

INTERNATIONAL BANK FOR RECONSTRUCTION AND
DEVELOPMENT

MANAGEMENT'S DISCUSSION AND ANALYSIS
JUNE 30, 2007

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Throughout Management's Discussion and Analysis, terms in **boldface** type are defined in the Glossary of Terms on page 41.

The Management Discussion and Analysis contains forward looking statements which may be identified by such terms as "anticipates", "believes", "expects", "intends" or words of similar meaning. Such statements involve a number of assumptions and estimates that are based on current expectations, which are subject to risks and uncertainties beyond IBRD's control. Consequently, actual future results could differ materially from those currently anticipated.

1. OVERVIEW

The International Bank for Reconstruction and Development (IBRD) is an international organization established in 1945 and is owned by its member countries. IBRD's main goals are promoting sustainable economic development and reducing poverty in its developing member countries. It pursues these goals primarily by providing loans, guarantees and related technical assistance for projects and for programs for economic reform. IBRD's ability to intermediate funds from international capital markets for lending to its developing member countries is an important element in achieving its development goals. IBRD's financial objective is not to maximize profit, but to earn adequate net income to ensure its financial strength and to sustain its development activities. **Box 1** presents selected financial data for the last five fiscal years.

The financial strength of IBRD is based on the support it receives from its shareholders and on its array of financial policies and practices. Shareholder support for IBRD is reflected in the capital backing it has received from its members and in the record of its borrowing members in meeting their debt-service obligations to it. IBRD's financial policies and practices have led it to build reserves, to diversify its funding sources, to hold a large portfolio of liquid investments, and to limit a variety of risks, including credit, market and liquidity risks.

IBRD's principal assets are its loans to member countries. The majority of IBRD's outstanding loans are priced on a cost pass-through basis. (See **Tables 6** and **7** for loan pricing details).

To raise funds, IBRD issues debt securities in a variety of currencies to both institutional and retail investors. These borrowings, together with IBRD's equity, are used to fund its lending and investment activities, as well as general operations.

IBRD holds its assets and liabilities primarily in U.S. dollars, euro and Japanese yen. IBRD mitigates its exposure to exchange rate risks by matching the currencies of its liabilities and equity with those of its assets. However, the reported levels of its assets,

liabilities, income and expenses in the financial statements are affected by exchange rate movements in all the currencies in which IBRD transacts compared to IBRD's reporting currency, the U.S. dollar. Since IBRD matches the currencies of its equity with those of its loans, the fluctuations captured in the cumulative translation adjustment for purposes of financial statement reporting do not significantly impact IBRD's risk-bearing capacity.

Lending commitments to member countries in FY 2007 were \$12.8 billion, reflecting a decrease of \$1.3 billion from the FY 2006 level of \$14.1 billion.

For the purposes of this document Operating Income refers to net income before Board of Governors-approved transfers and the effect of net unrealized (losses) gains on non-trading derivatives and borrowings measured at fair value per FAS 133 as amended. FY 2007 Operating Income was \$1,659 million, \$81 million less than that for FY 2006.

During FY 2007, provisioning requirements for probable losses on loans and guarantees were reduced by \$405 million due to the combined impact of changes in the creditworthiness of the loan portfolio, the annual update of the expected default frequencies (probability of default to IBRD), and the reduction in the volume of the loan portfolio.

In the context of assessing changes in IBRD's operating environment, it is management's practice to recommend each year the allocation of net income to augment reserves, waivers of loan charges to benefit eligible borrowers, and allocation of net income to support developmental activities. The allocations from FY 2007 net income, together with the waivers of loan charges, are expected to be approved by the Executive Directors and the Board of Governors during FY 2008.

Box 1: Selected Financial Data

As of or for the Years Ended June 30

In millions of U.S. dollars, except ratio and return data in percentages

Lending	2007	2006	2005	2004	2003
Commitments to member countries ^a	12,829	14,135	13,611	11,045	11,231
Gross Disbursements ^b	11,055	11,883	9,722	10,109	11,921
Net Disbursements ^b	(6,193)	(1,741)	(5,131)	(8,408)	(7,996)
Reported Basis	2007	2006	2005	2004	2003
Loan Income	5,467	4,864	4,155	4,403	5,742
Release of Provision for Losses on Loans and Guarantees	405	724	502	665	1,300
Investment Income	1,173	1,057	627	304	418
Borrowing Expenses	(4,416)	(3,941)	(3,037)	(2,789)	(3,594)
Net Noninterest Expense	(970)	(964)	(927)	(887)	(845)
Operating Income	1,659	1,740	1,320	1,696	3,021
Board of Governors-Approved Transfers	(957)	(650)	(642)	(645)	(540)
Net unrealized (losses) gains on non-trading derivatives and borrowings measured at fair value, per FAS 133 as amended	(842)	(3,479)	2,511	(4,100)	2,323
Net (Loss) Income	(140)	(2,389)	3,189	(3,049)	4,804
Net Return on Average Earning Assets ^c	1.34	1.34	0.96	1.18	2.06
after the effects Board of Governors-Approved Transfers and of FAS 133 as amended	(0.11)	(1.84)	2.32	(2.12)	3.27
Return on Equity ^c	4.64	5.05	3.90	5.21	10.32
after the effects Board of Governors-Approved Transfers and of FAS 133 as amended	(0.37)	(6.84)	9.26	(8.88)	14.55
Equity-to-Loans Ratio ^c	35.05	32.96	31.45	29.35	26.59
Total Assets	208,030	212,326	222,008	228,910	230,062
Loans Outstanding	97,805	103,004	104,401	109,610	116,240
Accumulated Provision for Loan Losses	(1,932)	(2,296)	(3,009)	(3,505)	(4,045)
Borrowings Outstanding ^d	87,759	95,835	101,297	108,066	108,554
Total Equity	39,926	36,474	38,588	35,463	37,918
Current Value Basis	2007	2006	2005	2004	2003
Net Income	900	640	402	484	2,896
of which current value adjustment	222	(446)	(273)	(513)	394
Net Return on Average Earning Assets	0.72	0.49	0.28	0.33	1.90
Return on Equity	2.53	1.86	1.17	1.44	9.41
Equity-to-Loans Ratio	34.47	32.44	30.83	29.07	26.36
Unrestricted Cash and Liquid Investments	22,214	24,888	26,395	31,126	26,620
Loans Outstanding	98,516	103,885	107,549	112,608	122,593
Borrowings Outstanding ^d	89,484	95,258	105,691	109,675	116,695
Total Equity	38,613	37,590	36,943	36,421	35,675

a. Effective FY 2005 commitments include guarantee commitments and guarantee facilities.
b. Amounts include transactions with IFC and capitalized front-end fees.
c. Before the effects of Board of Governors-approved transfers and FAS 133 as amended.
d. Borrowings outstanding, excluding derivatives, net of premium/discount.

2. BASIS OF REPORTING

Financial Statement Reporting

IBRD prepares its financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) and referred to in this document as the “reported basis.”

Under Statement of Financial Accounting Standards No.133, *Accounting for Derivative Instruments and Hedging Activities*, IBRD has marked all derivative instruments, as defined by this standard, to fair value, with changes in fair value being recognized immediately in earnings. This standard allows hedge accounting for qualifying hedging relationships, if certain criteria are met. While IBRD believes that its hedging strategies achieve its objectives, the application of these criteria to IBRD's derivative portfolio would not appropriately reflect its risk management strategies. Therefore, IBRD has elected not to define any qualifying hedging relationships and, as a result, all changes in the fair value of the derivative instruments are recognized immediately in earnings. In addition, effective July 1, 2006, IBRD early adopted Statement of Financial Accounting Standards No.155, *Accounting for Certain Hybrid Financial Instruments* which amends certain provisions of Statement of Financial Accounting Standards No.133. As a result, IBRD also recognizes at fair value, all qualifying hybrid debt instruments that would otherwise be bifurcated and valued separately.

In this document, the above Statement of Financial Accounting Standards No. 133 as amended by subsequent standards are together referred to as “FAS 133 as amended.”

Management Reporting

In implementing its risk management (interest rate and currency risk) and funding strategies, IBRD makes extensive use of derivatives. In addition, IBRD uses derivative instruments for asset/ liability management of individual positions and portfolios.

IBRD's funding operations are designed to meet a major organizational objective of providing lower cost funds to borrowing members. Because of the extent of IBRD's long-dated funding, the reported volatility under FAS 133 as amended may be more pronounced than for many other financial institutions. The effects of applying FAS 133 as amended may significantly affect reported results in each accounting period, depending on changes in market rates. However, IBRD believes that its funding and asset/liability management strategies accomplish its objectives of protection from market risk and provision of lower cost funding, and that a current value basis provides more meaningful information for risk management and management reporting.

IBRD believes that a current value presentation reflects the economic value of all of its financial instruments. The current value model is based on the present value of expected cash flows. The model incorporates available market data in determining the cash flow and discount rates for each instrument. The current value financial statements are non U.S. GAAP measures and do not purport to present the net realizable, liquidation, or market value of IBRD as a whole.

Box 2: Hedging Strategy and Use of Derivatives

IBRD is a financial intermediary, borrowing funds in international capital markets for on-lending to member countries. As a matter of policy, IBRD mitigates interest rate and foreign exchange risks in its financing operations by entering into derivative transactions to reduce any mismatches between the interest rate position/currency composition of its liabilities and the assets funded by these liabilities. This approach insulates IBRD's balance sheet from material interest rate or currency exposure. A number of risk management techniques that IBRD utilizes would not qualify for hedge accounting treatment under FAS 133 as amended. Accordingly, IBRD has elected not to define any qualifying hedging relationships, though IBRD's policies and hedging strategy achieve its risk minimization objectives.

IBRD's application of FAS 133 as amended, accounts for all derivatives and certain debt instruments, at fair value, with changes in the fair value being recognized in earnings. IBRD's portfolio of derivatives that convert long-dated fixed-rate borrowings into floating rate obligations are financially equivalent to fixed non-U.S. dollar rate assets. In general, the reported values of these derivatives will decline when market interest rates increase and vice versa. Although these derivatives economically offset other financial positions on plain vanilla bonds and loans, those positions are generally not accounted for at fair value. Consequently, the reported values of plain vanilla bonds and loans are not affected by interest rate movements. Thus an asymmetry results in the reported financial statements when the values of economically offsetting transactions are reported on different bases.

Taking the above factors into account, IBRD believes that reported income does not capture the true economic income for IBRD. Accordingly, for management reporting purposes, IBRD instead uses current value financial statements, as shown in Tables 2 and 3, which mark both the derivatives and the underlying liabilities and assets to current value. Furthermore, IBRD bases its annual allocation and distribution decisions on reported income less the associated adjustments for derivatives as defined by FAS133 as amended and Board of Governors-approved transfers. IBRD does not utilize reported income for any management purposes. IBRD has consistently followed this approach from FY2000, since the introduction of FAS 133, regardless of whether the effects of that standard or its amendments by subsequent standards, increased or decreased IBRD's reported income in a given fiscal year.

Current Value Basis

The Condensed Current Value Balance Sheets in **Table 1** present IBRD's estimates of the economic value of its financial assets and liabilities, after considering market and credit risks. The current year's Condensed Current Value Balance Sheet is presented with a reconciliation to the reported basis. The prior year's Condensed Current Value Balance Sheet is presented, with a reconciliation to the reported basis, in **Table 20** in Section 10.

IBRD's Condensed Current Value Statement of Income is presented in **Table 2**. The "Adjustments to Current Value" column provides a reconciliation between net income on a reported basis and net income on a current value basis. The movement in unrealized mark-to-market gains from the investment portfolio of \$24 million, and the reduction in the provision for losses on loans and guarantees of \$405 million are reversed from the reported operating income, to arrive at \$1,230 million in operating income on a current value basis before the effects of unrealized gains and losses. To arrive at net income on a current value basis, the Current Value adjustment of \$222 million for market risk and the release in the provision for losses on loans and guarantees of \$405 million reflecting credit risk are added while the \$842 million effect of FAS 133 as amended is reversed. The prior year's Condensed Current Value Statement of Income is presented, with a reconciliation to the reported basis, in **Table 21** in Section 10.

A summary of the effects on net income of the current value adjustments in the balance sheet is presented in **Table 3**.

Current Value Balance Sheets

Loan Portfolio

All of IBRD's loans are made to or guaranteed by countries that are members of IBRD. In addition, IBRD may also make loans to the International Finance Corporation, an affiliated organization, without any guarantee. IBRD does not currently sell its loans, nor does management believe there is a market for loans comparable to those made by IBRD.

The current value of loans, including associated financial derivatives, is based on a discounted cash flow method. The estimated cash flows from principal repayments and interest are discounted using the rate at which IBRD would originate a similar loan at the reporting date. The cash flows of these instruments are based on management's best estimates, taking into account market exchange rates and interest rates.

