level of interest rates (as equity funds a significant portion of its interest-bearing assets); the spread on its loans and investment assets funded by borrowings; provisions for losses on loans and guarantees; and noninterest expenses, primarily administrative. During fiscal 2006, loan interest income net of funding costs increased by US\$274 million to US\$1,863 million due to higher lending spreads on loans funded by equity (net interest income on loans funded by debt fell by US\$13 million); the release of provision for losses on loans and guarantees increased by US\$222 million to US\$724 million; and administrative expense increased by US\$34 million to US\$1,055 million. The bank's operating return on average total assets plus guarantees during fiscal 2006 was 0.8%, up from 0.6% one year earlier; and its operating return on average adjusted shareholders' equity was 5.0%, up from 3.8% one year earlier. Looking ahead, with the accumulated provision for losses down to US\$2.3 billion at fiscal year-end 2006 from US\$5.1 billion at fiscal year-end 2002, the scope for further contributions to operating income from this source is limited. On the other hand, loan and guarantee commitments increased to US\$14.1 billion during fiscal 2006, up from US\$13.6 billion during fiscal 2005 and US\$11.0 billion during 2004, which augurs well for increases in net interest income, particularly if prepayments of loans abate. Further increases in interest rates would also boost operating income.

In contrast to operating income, net income on a U.S. GAAP basis was a negative US\$2,389 million during fiscal 2006, as opposed to positive net income of US\$3,189 million one year earlier, the second such loss in IBRD's history (the first being in fiscal 2004). Like the fiscal 2004 loss, it was entirely the result of the decision of IBRD not to employ hedge accounting and the resulting asymmetric treatment of offsetting transactions required by FAS 133.

The bank has elected not to define any qualifying hedging relationships and, consequently, carries all derivatives on its balance sheet at fair value, with changes in fair value reflected in net income. However, IBRD's loans and, especially, the borrowings that these derivatives hedge are not carried at fair value, and changes in their fair values are not reflected in net income. Since the bank makes extensive use of swaps

to mitigate its currency and interest-rate risk and tends to have loans and borrowings with longer maturities than most other financial institutions, this asymmetric accounting treatment has had a large impact on IBRD's reported net income in recent years, given the substantial changes in interest rates in the U.S. and in other countries in whose currencies IBRD borrows, as well as changes in exchange rates vis-à-vis the dollar. FAS 133-related adjustments were negative US\$3,479 million in fiscal 2006; positive US\$2,511 million in fiscal 2005; and negative US\$4,111 million in fiscal 2004. In each case, these adjustments were much larger than operating income. Standard & Poor's is unconcerned about the volatility these adjustments introduce into IBRD's net income and the fact that net income is now sometimes negative, because they reflect an asymmetric treatment of offsetting transactions and are essentially accounting artifacts.

A second difference between operating and net income was introduced during fiscal 2006, when IBRD began reporting all board-of-governors-approved transfers as expenses, with the change applied retrospectively. These transfers had been treated as reductions in retained earnings since 1964, akin to and in lieu of distributions to shareholders. The principal claimed advantage of this new presentation is "greater transparency"; it is also deemed to provide "greater consistency with the more traditional corporate legal form and associated expense recognition policies presumed by generally accepted accounting principles." However, these proclaimed advantages are obtained at the cost of including as expenses transactions (including "contributions to special programs," which have previously been included in net income and represent grants for agricultural research and other developmental activities) that are qualitatively different from typical expense items, which sacrifices transparency. From its perspective, Standard and Poor's is not convinced that this change is for the better.

For management purposes, IBRD prepares separate statements for operating and net income on a current-value basis that reflect the economic value of its financial assets and liabilities after considering credit and interest- and exchange-rate risk (see memo items in table 8). Although still subject to volatility as a consequence of changes in the nonaccounting drivers of reported net income, current-value basis income has been both positive and more stable than U.S. GAAP income. During fiscal 2006, current-value operating income increased to US\$1,012 million from US\$815 million one year earlier, and current value net income increased to US\$640 million from US\$402 million. Standard & Poor's accepts that operating income and net income on a current value basis are more meaningful indicators of IBRD's income performance than its net income reported on a U.S. GAAP basis.

While permitted to do so by its Articles, IBRD historically has not paid dividends on its net income, making the transfers from retained earnings referred to above to a variety of developmental activities, most notably to IDA and the Highly Indebted Poor Country (HIPC) Initiative. Table 8 shows the distributions over the past five years. Over this period, IBRD's cumulative reported net income on a U.S. GAAP basis before transfers was US\$4.9 billion. Over the same period, US\$2.9 billion (58%) was allocated for transfers, US\$1.6 billion of which was allocated to IDA and US\$1.0 billion to the HIPC Initiative Trust Fund.

## Liquidity

IBRD maintains liquidity consistent with its 'AAA' rating. Its liquidity management policy calls for aggregate liquid asset holdings (excluding cash due from banks) to be equal to the highest consecutive six months of expected debt service obligations for the fiscal year, plus one-half of net approved loan disbursements as projected for the fiscal year. The prudential minimum has been established as US\$15.5 billion for fiscal 2007, down US\$2 billion from that for fiscal 2006. On this basis, liquidity was US\$24.7 billion at fiscal year-end 2006, well above the minimum.

IBRD's liquidity as calculated by Standard & Poor's for comparison purposes—including the portion due from banks that is not restricted, its investments, and its securities purchased under resale agreements—was 27% of gross debt at fiscal year-end 2006, down from 28% one year earlier but in line with historical percentages. However, this is typically among the lowest percentages among 'AAA' rated MDFIs. IBRD's liquidity was 50% of undisbursed loans and estimated one-year debt service at fiscal year-end 2006, down from 61% one year earlier and also among the lowest for 'AAA' rated MDFIs.

The adequacy of liquidity should, however, be viewed in the context of an issuer's market access. IBRD has been a major issuer in international capital markets for many years, with a well-established reputation for sophistication and professionalism. Accordingly, in a time of financial stress the bank is likely to maintain market access well after that of some other similarly rated entities has been lost.

In sum, in terms of both risk-bearing capacity relative to risk and liquidity, IBRD is clearly a 'AAA' credit with the capacity to substantially increase its DRE while maintaining that rating.

## Comparative Data

Comparative data for IBRD and 15 other MDFIs may be found on pages 58 through 62 of Standard &

Poor's annual Supranationals Special Edition 2006 (available on [www.sandp.com](http://www.sandp.com); enter Supranationals Special Edition in search box and click on title under "Credit Ratings" in the center of the screen).

### Ratings Detail (As Of 29-Dec-2006)\*

#### International Bank for Reconstruction and Development

Issuer Credit Rating	
<i>Foreign Currency</i>	AAA/Stable/A-1+
Senior Unsecured	
<i>Foreign Currency</i>	AAA
Short-Term Debt	
<i>Foreign Currency</i>	A-1+

#### Issuer Credit Ratings History

05-Sep-1997	<i>Foreign Currency</i>	AAA/Stable/A-1+
05-Apr-1990		AAA/Stable/--
13-Sep-1959		AAA/--/--

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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