The current value also includes IBRD's assessment of the appropriate credit risk, considering various factors including its history of payment receipts from borrowers. IBRD has always eventually collected all contractual principal and interest due on its loans. However, IBRD has suffered losses resulting from the difference between the discounted present value of payments for interest and charges, according to the loan's contractual terms, and the actual timing of cash flows. To recognize the credit risk inherent in these and any other potential overdue payments, IBRD adjusts the value of its loans through its loan loss provision.

At June 30, 2007, the \$711 million increase in IBRD's loan portfolio from the reported basis to the current value basis as shown in **Table 3** (\$881 million—June 30, 2006) reflects the fact that the loans in the portfolio, on average, carry a higher rate of interest than the rate at which IBRD would currently originate a similar loan at the reporting date. The \$170 million decrease in the current value adjustment from June 30, 2006 was primarily due to the decrease in the mark on euro and Japanese yen denominated loans, consistent with the increase in the reference market yield curves for the euro and Japanese yen during the year, partially offset by the increase in the mark on U.S. dollar denominated loans. For the U.S. dollar reference market yield curves see **Figure 11**.

Investment Portfolio

Under both the reported and current value basis, the investment securities and related financial instruments held in IBRD's trading portfolio are carried and reported at fair values. Therefore, for the investment portfolio, no additional adjustment is necessary. Fair value is based on market quotations. Instruments for which market quotations are not readily available have been valued using market-based methodologies and market information.

Borrowing Portfolio

The borrowing portfolio on a current value basis includes debt securities and associated financial derivatives, and represents the present value of expected cash flows on these instruments discounted by the cost at which IBRD would obtain funding at the reporting date. The valuation model incorporates available market data in determining the expected cash flow and discount rates for each instrument. Market data include exchange rates and reference market interest rates. The current value for the borrowing portfolio includes current value adjustments for borrowings, payable for derivatives, receivable from derivatives and the reduction in other assets due to unamortized issuance costs.

Table 1: Condensed Current Value Balance Sheets at June 30, 2007 and 2006*In millions of U.S. dollars*

	June 30, 2007			June 30, 2006	
	Reported Basis	Reversal of FAS 133 Effects	Current Value Adjustments	Current Value Basis	Current Value Basis
Due from Banks	\$ 765			\$ 765	\$ 758
Investments	23,336			23,336	25,826
Loans Outstanding	97,805		\$711	98,516	103,885
Less Accumulated Provision for Loan Losses and Deferred Loan Income	(2,372)			(2,372)	(2,783)
Receivable from Derivatives					
Investments	7,138			7,138	7,525
Client Operations	4,778	\$ 175	(175)	4,778	89
Borrowings	69,507	13	(13)	69,507	70,036
Other Assets/Liabilities	13	2	(2)	13	835
Other Assets	7,060		(299)	6,761	6,694
Total Assets	<u>\$208,030</u>	<u>\$ 190</u>	<u>\$222</u>	<u>\$208,442</u>	<u>\$212,865</u>
Borrowings	\$87,759	1,072	\$653	\$89,484	\$95,258
Payable for Derivatives					
Investments	7,527			7,527	7,960
Client Operations	4,776	174	(174)	4,776	84
Borrowings	62,850	(33)	33	62,850	65,819
Other Assets/Liabilities	38	(24)	24	38	1,014
Other Liabilities	5,154			5,154	5,140
Total Liabilities	<u>168,104</u>	<u>1,189</u>	<u>536</u>	<u>169,829</u>	<u>175,275</u>
Paid in Capital Stock	11,486			11,486	11,483
Retained Earnings and Other Equity	28,440	(999)	(314)	27,127	26,107
Total Equity	<u>39,926</u>	<u>(999)</u>	<u>(314)</u>	<u>38,613</u>	<u>37,590</u>
Total Liabilities and Equity	<u>\$208,030</u>	<u>\$ 190</u>	<u>\$222</u>	<u>\$208,442</u>	<u>\$212,865</u>

At June 30, 2007, the \$998 million increase in IBRD's borrowing portfolio from the reported basis to the current value basis as shown in Table 3 (\$1,076 million—June 30, 2006) reflects the average cost of the borrowing portfolio being higher than the rate at which IBRD could obtain funding at the reporting date. The \$78 million decrease from June 30, 2006 in the current value adjustment was due primarily to the decrease in the mark on the euro and Japanese yen

denominated debt consistent with the rise in the reference market yield curves for the euro and Japanese yen during the year. This was partially offset by the increase in the mark on U.S. dollar denominated debt. For the U.S. dollar reference market yield curves see Figure 11.

Table 2: Condensed Current Value Statements of Income for the years ended June 30, 2007 and 2006*In millions of U.S. dollars*

	FY 2007		FY 2006	
	Reported Basis	Adjustments to Current Value	Current Value Comprehensive Basis	Current Value Comprehensive Basis
Income from Loans	\$5,467		\$5,467	\$4,864
Income from Investments, net	1,173	\$ (24)	1,149	1,053
Other Income	268		268	267
Total Income	6,908	(24)	6,884	6,184
Borrowing Expenses	4,416		4,416	3,941
Administrative Expenses including contributions to Special Programs	1,236		1,236	1,231
Release of Provision for Losses on Loans and Guarantees	(405)	405		
Other Expenses	2		2	
Total Expenses	5,249	405	5,654	5,172
Operating Income	1,659	(429)	1,230	1,012
Board of Governors-Approved Transfers	(957)		(957)	(650)
Current Value Adjustments		222	222	(446)
Release of Provision for Losses on Loans and Guarantees—Current Value		405	405	724
Net unrealized (losses) gains on non-trading derivatives and borrowings at fair value, per FAS 133 as amended ^a	(842)	842	—	—
Net (Loss) Income	\$(140)	\$1,040	\$ 900	\$ 640

a. Unrealized (losses) gains on derivatives in the investment trading portfolio are included in income from investments, net.

Table 3: Summary of Current Value Adjustments*In millions of U.S. dollars*

	Balance Sheet Effects as of June 30, 2007				Less Prior Years' Effects	Total Income Statement Effect	
	Loans	Borrowings	Other Asset/Liability	Total		FY 2007	FY 2006
Current Value Adjustments on Balance Sheet due to Interest Rates	\$711	\$(998) ^a	\$(27)	\$314	\$246 ^b	\$(68)	\$(588)
Unrealized Gains on Investments ^c						24	4
Currency Translation Adjustment ^d	892	(636)	10	266		266	138
Total Current Value Adjustments						\$222	\$(446)

a. Amount is net of the current value adjustments for derivatives, and unamortized issuance costs.

b. Includes \$116 million representing a one-time cumulative effect of recording the adoption, on July 1, 2000, of the current value basis of accounting.

c. Unrealized gains on the investment portfolio have been moved from Operating Income under the reported basis and included as part of current value adjustments for current value reporting.

d. The currency translation effects have been moved from Other Comprehensive Income under the reported basis and included in Current Value Net Income for purposes of current value reporting.

Current Value Statements of Income

Income from Loans

Income from loans increased by \$603 million during FY 2007 in comparison with FY 2006. The main reason for this increase was higher lending rates which contributed \$794 million. This was partially offset by a \$134 million reduction in income due to lower average loan balances outstanding.

Provision for Losses on Loans and Guarantees

During FY 2007, there was a \$405 million release of provision for losses on loans and guarantees in comparison to a release of \$724 million during FY 2006. The release of provision in each period reflects the combined impact of changes in the creditworthiness of the loan portfolio, changes in the volume and distribution of loans and guarantees outstanding, net of translation adjustments and the annual update of the expected default frequencies (probabilities of default to IBRD) and developments in the nonaccrual portfolio. The effect has been a decrease in net income of \$319 million between the two fiscal years.

Income from Investments

During FY 2007, income from investments increased by \$96 million due to higher average short-term interest rates, in comparison with FY 2006 (see **Figure 10**). IBRD holds primarily short-term U.S. dollar fixed income investments with an average **duration** of less than three months.

Borrowing Expenses

Borrowing expenses increased by \$475 million during FY 2007, in comparison with FY 2006. With approximately two-thirds of borrowings based on short-term U.S. dollar interest rates, the increase in U.S. dollar six-month LIBOR in FY 2007 (see **Figure 10**), resulted in higher borrowing expenses. This was partly offset by a reduction in the average portfolio size.

Gross Administrative Expenses (Including Contributions to Special Programs)

Gross Administrative expenses increased by \$5 million during FY 2007 compared to FY 2006. The main reasons for this increase were costs related to contractual services and equipment and buildings which contributed \$21 million. This was partially offset by \$14 million decrease relating to pension and other postretirement benefits. (see **Table 19**).

Current Value Adjustments

As part of its risk management strategy, IBRD closely aligns the duration (interest rate sensitivity) and the currency composition of its equity to that of its loan portfolio in order to minimize the impact of any interest rate and currency exchange rate movements

on its risk bearing capacity. Therefore, on a current value basis while there will be some mark-to-market effect on equity, such an impact will not significantly affect IBRD's **risk bearing capacity**. Consistent with the positive **duration** of IBRD's equity, in a rising interest rate environment, the current value adjustment due to interest rate changes, decreased net income in FY 2007 by \$68 million (decrease of \$588 million in FY 2006) as shown in **Table 3**. This decrease was more than offset by the favorable effect of \$266 million (\$138 million in FY2006) due to the appreciation of the euro against the U.S. dollar. The overall effect on the Statement of Income was a positive \$222 million in FY 2007 against a negative effect of \$446 million in FY 2006.

Impact of changes due to interest rates

The current value effect on the Statement of Income of negative \$68 million during FY 2007, was primarily due to the decrease in the current value mark on the loan portfolio of \$170 million partially offset by the decrease in the current value mark on the borrowing portfolio of \$78 million. These adjustments have been explained under the Current Value Balance Sheet Section. Similarly, during FY 2006, IBRD's net income on a current value basis included a negative adjustment of \$588 million, due to the decrease in the current value mark on the loan portfolio reflecting higher U.S. dollar reference market yield curve. These losses were partially offset by the decrease in the current value mark on the borrowing portfolio.

Impact of changes due to currency translation

The current value adjustment from currency translation adjustments of positive \$266 million was primarily due to the appreciation of the euro (7%) offset by the depreciation of the Japanese yen (5.1%) against the U.S. dollar during FY 2007. **Table 4** provides a breakdown of this adjustment by the loans and borrowing portfolios. The loan portfolio contributed \$892 million towards this increase. The euro and the Japanese yen accounted for approximately 18% and 4% of the total loan portfolio, and 97% of total non-U.S. dollar denominated loans at June 30, 2007. The borrowing portfolio accounted for a negative \$636 million. The euro and the Japanese yen accounted for approximately 13% and 3% of the total borrowing portfolio, and 96% of total non-U.S. dollar denominated borrowings at June 30, 2007.

Table 4: Impact of Currency Translation Adjustment

<i>In millions of U.S. dollars</i>		
	2007	2006
Loans	\$ 892	\$ 347
Borrowings	(636)	(216)
Other Asset/Liability	10	7
Total	<u>\$ 266</u>	<u>\$ 138</u>

In comparison, during FY 2006 the impact of exchange rate changes on IBRD's net assets resulted in a positive translation adjustment of \$138 million due to the appreciation of the euro (3.8%) offset by the depreciation of the Japanese yen (5.5%) against the U.S. dollar.

Given IBRD's risk management strategy, the stability of the current value **equity-to-loans ratio** is considered more significant than fluctuations in the net current value adjustments.

3. DEVELOPMENT ACTIVITIES

IBRD offers loans, related derivative products, and guarantees to its borrowing member countries to help meet their development needs. It also provides technical assistance and other advisory services to support poverty reduction in these countries.

Loans

From its establishment through June 30, 2007, IBRD had approved loans, net of cancellations, totaling \$378,204 million to borrowers in 133 countries. A summary of cumulative lending is contained in Table 5.

At June 30, 2007, the total volume of outstanding loans was \$97,805 million, \$5,199 million lower than the \$103,004 million of outstanding loans at June 30, 2006. This decrease was due primarily to negative **net disbursements** of \$6,193 million, including \$6,354 million of prepayments. Undisbursed balances at June 30, 2007 totaled \$35,440 million, reflecting an increase of \$502 million from June 30, 2006. This change was due to new commitments and positive currency translation adjustments, partially offset by cancellations and disbursements of loans.

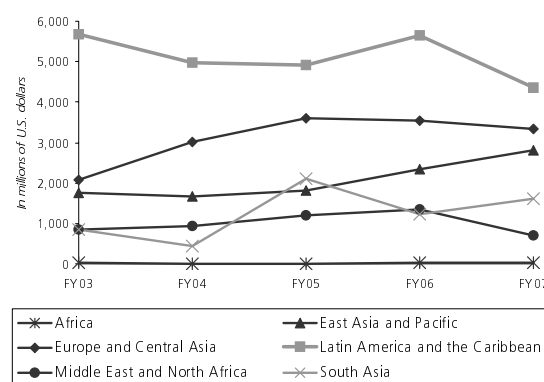
Table 5: Lending Status at June 30, 2007 and 2006

<i>In millions of U.S. dollars</i>		
	2007	2006
Cumulative Approvals ^a	\$378,204	\$367,002
Cumulative Repayments ^b	\$248,646	\$231,372

a. *Net of cancellations*

b. *Multicurrency pool loan repayments are included at exchange rates in effect on the date of original disbursement. All other amounts are based on U.S. dollar equivalents at the time of repayment by borrowers.*

During FY 2007, new loans, guarantee commitments and guarantee facilities to member countries were \$12,829 million, (\$14,135 million-FY 2006). During the five year period from FY 2003 to FY 2007, Latin America and the Caribbean region accounted for the largest share of commitments. Figure 1 presents the regional composition of commitments from FY 2003 to FY 2007.

Figure 1: Commitments including Guarantee Facilities by Region

Under IBRD's Articles of Agreement (the Articles), as applied, the total amount outstanding of direct loans made by IBRD, including participation in loans and callable guarantees may not exceed the **statutory lending limit**. At June 30, 2007, outstanding loans and callable guarantees (net of the accumulated provision for losses on loans and guarantees) totaled \$96,040 million, equal to 44% of the **statutory lending limit**.

IBRD's lending operations have conformed generally to five principles derived from its Articles. These principles, taken together, seek to ensure that IBRD loans are made to member countries for financially and economically sound purposes to which those countries have assigned high priority, and that funds lent are utilized as intended. The five principles are described in Box 3. Within the scope permitted by the Articles, application of these principles must be developed and adjusted in light of experience and changing conditions.

Box 3: Lending Operations Principles

- (i) IBRD makes loans to governments, governmental authorities or private enterprises in the territories of member countries. A loan that is not made directly to the member in whose territories the project is located must be guaranteed as to principal, interest and other charges by the member or its central bank or a comparable agency of the member acceptable to IBRD. A guarantee by the member itself has been obtained in all such cases to date.
- (ii) IBRD's loans are designed to promote the use of resources for productive purposes in its member countries. Investment projects financed by IBRD loans are required to meet IBRD's standards for technical, economic, financial, institutional and environmental soundness. Specific provisions apply to development policy lending financed by IBRD loans, including the treatment of the macro-economic framework, poverty and social impact, environment, forests and other natural resources.
- (iii) In making loans, IBRD must act prudently and pay due regard to the prospects of repayment. Decisions to make loans are based upon, among other things, studies by IBRD of a member country's economic structure, including assessments of its resources and ability to generate sufficient foreign exchange to meet debt-service obligations.
- (iv) IBRD must be satisfied that in the prevailing market conditions (taking into account the member's overall external financing requirements), the borrower would be unable to obtain financing under conditions which, in the opinion of IBRD, are reasonable for the borrower. However, this does not preclude lending to members who may have access to international credit markets. It is the intention of IBRD to promote private investment, not to compete with it.
- (v) The use of loan proceeds is supervised. IBRD makes arrangements intended to ensure that funds loaned are used only for authorized purposes and, where relevant, with due attention to considerations of cost-effectiveness. This policy is enforced primarily by requiring borrowers (a) to submit documentation establishing, to IBRD's satisfaction, that the expenditures financed with the proceeds of loans are made in conformity with the applicable lending agreements and (b) to maximize competition in the procurement of goods and services by using, wherever possible, international competitive bidding or, when it is not appropriate, other procedures that ensure maximum economy and efficiency. In addition, under a pilot program approved by the Executive Directors in March 2005, IBRD considers the use of borrower country environmental and social safeguard systems in selected operations where these systems are assessed as being equivalent to IBRD's systems and where the borrower's implementation practices, track record, and capacity are considered acceptable to IBRD.

Lending Cycle

The process of identifying and appraising a project, and approving and disbursing a loan, often extends over several years. However, on numerous occasions IBRD has shortened the preparation and approval cycle in response to emergency situations such as natural disasters.

Generally, the appraisal of projects is carried out by IBRD's operational staff (economists, engineers, financial analysts, and other sector and country specialists). With certain exceptions^a, each loan must be approved by IBRD's Executive Directors.

Loan disbursements are subject to the fulfillment of conditions set out in the loan agreement. During implementation of IBRD-supported operations, experienced IBRD staff review progress, monitor

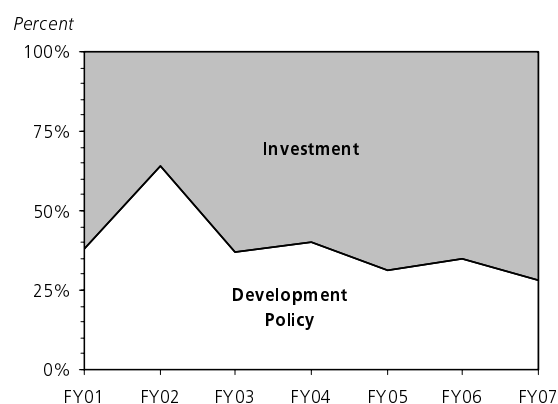
a. For Adaptable Program Loans (APLs), the Board approves all first-phase APLs and delegates to Management the approval of subsequent phases subject to agreed procedures. Learning and Innovation Loans are loans of \$5 million or less approved by Management.

compliance with IBRD policies and assist in resolving any problems that may arise. The Independent Evaluation Group, an IBRD unit whose director reports to the Executive Directors rather than to the President, evaluates the extent to which operations have met their major objectives.

Lending Instruments

IBRD lending generally falls into one of two categories: investment or development policy lending (previously referred to as adjustment lending). Investment lending is generally used to finance goods, works, and services in support of economic and social development projects in a broad range of sectors. In contrast, development policy lending is generally provided in exchange for commitments by borrowers to implement social, structural, and institutional reforms. The majority of IBRD loans are for investment projects or programs. **Figure 2** shows the percentage of IBRD loans approved for development policy lending over the past seven years.

Figure 2: IBRD Lending Commitments



In FY 2007, new IBRD commitments for development policy lending accounted for 28% of total commitments (35%—FY 2006; 31%—FY 2005).

Contractual Terms of Loans

Contractual Terms of Currently Available Products

IBRD currently offers a product mix that is intended to provide borrowers with the flexibility to select terms that are both compatible with their debt management strategy and suited to their debt-servicing capacity. As of June 30, 2007, IBRD offers the following two basic types of loan terms, each denominated in the currency or currencies chosen by

the borrower provided it is a currency in which IBRD can efficiently intermediate: variable-spread loans, and fixed-spread loans. Variable-spread loans, which were introduced in FY 1993, have a variable spread over LIBOR that is adjusted every six months. Fixed-spread loans, which were introduced in FY 2000, have a fixed spread over LIBOR that is fixed for the life of the loan.

Borrowers selecting the fixed-spread loan product may, for a fee, change the currency or interest rate basis over the life of the loan. For example, borrowers have the option to fix, unfix, or re-fix the interest rate at market rates on all or a part of the disbursed amounts for up to the remaining maturity of the loan.

The transaction fees for changing the currency or interest rate basis of fixed-spread loans were revised during FY 2006. On undisbursed loans, the fee (based on percentage of principal amount converted) for currency conversion is an up-front charge of 0.125% of the principal to be converted. On disbursed loans, the fee for currency conversion is an annual charge of 0.02% of the amount converted. Interest rate conversion carries no transaction fee.

Table 6 summarizes the contractual terms for these types of loans.

Table 6: Contractual Terms of Currently Available Products

Basis Points	Variable Spread Loans (VSL)	Fixed Spread Loans (FSL)	Special Development Policy Loans
	Six month LIBOR	Six month LIBOR	Six month LIBOR
Spread			
Contractual Lending Spread	75 (new loans) 50 (old loans)	75	400
Market Risk Premium	—	5 ^a	—
Funding Cost Margin	Weighted average spread to LIBOR of debt allocated to VSLs	Projected funding spread to LIBOR	—
Charges			
Commitment charge on undisbursed balances	75	85 ^b	75
Front-end fee on effective loans	100 (new loans) 0 (old loans)	100	100
Eligible for Waivers^c			
Interest	Yes	Yes	No
Commitment	Yes	Yes	No
Front-end fee	Yes	Yes	No
Final Maturity	15-20 years	15-25 years	5 years
Grace period	3-5 years	3-8 years	3 years

a. The market risk premium compensates IBRD for additional funding risk associated with this product.

b. The commitment charge is 85 basis points for the first four years and 75 basis points thereafter for loans signed on or before July 19, 2006 to compensate IBRD for additional funding and refinancing risk associated with this product. All loans which are signed on or after July 20, 2006 will have a flat commitment charge of 75 basis points.

c. Waivers of a portion of charges and interest are determined annually, see Table 7 for details.

Repayment terms for fixed-spread loans are more flexible than for variable-spread loans, subject to certain constraints on the average repayment maturity and final maturity on a country basis. Within these constraints, borrowers have flexibility to configure grace periods and maturity profiles in a manner consistent with the purpose of the loan. Repayment profiles may be level repayment of principal, an annuity type schedule, a single lump-sum repayment, or a customized schedule. Repayment profiles cannot be changed after a loan is signed.

At June 30, 2007, 78% (71%—June 30, 2006) of loans outstanding were made on currently available terms.

Local Currency Lending

IBRD offers its borrowers products to convert or swap their IBRD loans into their domestic currencies to reduce their foreign currency exposure with respect to projects or programs that do not generate foreign currency revenues. These local currency loans have Fixed Spread Loan terms. The balance of such loans outstanding at June 30, 2007 was \$49 million.

As part of the initiative taken during FY 2005 by the Executive Directors to increase the usability of local currency paid-in capital, IBRD entered into a Local Currency Loan Facility Agreement with IFC which is capped at \$300 million. Under this agreement, IBRD would lend local currencies of its member countries, funded from paid-in capital, to IFC. These currencies would subsequently be used by IFC to finance projects in those member countries. Loan commitments under this facility are subject to consents of the respective IBRD member countries whose currency is involved. At June 30, 2007, loans outstanding equivalent to \$50 million had been made under this facility.

Loans with a Deferred Drawdown Option

A Deferred Drawdown Option (DDO) for use with IBRD development policy loans gives IBRD borrowers the option of deferring the loan's disbursement for up to three years. Loans with a DDO are subject to a commitment fee of 100 basis points, which is 25 basis points higher than that for standard IBRD loans. Also, the front-end fee which is normally payable at the time a loan becomes effective, is only payable for a DDO loan at the time it is disbursed.

Waivers

Waivers of a portion of charges and interest owed by all eligible borrowers are determined annually and have been in effect since FY 1992. Eligibility for the

partial waiver of interest is limited to borrowers that have made full payments of principal, interest and other charges within 30 calendar days of the due dates during the preceding six months, on all their loans. Waivers of a portion of the commitment charge owed on the undisbursed portion of loans are also determined annually and have been in effect since FY 1990. All borrowers receive the commitment charge waiver on their eligible loans. Table 7 presents a breakdown of IBRD's loan charge waivers. Further details are provided in the Notes to Financial Statements-Note D-Loans and Guarantees.

Table 7: Loan Charge Waivers

	<i>Basis points</i>	
	<i>Interest Period Commencing</i>	
	<i>FY 2007</i>	<i>FY 2006</i>
Commitment charge waivers	50	50
Interest waivers ^a		
Old loans	5	5
New loans	25	25
Average eligibility	99.6%	99.5%
Front-end fee waivers	100	75

a. On loans to eligible borrowers.

Related Derivative Products

Derivatives for Client Operations

Along with the approval of the introduction of the fixed-spread loan product with its various risk management features such as rate fixing and currency conversion, IBRD also offers derivative products to borrowers and non-affiliated organizations.

Borrowers: These products respond to borrowers' needs for access to better risk management tools in connection with existing IBRD loans. These derivative products include **currency and interest rate swaps**, and interest rate caps and collars. IBRD will pass through its market cost of the instrument to the borrower, and will charge a transaction fee comparable to the fee charged on the fixed-spread loan conversion features. These instruments may be executed either under a master derivatives agreement, which substantially conforms to industry standards, or in individually negotiated transactions.

Non-affiliated Organizations: IBRD has executed a master derivatives agreement with the International Finance Facility for Immunisation (IFFIm), a AAA-rated non-affiliated organization. During the fiscal year ended June 30, 2007, several transactions were executed between IBRD and IFFIm under this arrangement. Concurrently IBRD entered into

offsetting transactions with market counterparties. In addition, during the fiscal year ended June 30, 2007, IBRD facilitated access to the financial markets for the Caribbean Catastrophe Risk Insurance Facility (CCRIF), a non-affiliated organization, by entering into a one year earthquake and weather derivative contract. As in the case of IFFIm, IBRD entered into an offsetting transaction with a market counterparty. IBRD has applied all its normal commercial credit risk policies to these transactions. Further details on derivatives for clients are provided in the Notes to Financial Statements-Note D-Loans and Guarantees, and Note O-Derivatives for Client Operations.

Contractual Terms of Previously Available Products

In previous years, IBRD offered loans with a variety of other contractual terms including: multicurrency pool loans and fixed-rate single currency loans.

Table 8 summarizes the contractual terms for variable-rate multicurrency and single-currency pool loans, and fixed-rate single-currency loans.

In 1980, IBRD established the currency pool system, funded primarily with fixed rate medium-to-long term borrowings. In 1982, IBRD mitigated its interest rate risk by moving from offering a fixed rate to a variable rate on these loans.

The currency composition of multicurrency pool loans is determined on the basis of a pool, which provides a currency composition that is the same for all loans in the pool. Pursuant to a policy established by the Executive Directors, and subject to their periodic review, at least 90% of the U.S. dollar equivalent value of the pool is in a fixed ratio of one U.S. dollar to 125 Japanese yen to one euro. The lending rate formulation for loans with single currency pool terms is the same as that for multicurrency pool loans. Single-currency pool loans are held in U.S. dollars, Japanese yen, and euro.

The variable rate multi-currency pool and variable rate U.S. dollar pool lending rates were revised in FY 2006 to composite LIBOR + 100 basis points or the fixed rate equivalent thereof (at the borrower's choice) for borrowers that agree to certain amendments to their loan agreements. This revision was required to adjust the pool lending rates, which are rising above market rates as these products are phased out, in a manner that was not envisioned at the time that borrowers signed their loan agreements. These modified loan terms were offered from July 2006 and applied on interest rate reset dates that occurred on or after January 1, 2007. At June 30, 2007, 7% of the outstanding balance of variable rate multi-currency pool and variable rate U.S. dollar had been so modified.

Table 8: Contractual Terms of Previously Available Products

Basis Points	Variable rate multicurrency pool loans (1982-2001)	Variable rate single currency pool loans ^a (1996-1998)	Fixed rate single currency Loans ^b (1995-1999)
	Weighted average cost of allocated debt	Weighted average cost of allocated debt	LIBOR
Cost Base			
Spread			
Contractual Lending Spread	75 (new loans) ^c 50 (old loans)	50 ^c	75 (new loans) 50 (old loans)
Market Risk Premium	—	—	0-10
Funding Cost Margin	—	—	IBRD's funding spread to LIBOR
Charges			
Commitment charge on undisbursed balances	75	75	75
Front-end fee on effective loans	100 (new loans) 0 (old loans)	— —	100 (new loans) 0 (old loans)
Eligible for Waivers^d			
Interest	Yes	Yes	Yes
Commitment	Yes	Yes	Yes
Final Maturity	15-20 years	based on original loan agreement	12-20 years
Grace period	3-5 years	based on original loan agreement	3 years

a. Converted from variable-rate multicurrency pool loans.

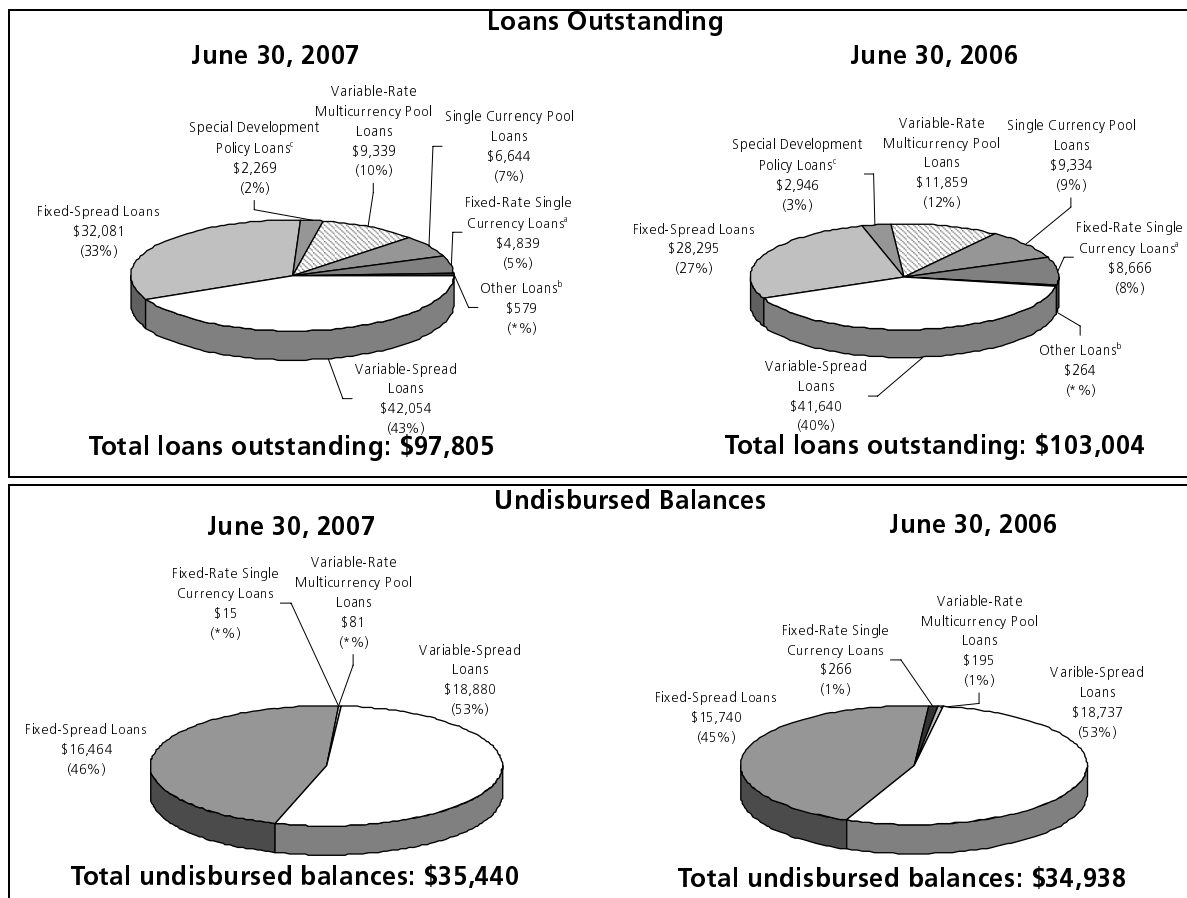
b. Cost base and spread are fixed on rate-fixing date for amounts disbursed during the preceding six months.

c. The modified loan terms offered are composite LIBOR + 100 basis points or fixed rate equivalent thereof.

d. Waivers of a portion of charges and interest are determined annually, see Table 7 for details.

Figure 3: Loan Portfolio by Loan Product

In millions of U.S. dollars



- a. Includes fixed-rate single currency loans for which the rate had not yet been fixed at fiscal year-end.
- b. Includes loans issued prior to 1980, loans to IFC, and fixed-rate multicurrency pool loans.
- c. Includes loans with non-standard terms.
- * Indicates amounts less than 0.5%.

Any fixed-rate multicurrency pool loans that were converted to single currency pools continued to carry their fixed rate.

Fixed-rate single currency loans carry lending rates fixed on semi-annual rate fixing dates for amounts disbursed during the preceding six months. For the interim period from the date each disbursement is made until its rate fixing date, interest accrues at the rate applicable to variable-spread loans.

At June 30, 2007, 22% (29%—June 30, 2006) of loans outstanding carried these previously available contractual terms.

Figure 3 presents a breakdown of IBRD's loan portfolio by loan product. For more information, see the Notes to Financial Statements-Note D-Loans and Guarantees.

Guarantees

IBRD offers guarantees on loans from private investors for projects in countries eligible to borrow from IBRD. These guarantees can also be offered on securities issued by entities eligible for IBRD loans, and in exceptional cases offered in countries only eligible to borrow from IDA. IBRD applies the same country creditworthiness and project evaluation criteria to guarantees as it applies to loans.

IBRD guarantees can be customized to suit varying country and project circumstances, and may be provided directly or via facilities. They can be targeted to mitigate specific risks or generally risks relating to political, regulatory and government performance, which the private sector is not normally in a position to absorb or manage.

Each guarantee requires the counter-guarantee of the member government. IBRD prices guarantees consistent with the way it prices its loans.

IBRD generally provides the following types of guarantees:

Partial risk guarantees: These cover debt-service defaults on a loan that result from non-performance of government obligations.

Partial credit guarantees: These are used for public sector projects when there is a need to extend loan maturities and guarantee specified interest or principal payments on loans to the government or its agencies.

Policy-based guarantees: When partial credit guarantees are used in support of agreed structural, institutional and social policies and reforms, they are considered policy-based guarantees. Eligibility for IBRD development policy lending is a necessary condition for eligibility for policy-based guarantees.

Enclave guarantees: These partial risk guarantees are offered in exceptional cases for loans for foreign-exchange generating projects in a member country usually eligible only for credits from IDA. Fees charged for enclave guarantees are higher than those charged for non-enclave guarantees. The annual commitment of enclave guarantees is limited to an aggregate guaranteed amount of \$300 million. As of June 30, 2007 commitments made under enclave guarantees were \$30 million.

IBRD's exposure at June 30, 2007 on its guarantees (measured by discounting each guaranteed amount from its first call date) is detailed in **Table 9**. For additional information see the Notes to Financial Statements-Note D-Loans and Guarantees.

Table 9: Guarantee Exposure

In millions of U.S. dollars

	<i>FY 2007</i>	<i>FY 2006</i>	<i>FY 2005</i>
Partial risk	\$270	\$248	\$ 413
Partial credit	538	523	523
Policy based	79	154	156
Total	\$887	\$925	\$1,092

Other Activities

Consultation: In addition to its financial operations, IBRD provides technical assistance to its member countries, both in connection with, and independently of, lending operations. There is a growing demand from borrowers for strategic advice, knowledge transfer, and capacity building. Such assistance includes assigning qualified professionals to survey developmental opportunities in member

countries, analyzing their fiscal, economic and developmental environment, assisting member countries in devising coordinated development programs, appraising projects suitable for investment and assisting member countries in improving their asset and liability management techniques.

Research and Training: To assist its developing member countries, IBRD-through the World Bank Institute and its partners-provides courses and other training activities related to economic policy development and administration for governments and organizations that work closely with IBRD.

Trust Fund Administration: IBRD, alone or jointly with IDA, administers on behalf of donors, funds restricted for specific uses. These funds are held in trust and are not included in the assets of IBRD. See the Notes to Financial Statements-Note J-Management of External Funds.

Investment Management: IBRD offers investment management services to several types of external institutions, including central banks of member countries. One objective of providing the services to central banks is to assist them in developing portfolio management skills. These managed funds are not included in the assets of IBRD. See the Notes to Financial Statements-Note J-Management of External Funds.

4. LIQUIDITY MANAGEMENT

IBRD's liquid assets are held principally in highly-rated fixed income securities. These securities include obligations of governments and other official entities, **time deposits** and other unconditional obligations of banks and financial institutions, **currency and interest rate swaps** (including currency forward contracts), asset-backed (including mortgage-backed) securities, and **futures, options and swaptions** contracts.

Liquidity risk arises in the general funding of IBRD's activities and in the management of its financial positions. It includes the risk of being unable to fund its portfolio of assets at appropriate maturities and rates and the risk of being unable to liquidate a position in a timely manner at a reasonable price. The objective of liquidity management is to ensure the availability of sufficient cash flows to meet all of IBRD's financial commitments.

As one component of liquidity management, IBRD maintained a \$1 billion line of credit as of June 30, 2007, with an independent financial institution. The terms of this facility provided for a usage fee on any outstanding balance at the rate of 0.15% per annum

and fluctuating interest per annum on the overnight borrowings calculated at 200 basis points above the Federal Funds Rate. This facility was used to cover any overnight overdrafts that may have occurred due to failed trades. In addition, an intra-day overdraft facility of \$1 billion used for covering daily trade activities was maintained by IBRD as of June 30, 2007 with another independent financial institution. The terms of this facility provided for a basic annual overdraft usage fee of \$325,000 and a daily overnight borrowing fee calculated at the rate of 12.5 basis points per annum above the provider's monthly average daily effective Federal Funds Rate. Both these facilities were jointly held with the International Development Association (IDA) and the Multilateral Investment Guarantee Agency (MIGA) which are affiliated organizations. For further details about these facilities, see the Notes to Financial Statements-Note E-Borrowings.

The primary objective for IBRD in the management of liquid assets is to protect the principal amount of these investments. In addition, IBRD seeks to achieve a reasonable return on the liquid asset portfolio using prudent asset and risk management techniques. The General Investment Authorization for IBRD approved by the Executive Directors provides the basic authority under which the liquid assets of IBRD can be invested. Further, all investment activities are conducted in accordance with a more detailed set of Investment Guidelines. The Investment Guidelines are approved by the Chief Financial Officer and implemented by the Treasurer. These Investment Guidelines set out detailed trading and operational rules including providing criteria for eligible instruments for investment, establishing risk parameters relative to benchmarks, such as an overall stop-loss limit and duration deviation, specifying concentration limits on counterparties and instrument classes, as well as establishing clear lines of responsibility for risk monitoring and compliance.

Under IBRD's liquidity management guidelines, aggregate liquid asset holdings are kept at or above a specified prudential minimum in order to safeguard against cash flow interruptions. That minimum is equal to the highest consecutive six months of expected debt service obligations plus one-half of approved net loan disbursements (if positive) as projected for the relevant fiscal year. The FY 2008 prudential minimum liquidity level has been set at \$16 billion, an increase of \$0.5 billion from that set

for FY 2007. In general, the size of the liquid asset portfolio should not exceed 150% of the prudential minimum liquidity level. From time to time, IBRD may however hold liquid assets over the specified maximum level to provide flexibility in timing its borrowing transactions and to meet working capital needs.

Liquid assets may be held in three distinct sub-portfolios: stable; operational; and discretionary, each with different risk profiles and performance benchmarks.

The stable portfolio is principally an investment portfolio holding the prudential minimum level of liquidity, which is set at the beginning of each fiscal year. Investment of up to 20% of the stable portfolio may be contracted out to external managers. Separate investment guidelines which conform to IBRD's overall Investment Guidelines are provided to each external manager.

The operational portfolio provides working capital for IBRD's day-to-day cash flow requirements.

The discretionary portfolio, when used, provides flexibility for the execution of IBRD's borrowing program and can be used to take advantage of attractive market opportunities.

Figure 4 represents IBRD's liquid asset portfolio size and structure at the end of FY 2007 and FY 2006, excluding investment assets associated with certain other postemployment benefits. At the end of FY 2007, the aggregate size of the IBRD liquid asset portfolio was \$21,958 million, reflecting a decrease of \$2,697 million from FY 2006. Of this amount, \$1,519 million (\$1,443 million in FY 2006) in the stable portfolio was managed by external firms. IBRD's liquid asset portfolio is largely composed of assets denominated in U.S. dollars with net exposure to short-term interest rates. The debt funding these liquid assets also shares similar currency and duration profiles. This is a direct consequence of IBRD's exchange rate and interest rate risk management policies (see Section 6-Financial Risk Management), combined with appropriate investment benchmarks. In addition to monitoring gross investment returns compared to their benchmarks, IBRD also monitors overall investment earnings net of funding costs (see Section 8-Results of Operations).

Figure 4: Liquid Asset Portfolio Composition

In millions of U.S. dollars

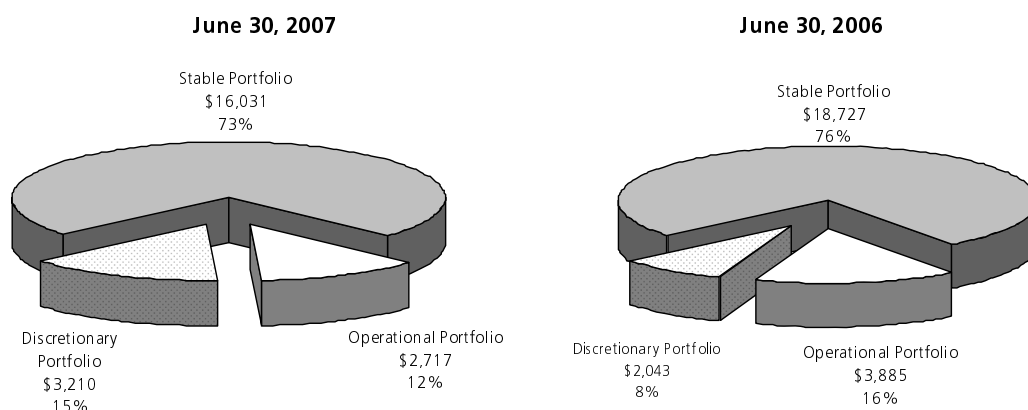


Table 10: Liquid Asset Portfolio Returns and Average Balances

In millions of U.S. dollars

	Average Balances		Financial Return (%)	
	FY 2007	FY 2006	FY 2007	FY 2006
IBRD Overall Portfolio	\$22,256	\$26,008	5.24	4.04
Stable	15,939	18,368	5.39	4.24
Operational	3,190	6,724	4.35	3.40
Discretionary	3,127	916	5.34	4.68

The returns and average balances of the liquid asset portfolio in FY 2007 compared to FY 2006 are presented in **Table 10**. These returns exclude investment assets funding certain other postemployment benefits.

The higher returns in FY 2007 are due primarily to the higher average short-term interest rate environment in FY 2007 as compared to FY 2006, as shown in **Figure 10**.

IBRD enters into derivative transactions to manage its investment portfolio. The main purposes of these derivative instruments are to enhance the return, and manage the overall **duration**, of the portfolio.

Contractual Obligations

In the normal course of business, IBRD enters into various contractual obligations that may require future cash payments. **Table 11** summarizes IBRD's significant contractual cash obligations, by remaining maturity, at June 30, 2007. Debt includes all borrowings excluding derivatives, but does not include any adjustment for unamortized premiums, discounts or effects of applying **FAS 133 as amended**

(additional information can be found in the Notes to Financial Statements-Note E- Borrowings). Operating lease expenditures primarily represent future cash payments for real estate-related obligations and equipment. Other long-term liabilities include accrued liabilities for staff compensation and benefits. Operating leases, contractual purchases and capital expenditures, and other long term obligations include amounts which will be shared with IDA, IFC and MIGA in accordance with individual cost sharing agreements (additional information can be found in the Notes to Financial Statements-Note I-Administrative Expenses, Contributions to Special Programs, and Other Income).

Excluded from **Table 11** are a number of obligations to be settled in cash. These obligations are presented in IBRD's balance sheet and include undisbursed loans; short-term borrowings; payable for **currency and interest rate swaps**; payable for investment securities purchased, and payable for transfers approved by the Board of Governors.

Table 11: Contractual Cash Obligations*In millions of U.S. dollars*

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Debt-principal only	\$89,977	\$22,853	\$26,346	\$3,837	\$36,941
Operating leases	418	41	66	33	278
Contractual purchases and capital expenditures	32	31	1	—	—
Other long-term liabilities	441	80	64	57	240
Total	<u>\$90,868</u>	<u>\$23,005</u>	<u>\$26,477</u>	<u>\$3,927</u>	<u>\$37,459</u>

5. FUNDING RESOURCES

Equity

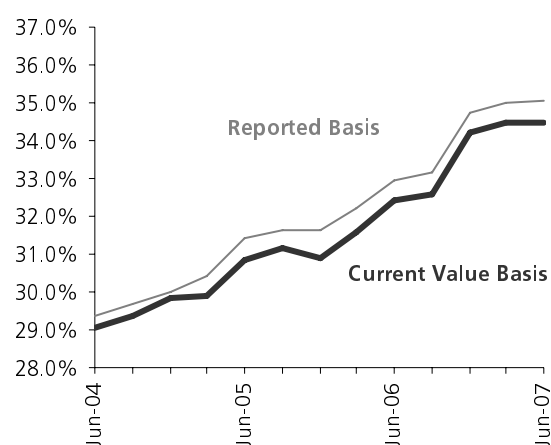
Total shareholders' equity, as reported in IBRD's balance sheet at June 30, 2007, was \$39,926 million compared to \$36,474 million at June 30, 2006. The increase from FY 2006 primarily reflects the adjustment to beginning retained earnings of \$3,189 million for the cumulative effect of adopting FAS 155.

IBRD's equity base plays a critical role in securing its financial objectives. By enabling IBRD to absorb risk out of its own resources, its equity base protects shareholders from a possible call on callable capital. The adequacy of IBRD's equity capital is judged on the basis of its ability to generate future net income sufficient to absorb potential risks and support normal loan growth, without reliance on additional shareholder capital.

For management purposes, IBRD closely monitors equity as defined and utilized in the **equity-to-loans ratio**. Table 12 presents the composition of this measure at June 30, 2007 and 2006, respectively.

The **equity-to-loans ratio** is a summary statistic that IBRD uses as one measure of the adequacy of its **risk-bearing capacity**. IBRD also uses a stress test as a measure of income-generating capacity and an input to the assessment of capital adequacy. See discussion in Section 6, Financial Risk Management- Managing Risk-Bearing Capacity.

As presented in Figure 5, IBRD's **equity-to-loans ratio** increased during FY 2007, on both a reported basis (excluding cumulative translation adjustments associated with the FAS 133 adjustments) and a current value basis.

Figure 5: Equity-to-Loans Ratio

The increase in this ratio to 35.05% at June 30, 2007 from 32.96% at June 30, 2006 was due to the decrease in loans outstanding and present value of guarantees, net of relevant accumulated provisions and deferred loan income in FY 2007.

Capital

Shareholder support for IBRD is reflected in the capital backing it has received from its members. At June 30, 2007, the authorized capital of IBRD was \$190,811 million, of which \$189,801 million had been subscribed. Of the subscribed capital, \$11,486 million had been paid-in and \$178,315 million was callable. Of the paid-in capital, \$9,277 million was available for lending and \$2,208 million was not available for lending. The terms of payment of IBRD's capital and the restrictions on its use that are derived from the Articles and from resolutions of IBRD's Board of Governors are as follows:

Table 12: Equity Capital*In millions of U.S. dollars*

	<i>June 30, 2007</i>	<i>June 30, 2006</i>
Usable Capital		
Paid-in Capital	\$11,486	\$11,483
Restricted Paid-in Capital	(2,448)	(2,460)
Net Payable for Maintenance of Value	236	102
Total Usable Capital	9,274	9,125
Special Reserve	293	293
General Reserve^a	23,948	23,948
Cumulative Translation Adjustment^b	239	(27)
Equity used in Equity-to-Loans Ratio^c	\$33,754	\$33,339
Current Value Adjustments	(314)	(246)
Equity used in Equity-to-Loans Ratio—Current Value Basis	\$33,440	\$33,093
Loans Outstanding and Present Value of Guarantees, net of Relevant Accumulated Provisions and Deferred Loan Income	\$96,309	\$101,140
Current Value Loans and Guarantees Outstanding, net of Accumulated Provision for Losses on Loans and Guarantees and Deferred Loan Income	\$97,020	\$102,021
Equity-to-Loans Ratio—Reported Basis^b	35.05%	32.96%
Equity-to-Loans Ratio—Current Value Basis	34.47%	32.44%

a. *Transfers from FY 2007 net income has not been determined.*

b. *Excluding cumulative translation amounts associated with the FAS 133 as amended adjustment.*

c. *Before the effects of Board of Governors-approved transfers and FAS 133 as amended.*

Paid-in Capital

- (i) \$3,223 million of IBRD's capital was initially paid in gold or U.S. dollars or was converted from the currency of the subscribing members into U.S. dollars. This amount may, under the Articles, be freely used by IBRD in its operations.
- (ii) \$8,169 million of IBRD's capital was paid in the national currencies of the subscribing members. Under the Articles this amount is subject to maintenance of value obligations and may be used for funding loans only with the consent of the member whose currency is involved, or used for administrative expenses without the need for consent of the member whose currency is involved. In addition, these national currencies may be used by IBRD following a decision by the Board of Executive Directors to invest or lend in that currency, or swap the national currency into another currency for investment or lending purposes, provided it has the consent of the member whose currency is involved. In accordance with such consents, \$5,329 million of this

amount was being used in IBRD's lending and investment operations at June 30, 2007.

- (iii) \$94 million of IBRD's capital was converted to U.S. dollars from the currency of the subscribing members by providing U.S. dollar denominated nonnegotiable, non-interest bearing demand notes, encashable in the currency of the subscribing member. This amount may, under the terms of the note, be encashed for administrative expenses or, after all subscribed capital has been called, IBRD will have the right to encash the note to meet its obligations.

Callable Capital

- (iv) \$151,841 million of IBRD's capital may, under the Articles, be called only when required to meet obligations of IBRD for funds borrowed or on loans guaranteed by it. This amount is thus not available for use by IBRD in making loans. Payment on any such call may be made, at the option of the particular member, either in gold, in U.S. dollars or in the currency required to dis-

charge the obligations of IBRD for which the call is made.

- (v) \$26,474 million of IBRD's capital is to be called only when required to meet obligations of IBRD for funds borrowed or on loans guaranteed by it, pursuant to resolutions of IBRD's Board of Governors (though such conditions are not required by the Articles). Of this amount, 10% would be payable in gold or U.S. dollars and 90% in the national currencies of the subscribing members. While these resolutions are not legally binding on future Boards of Governors, they do record an understanding among members that this amount will not be called for use by IBRD in its lending activities or for administrative purposes. No call has ever been made on IBRD's callable capital. Any calls on unpaid subscriptions are required to be uniform, but the obligations of the members of IBRD to make payment on such calls are independent of each other. If the amount received on a call is insufficient to meet the obligations of IBRD for which the call is made, IBRD has the right and is bound to make further calls until the amounts received are sufficient to meet such obligations. However, no member may be required on any such call or calls to pay more than the unpaid balance of its capital subscription.

At June 30, 2007, \$103,604 million (58.1%) of the uncalled capital was callable from the member countries of IBRD that are also members of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD). This amount exceeded IBRD's outstanding borrowings including swaps at June 30, 2007. Table 13 sets out the capital subscriptions of those countries and the callable amounts.

The United States is IBRD's largest shareholder. Under the Bretton Woods Agreements Act, the Par Value Modification Act and other U.S. legislation, the Secretary of the U.S. Treasury is permitted to pay up to \$7,663 million of the uncalled portion of the subscription of the United States, if it were called by IBRD, without any requirement of further congressional action. The balance of the uncalled portion of the U.S. subscription, \$22,303 million, has been authorized by the U.S. Congress but not appropriated. Further action by the U.S. Congress would be required to enable the Secretary of the Treasury to pay any portion of this balance. The General Counsel of the U.S. Treasury has rendered an opinion that the entire uncalled portion of the U.S. subscription is an obligation backed by the full faith

and credit of the United States, notwithstanding that congressional appropriations have not been obtained with respect to certain portions of the subscription. For a further discussion of capital stock, restricted currencies, maintenance of value and membership refer to the Notes to Financial Statements-Note A-Summary of Significant Accounting and Related Policies and Note B-Capital Stock, Restricted Currencies, Maintenance of Value and Membership.

Table 13: Capital Subscriptions of DAC Members of OECD Countries

In millions of U.S. dollars

<i>Member Country^a</i>	<i>Total Capital Subscription</i>	<i>Uncalled Portion of Subscription</i>
United States	\$ 31,965	\$ 29,966
Japan	15,321	14,377
Germany	8,734	8,191
France	8,372	7,851
United Kingdom	8,372	7,832
Canada	5,404	5,069
Italy	5,404	5,069
Netherlands	4,283	4,018
Belgium	3,496	3,281
Spain	3,377	3,171
Switzerland	3,210	3,012
Australia	2,951	2,770
Sweden	1,806	1,696
Denmark	1,623	1,525
Austria	1,335	1,254
Norway	1,204	1,132
Finland	1,033	971
New Zealand	873	821
Portugal	659	620
Ireland	636	599
Greece	203	189
Luxembourg	199	190
Total	\$110,460	\$103,604

a. See details regarding the capital subscriptions of all members of IBRD at June 30, 2007 in Financial Statements-Statement of Subscriptions to Capital Stock and Voting Power.

Borrowings

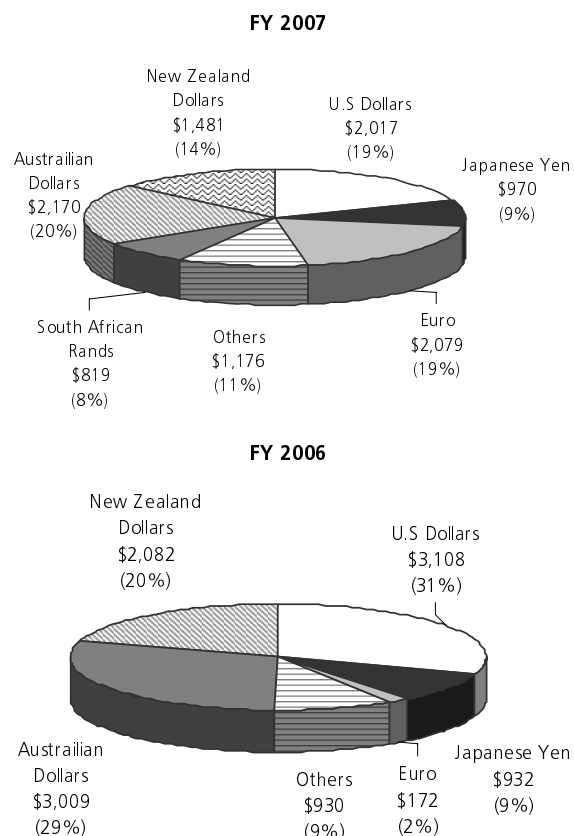
Source of Funding

IBRD diversifies its sources of funding by offering its securities to institutional and retail investors around the world, both through global offerings and by way of bond issues designed to meet the needs of specific markets or types of investors. Under its Articles, IBRD may borrow only with the approval of the member in whose markets the funds are raised and the member in whose currency the borrowing is denominated, and only if each such member agrees

that the proceeds may be exchanged for the currency of any other member without restriction.

Medium- and long-term funding raised excluding derivatives by currency for FY 2007, as compared to FY 2006, is shown in Figure 6.

Figure 6: Medium- and Long-term Funding Raised Excluding Derivatives by Currency
In millions of U.S. dollars equivalent



Funding Operations

In FY 2007, medium- and long-term debt raised directly in financial markets by IBRD amounted to \$10,712 million compared to \$10,233 million in FY 2006. Table 14 summarizes IBRD's funding operations for FY 2007 and FY 2006.

Table 14: Funding Operations Indicators

	FY 2007	FY 2006
Total Medium- and Long-term Borrowings (USD million)	\$10,712	\$10,233
Average Maturity ^a (years)	3.9	3.7
Number of Transactions	348	259
Number of Currencies	11	11

a. Average maturity to first call date.

Funding raised in any given year is used for IBRD's general operations, including loan disbursements, refinancing of maturing debt and prefunding of

future lending activities. Funding opportunities in FY 2007 and FY 2006 remained relatively stable in terms of instruments, and IBRD followed a strategy of selective bond issuance, combining issues targeted to retail investors with private placements and public issues placed with large institutional investors. All proceeds from new funding are initially invested in the liquid asset portfolio until they are required for IBRD's operations. Debt is allocated on a periodic basis to the different debt pools funding loans as necessary, in accordance with operating guidelines.

IBRD strategically repurchases, calls or prepays its debt to reduce the cost of borrowings and to reduce exposure to refunding requirements in a particular year or to meet other operational needs. In response to market conditions, during FY 2007, IBRD repurchased or called \$3,740 million of its outstanding borrowings (\$3,918 million during FY 2006).

Use of Derivatives

All new funding is initially swapped into floating-rate U.S. dollars, with conversion to other currencies or fixed-rate funding being carried out subsequently in accordance with loan funding requirements.

Figures 7a and 7b illustrate the effect of derivatives on both the interest rate structure and currency composition of the borrowing portfolio at June 30, 2007. Interest rate and currency swaps are also used for asset/liability management purposes to match the pool of liabilities as closely as possible to the interest rate and currency characteristics of liquid assets and loans. IBRD does not enter into derivatives for speculative purposes in the borrowing portfolio.

A more detailed analysis of borrowings outstanding is provided in the Notes to Financial Statements- Note E-Borrowings.

6. FINANCIAL RISK MANAGEMENT

IBRD assumes various kinds of risk in the process of providing development banking services. Its activities can give rise to four major types of risk: credit risk; market risk (interest rate and exchange rate); liquidity risk; and operational risk. The major inherent risk to IBRD is country credit risk, or loan portfolio risk.

Governance Structure

The risk management governance structure includes a Risk Management Unit supporting Senior Management in their oversight function, particularly in the coordination of different aspects of risk management, and in connection with risks that cut across functional areas.

Figure 7a: Effect of Derivatives on Interest Rate Structures on the Borrowing Portfolio—June 30, 2007

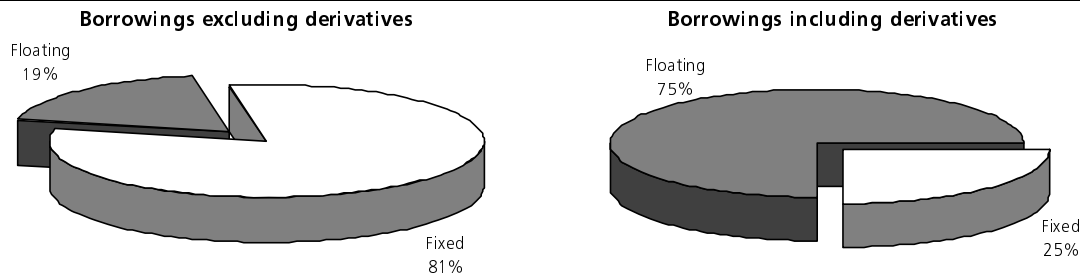
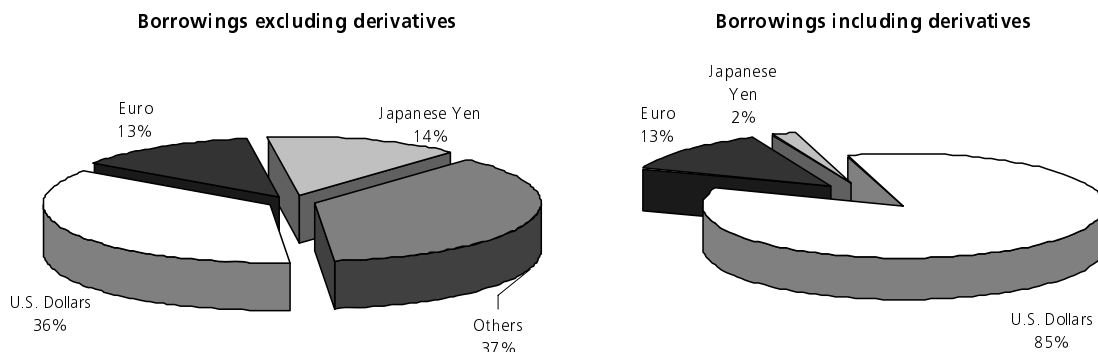


Figure 7b: Effect of Derivatives on Currency Composition on the Borrowing Portfolio—June 30, 2007



For financial risk management, there is a Finance Committee chaired by the Chief Financial Officer. The Finance Committee makes recommendations and, where appropriate to the topic, takes decisions in the areas of financial policy, the adequacy and allocation of risk capital, and oversight of financial reporting. Three subcommittees that report to the Finance Committee are the Market Risk and Currency Management Subcommittee, the Credit Risk Subcommittee and the Financial Instruments Subcommittee.

The Market Risk and Currency Management Subcommittee develops and monitors the policies under which market and commercial credit risks faced by IBRD are measured, reported and managed. The subcommittee also monitors compliance with policies governing commercial credit exposure and currency management. Specific areas of activity include reviewing and endorsing guidelines for limiting balance sheet and market risks, the use of derivative instruments, investing activities, and monitoring matches between assets and their funding. The Credit Risk Subcommittee monitors the measurement and reporting of country credit risk and reviews the impact on the provision for losses on loans and guarantees of any changes in exposure, risk ratings of borrowing member countries, or movements between the accrual and nonaccrual portfolios. The Financial Instruments

Subcommittee reviews the financial, organizational and implementational issues of new products offered to IBRD borrowers.

Country credit risk, the primary risk faced by IBRD, is identified, measured and monitored by the Credit Risk Department, led by the Chief Credit Officer who reports to the Chief Financial Officer. This unit is independent from IBRD's business units. Moreover, in order to further protect the independence of the unit, individual country credit risk ratings are not shared with the Executive Directors and are not made public. In addition to continuously reviewing the creditworthiness of IBRD borrowers, this department is responsible for assessing loan portfolio risk, determining the adequacy of provisions for losses on loans and guarantees, and monitoring borrowers that are vulnerable to crises in the near term.

Market risks, liquidity risks and counterparty credit risks in IBRD's financial operations are identified, measured and monitored by the Corporate Finance Department, which also reports to the Chief Financial Officer and is independent from the business units responsible for managing these risks. The Corporate Finance Department works with IBRD's financial managers, who are responsible for the day-to-day management of these risks, to establish and document processes that facilitate,

control and monitor risk. These processes are built on a foundation of initial identification and measurement of risks by each of the business units. Under the direction of the Finance Committee, policies and procedures for measuring and managing such risks are formulated, approved and communicated throughout IBRD. Senior managers represented on the Committee are responsible for maintaining sound credit assessments, addressing transaction and product risk issues, providing an independent review function and monitoring the loans, investments and borrowing portfolios.

The primary responsibility for the management of operational risk in IBRD's financial operations resides with each of IBRD's managers. These individuals are responsible for identifying operational risks and establishing, maintaining and monitoring appropriate internal controls in their respective areas using an operational risk management framework.

This framework requires each business unit to document operational risks and controls, assess the likelihood and impact of operational risks and evaluate the design and operating effectiveness of existing controls using guidelines established by IBRD. An independent operational risk control unit supports this process by undertaking periodic reviews, performing quality assurance testing and reporting exceptions.

The processes and procedures by which IBRD manages its risk profile continually evolve as its activities change in response to market, credit, product, operational and other developments. The Executive Directors, particularly the Audit Committee members, periodically review trends in IBRD's risk profiles and performance, as well as any significant developments in risk management policies and controls.

Managing Risk-Bearing Capacity

The risk bearing capacity of IBRD is the adequacy of its capital to absorb credit shocks and still be able to lend for development purposes without the need for additional shareholder support. The Board of Executive Directors assesses IBRD's **risk-bearing capacity** based on a variety of metrics, including a framework of stress testing and simpler measures such as the **equity-to-loans ratio**, to assess capital adequacy.

The risk that a significant portion of its loan portfolio may go into extended arrears is the most significant risk faced by IBRD, and almost all of IBRD's equity

capital is held against this risk. Credit risk is measured in terms of both probable and unexpected losses from protracted payments arrears. Probable losses are covered by IBRD's accumulated provision for losses on loans and guarantees, and unexpected losses are covered by income-generating capacity and equity.

The framework of stress testing provides a basis for evaluating whether IBRD has sufficient financial capacity to be able to (i) absorb the income loss due to a credit shock, and (ii) generate sufficient income to support loan growth in the following years. The first requirement on the degree of shock absorption is designed to reduce the probability of having to rely on additional shareholder support (in terms of additional paid-in capital or a call on callable capital). This is intended both to protect shareholders and to support IBRD's credit standing, which reduces borrowing costs and correspondingly, lending rates for borrowers. The second requirement on loan growth reflects the view that as a development institution, IBRD needs to play a positive role in a crisis by maintaining the capacity to continue lending to assist recovery in borrowing member countries. One of the credit shock events used in the stress testing framework is an estimate of the amount of the loan portfolio that could enter nonaccrual status (payment arrears in excess of six months) in the next three years at an appropriate confidence level.

IBRD's equity supports its **risk-bearing capacity** for its lending operations. IBRD strives to immunize its **risk-bearing capacity** from fluctuations in interest and exchange rates. Therefore, IBRD uses the **equity-to-loans ratio** (on a current value basis) as one tool to monitor the sensitivity of its **risk-bearing capacity** to movements in interest and exchange rates. One of IBRD's financial risk management objectives is to seek to protect the **equity-to-loans ratio** from movements arising from market risks.

The sensitivity of IBRD's operating income to interest rate movements arises primarily from the sensitivity of the "contribution of equity" (the income earned from that portion of IBRD's assets funded with equity rather than with debt). The sensitivity of IBRD's operating income to changes in market interest rates has been increasing as borrowers have chosen to borrow from IBRD primarily on floating rate terms since the introduction of LIBOR-based loans. To the extent that the **duration** of its equity capital is matched to that of its loan portfolio, this ratio is protected against interest rate movements. To the extent that the currency composition of its equity

capital is matched with that of its loan portfolio, the equity-to-loans ratio is also protected from exchange rate movements.

As presented in Figure 5 in Section 5, Funding Resources, IBRD's equity-to-loans ratio on both the current value and reported basis has been on an upward trend.

Credit Risk

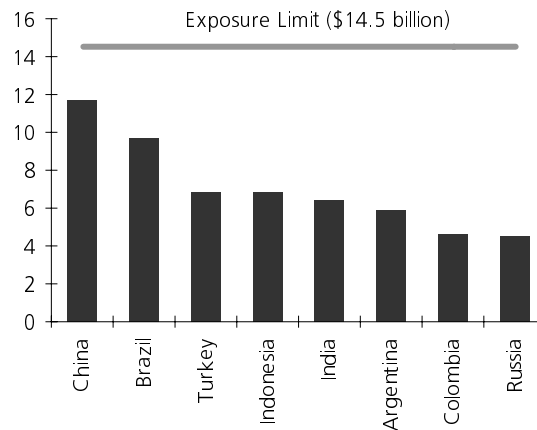
Country Credit Risk

Country credit risk is the risk of loss due to a country not meeting its contractual obligations. IBRD's Credit Risk Department continuously reviews the credit risk of its borrowing member countries. These reviews are taken into account in determining IBRD's overall country programs and lending operations, used to estimate the appropriate level of provisions for losses on loans and guarantees, and used to assess the adequacy of IBRD's income-generating capacity and risk-bearing capital. In keeping with standard practice, probable losses inherent in the portfolio due to country credit risk are covered by the accumulated provision for losses on loans and guarantees, while unexpected losses due to country credit risk are covered by income-generating capacity and risk-bearing capital.

Portfolio concentration risk, which arises when a small group of borrowers account for a large share of loans outstanding, is a key concern for IBRD and is carefully managed, in part, through an exposure limit for loans outstanding plus the present value of guarantees to a single borrowing country. Under the current guidelines, IBRD's exposure to a single borrowing country is restricted to the lower of an Equitable Access Limit or the Single Borrower Limit. The Equitable Access Limit is equal to 10% of IBRD's subscribed capital, reserves and unallocated surplus. The Single Borrower Limit is established by assessing its impact on the overall portfolio risk relative to **risk-bearing capacity**, as measured by the level of usable equity. The Single Borrower Limit is determined by the Executive Directors each year at the time they consider the adequacy of IBRD's reserves and the allocation of its net income from the preceding fiscal year. For FY 2007, the Single Borrower Limit was \$14.5 billion and the Equitable Access Limit at June 30, 2007 was \$21.7 billion. As depicted in Figure 8, IBRD's largest exposure

(including the present value of guarantees) to a single borrowing country was \$11.6 billion at June 30, 2007

Figure 8: Top Eight Country Exposures at June 30, 2007
In billions of U.S. dollars



Since the current exposure data presented are at a point in time, evaluating these exposures relative to the limit requires consideration of the repayment profiles of existing loans, as well as disbursement profiles and projected new loans and guarantees.

Under certain circumstances, IBRD would be able to continue to lend to a borrower that was reaching the single borrower exposure limit by entering into an arrangement that would prevent its net exposure from exceeding the limit. Any such arrangement would need to be approved in advance by IBRD's Executive Directors. As of June 30, 2007 IBRD had entered into one such arrangement with China. As of this date, China had not reached the single borrower exposure limit and therefore, activation of this arrangement was not required.

Overdue and Non-performing Loans

When a borrower fails to make payment on any principal, interest or other charges due to IBRD, IBRD has an option to suspend disbursements immediately on all loans. IBRD's current policy however, is to exercise this option through a graduated approach as summarized in Box 4. These policies also apply to those member countries who are eligible to borrow from both IBRD and IDA, and whose payments on IDA credits may become overdue. For borrowers with IBRD loans who become overdue in their debt service payments on IDA credits, IBRD also applies the treatment described in Box 4.

Box 4: Treatment of Overdue Payments

Overdue by 30 days	Where the borrower is the member country, no new loans to the member country, or to any other borrower in the country, will be presented to the Board of Executive Directors for approval, nor will any previously approved loan be signed, until payments for all amounts 30 days overdue or longer have been received. Where the borrower is not the member country, no new loans to that borrower will be signed or approved. In either case, the borrower will lose its eligibility for any waiver of interest charges in effect at that time.
Overdue by 45 days	In addition to the provisions cited above for payments overdue by 30 days, to avoid proceeding further on the notification process leading to suspension of disbursements, the country as borrower or guarantor and all borrowers in the country must pay not only all payments overdue by 30 days or more, but also all payments due regardless of the number of days since they have fallen due. Where the borrower is not the member country, no new loans to, or guaranteed by, the member country, will be signed or approved.
Overdue by 60 days	In addition to the suspension of approval for new loans and signing of previously approved loans, disbursements on all loans to or guaranteed by the member country are suspended until all overdue amounts have been paid. This policy applies even when the borrower is not the member country.
Overdue by more than six months	All loans made to or guaranteed by a member of IBRD are placed in nonaccrual status, unless IBRD determines that the overdue amount will be collected in the immediate future. Unpaid interest and other charges not yet paid on loans outstanding are deducted from the income of the current period. To the extent that these payments are received, they are included in income. At the time of arrears clearance, a decision is made on the restoration of accrual status on a case by case basis; in certain cases that decision may be deferred until after a suitable period of payment performance has passed.

See Notes to Financial Statements-Note D-Loans and Guarantees for a summary of countries with loans or guarantees in nonaccrual status at June 30, 2007.

Accumulated Provision for Losses on Loans and Guarantees

IBRD maintains an accumulated provision for losses on loans and guarantees to recognize the probable losses inherent in both the accrual and nonaccrual portfolios. The methodology for determining the accumulated provision for losses on loans and guarantees is discussed in Section 7, Critical Accounting Policies.

IBRD's provision for losses on loans and guarantees covers probable credit losses from protracted arrears. The Credit Risk Subcommittee reviews the allowance for losses on loans and guarantees at least quarterly and, if necessary, adjustments are made to the

provision. In addition, the Audit Committee is apprised by management at least twice a year on the accumulated provision for losses on loans and guarantees.

The accumulated provision for losses on both the accrual and nonaccrual loan portfolio decreased by \$364 million (Table 15). This decrease comprises a release of provision for losses on loans (excluding guarantees) of \$404 million and a positive translation adjustment of \$40 million during FY 2007. The decrease was primarily due to the combined impact of changes in the creditworthiness of the loan portfolio, changes in the volume and distribution of loans and guarantees outstanding and the annual update of the expected default frequencies (probability of default to IBRD) and developments in the nonaccrual portfolio.

Table 15: Accumulated Provision for Losses on Loans by Portfolio as a Percentage of Total Loans Outstanding*In millions of U.S. dollars*

	2007			2006		
	<i>Loans outstanding</i>	<i>Accumulated Provision</i>	<i>Accumulated Provision as a Percentage of Total Loans Outstanding</i>	<i>Loans outstanding</i>	<i>Accumulated Provision</i>	<i>Accumulated Provision as a Percentage of Total Loans Outstanding</i>
Accrual Portfolio	\$96,735	\$1,085	1.1%	\$101,966	\$1,480	1.4%
Nonaccrual Portfolio	1,070	847	0.9%	1,038	816	0.8%
Total Loans Outstanding	<u>\$97,805</u>	<u>\$1,932</u>	<u>2.0%</u>	<u>\$103,004</u>	<u>\$2,296</u>	<u>2.2%</u>

Treatment of Protracted Arrears

In 1991, the Executive Directors adopted a policy to assist members with protracted arrears to IBRD to mobilize sufficient resources to clear their arrears and to support a sustainable growth-oriented adjustment program over the medium term. This policy is conditional on members agreeing to implement certain requirements including an acceptable structural adjustment program, adopting a financing plan to clear all arrears to IBRD and other multilateral creditors, and continuing to service their obligations to IBRD and other multilateral creditors on time.

It is IBRD's practice not to reschedule interest or principal payments on its loans or participate in debt rescheduling agreements with respect to its loans. During FY 1996 and FY 2002, exceptions were made to that practice with regard to Bosnia and Herzegovina (BiH) and Serbia and Montenegro, formerly the Federal Republic of Yugoslavia, based on criteria approved by the Executive Directors in connection with the financial assistance package for BiH in 1996. See the Notes to Financial Statements- Note A-Summary of Significant Accounting and Related Policies, for additional information.

Commercial Credit Risk

Commercial credit risk is the risk of loss due to a counterparty not honoring its contractual obligations.

IBRD's commercial credit risk is concentrated in investments in debt instruments issued by sovereign governments, agencies, banks and corporate entities. The majority of these investments are in AAA and AA rated instruments.

In the normal course of its business, IBRD utilizes various derivatives and foreign exchange financial instruments to reduce funding costs through its borrowing activities and to meet the financial needs

of its borrowers, to generate income through its investment activities and to manage its exposure to fluctuations in interest and currency rates.

The effective management of credit risk is vital to the success of IBRD's funding, investment and asset/liability management activities. The monitoring and managing of these risks is a continuous process due to changing market environments.

IBRD controls the counterparty credit risk arising from investments, derivatives and foreign exchange transactions through its credit approval process, the use of collateral agreements and risk limits, and monitoring procedures. The credit approval process involves evaluating counterparty creditworthiness, assigning credit limits and determining the risk profile of specific transactions. Credit limits are calculated and monitored on the basis of potential exposures taking into consideration current market values, estimates of potential future movements in those values and collateral agreements with counterparties. If there is a collateral agreement with the counterparty to reduce credit risk, then the amount of collateral obtained is based on the credit rating of the counterparty. Collateral held includes cash and government securities.

For foreign exchange and derivative products IBRD treats the credit risk exposure as the replacement cost. This is also referred to as replacement risk or the mark-to-market exposure amount. While contractual principal amount is the most commonly used volume measure in the derivative and foreign exchange markets, it is not a measure of credit or market risk.

Mark-to-market exposure is a measure, at a point in time, of the value of a derivative or foreign exchange contract in the open market. When the mark-to-market is positive, it indicates the counterparty owes IBRD and, therefore, creates an exposure for IBRD.

When the mark-to-market is negative, IBRD owes the counterparty and does not have replacement risk.

When IBRD has more than one transaction outstanding with a counterparty, and the parties have entered into a master derivatives agreement which contains legally enforceable close-out netting provisions, the “net” mark-to-market exposure represents the netting of the positive and negative exposures with the same counterparty. If this net mark-to-market is negative, then IBRD's exposure to the counterparty is considered to be zero. For the contractual value, notional amounts and related credit risk exposure amounts by instrument, see the Notes to Financial Statements-Note G-Credit Risk.

Table 16 provides details of IBRD's estimated credit exposure on its investments (excluding externally-managed assets-\$1,519 million at June 30, 2007, \$1,443 million at June 30, 2006) and swaps (excluding those executed with borrowing member countries and non-affiliated organizations), net of collateral held, by counterparty rating category.

The decrease in the proportion of A rated investments and the corresponding increase in AA and AAA rated investments reflect (i) an overall decrease in the size of the investment portfolio, (ii) an upgrade of Japanese Government securities from the A to the AA bracket with the effect partially offset by a decrease in investments in those securities, and (iii) an increase in investments in AAA agency mortgage-backed securities. After the effects of exposure netting arrangements across multiple transactions with a single counterpart, the credit exposure from swaps increased from \$4,375 million at June 30, 2006 to \$6,417 million at June 30, 2007. The swap credit exposure of \$6,417 million is offset by collateral of \$4,242 million which results in a total net swap exposure of \$2,175 million.

Table 16 does not include exposures due to swaps executed with IBRD clients including (i) Borrowers (\$11 million swap exposure), the IFFIm (no current swap exposure) and CCRIF (no current swap exposure).

Market Risk

IBRD faces risks which result from market movements, primarily changes in interest and exchange rates. In comparison to country credit risk, IBRD's exposure to market risks is small. IBRD has an integrated asset/liability management framework to flexibly assess and hedge market risks associated with the characteristics of the products in IBRD's portfolios.

Asset/Liability Management

The objective of asset/liability management for IBRD is to ensure adequate funding for each loan product and liquid asset at the most attractive available cost, and to manage the currency composition, maturity profile and interest rate sensitivity characteristics of the portfolio of liabilities supporting each lending product and liquid asset in accordance with the particular requirements for that product or liquid asset and within prescribed risk parameters. The current value information is used in the asset/liability management process.

Use of Derivatives

As part of its asset/liability management process, IBRD employs derivatives to manage and align the characteristics of its assets and liabilities. IBRD uses derivative instruments to adjust the interest rate repricing characteristics of specific balance sheet assets and liabilities, or groups of assets and liabilities with similar repricing characteristics, and to modify the currency composition of net assets and liabilities.

Table 17 details the current value information of each loan and debt product.

Table 16: Credit Exposure, Net of Collateral Held, by Counterparty Rating

In millions of U.S. dollars

Counterparty Rating	At June 30, 2007					At June 30, 2006		At June 30, 2005	
	Investments			Total Exposure on Investments and Swaps	% of Total	Total Exposure on Investments and Swaps	% of Total	Total Exposure on Investments and Swaps	% of Total
	Sovereigns	Agencies, Banks & Corporates	Net Swap Exposure						
AAA	\$349	\$ 6,552	\$ 226	\$ 7,127	30	\$ 7,321	29	\$11,208	42
AA	326	12,029	1,949	14,304	60	14,011	55	12,831	49
A	—	2,337	—	2,337	10	3,991	16	2,275	9
Total	\$675	\$20,918	\$2,175	\$23,768	100	\$25,323	100	\$26,314	100

Table 17: Loan and Borrowing Portfolios*In millions of U.S. dollars*

	At June 30, 2007			At June 30, 2006		
	Carrying Value	Contractual Yield	Current Value Adjustments	Carrying Value	Contractual Yield	Current Value Adjustments
Loans^a	\$97,805	5.66%	\$711	\$103,004	5.25%	\$881
Variable-Rate Multicurrency Pool Loans	9,339	6.01	890	11,859	5.16	1,059
Single Currency Pool Loans	6,644	6.35	189	9,334	4.92	179
Variable-Spread Loans ^b	42,075	5.50	(20)	41,677	5.10	(49)
Fixed-Rate Single Currency Loans	4,818	5.97	(3)	8,629	6.10	(3)
Special Development Policy Loans ^c	2,269	6.13	(2)	2,946	6.15	(5)
Fixed-Spread Loans	32,082	5.53	(350)	28,295	5.23	(300)
Other Fixed Rate Loans	578	6.05	7	264	7.88	*
Borrowings Allocation (including derivatives)^d	\$83,952	5.21%	\$ 998	\$92,083	4.88%	\$1,076
Variable-Rate Multicurrency Pools	6,209	6.90	1,551	8,238	5.85	1,657
Single Currency Pools	3,936	6.44	165	6,379	5.66	198
Variable-Spread	25,250	4.96	(114)	26,764	4.62	(144)
Fixed-Rate Single Currency	4,166	5.52	(12)	5,479	5.71	(15)
Special Development Policy	2,538	5.17	(3)	2,734	4.70	(5)
Fixed-Spread	18,520	4.69	(355)	16,604	4.38	(342)
Other Debt ^e	23,333	4.98	(234)	25,885	4.82	(273)

a. Contractual yield is presented before the application of interest waivers.

b. Includes fixed-rate single currency loans for which the rate had not yet been fixed at fiscal year-end.

c. Includes loans with non-standard terms as described in Contractual Terms of Loans.

d. Carrying amounts and contractual yields are on a basis which includes accrued interest and any unamortized amounts, but does not include the effects of applying FAS 133.

e. Includes amounts not yet allocated at June 30, 2007 and June 30, 2006.

* Indicates amounts less than \$0.5 million.

Interest Rate Risk

There are two main sources of potential interest rate risk to IBRD. The first is the interest rate sensitivity associated with the net spread between the rate IBRD earns on its assets and the cost of borrowings, which fund those assets. The second is the interest rate sensitivity of the income earned from funding a portion of IBRD assets with equity. In general, lower nominal interest rates result in lower lending rates which, in turn, reduce the nominal earnings on IBRD's equity. In addition, as the loan portfolio shifts from pool loans to LIBOR based loans, the sensitivity of IBRD's operating income to changes in market interest rates will increase.

The borrowing cost pass-through formulation incorporated in the lending rates charged on most of IBRD's existing loans has traditionally helped limit

the interest rate sensitivity of the net spread earnings on its loan portfolio. Such cost pass-through loans currently account for 59% of the existing outstanding loan portfolio (61% at the end of FY 2006). All cost pass-through loans, including single currency and multicurrency pool loans as well as variable-spread loans, pose residual interest rate risk, given the lag inherent in the lending rate calculation.

Another potential risk arises because the cost pass-through currency pool products have traditionally been funded with a large share of medium- and long-term fixed-rate debt, to provide the borrowers with a reasonably stable interest basis. Given that the cumulative impact of interest rate changes over time has resulted in a decline in the level of interest rates, the cost of these historical fixed-rate borrowings in the multicurrency pool and the single currency pools

is currently considerably higher than IBRD's new borrowing costs. The amount of debt allocated to the multicurrency debt pool will exceed the balance of the multicurrency loan pool from FY 2008. The debt which funds these loans has maturities that extend beyond those of the loans. This debt overhang presents a risk of loss to IBRD because the debt carries fixed interest rates.

Over-funding of the multicurrency loan pool will reach a maximum of approximately \$2.3 billion in FY 2017. Strategies for managing this risk include changing the interest rate characteristics of the over-funded portion of the debt from fixed to floating rates beyond FY 2008 through the use of forward-starting swaps. IBRD began executing these forward-starting swaps in FY 2000 and as of June 30, 2007, the overhang was within acceptable guidelines. Further prepayments of the multicurrency loan pool will create additional overhang debt, which may also need to be swapped to floating-rate liabilities. The cost to date of executing these defeasance swaps has been approximately \$708 million. The cost of the overhang will vary with interest rates and prepayments.

Interest rate risk on non-cost pass-through products, which currently account for 41% of the existing loan portfolio (39% at the end of FY 2006), is managed by using **interest rate swaps** to closely align the rate sensitivity characteristics of the loan portfolio with those of their underlying funding. As the portfolio of fixed-spread loans increases, the proportion of non-cost pass-through products will grow.

The interest rate risk on IBRD's liquid asset portfolio, which includes the risk that the value of assets in the liquid portfolio will fluctuate due to changes in market interest rates, is managed within specified **duration**-mismatch limits and is further limited by stop-loss limits.

Interest rate risk also arises from a variety of other factors, including differences in the timing between the contractual maturity or repricing of IBRD's assets, liabilities and derivative financial instruments. On floating rate assets and liabilities, IBRD is exposed to timing mismatches between the re-set dates on its floating rate receivables and payables. To

mitigate its exposure to these timing mismatches, IBRD has executed some overlay **interest rate swaps**.

Exchange Rate Risk

In order to minimize exchange rate risk in a multicurrency environment, IBRD matches its borrowing obligations in any one currency (after swap activities) with assets in the same currency, as prescribed by the Articles. In addition, IBRD's policy is to minimize the exchange rate sensitivity of its **equity-to-loans ratio**. It carries out this policy by undertaking currency conversions periodically to align the currency composition of its equity to that of its outstanding loans. This policy is designed to minimize the impact of exchange rate fluctuations on the **equity-to-loans ratio**, thereby preserving IBRD's ability to better absorb unexpected losses from arrears of loan repayments regardless of the market environment.

Figure 9 presents the currency composition of significant balance sheet components (net of swaps) at the end of FY 2007 and FY 2006.

Liquidity Risk

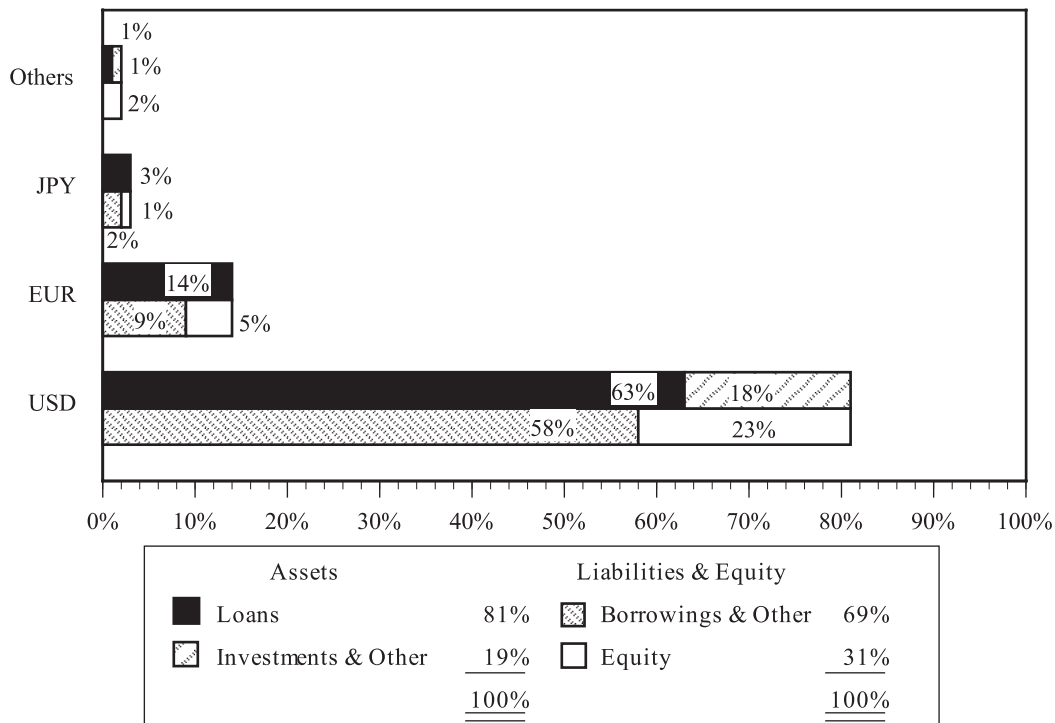
Liquidity risk arises from the general funding needs of IBRD's activities and in the management of its assets and liabilities. For a discussion on how liquidity is managed, refer to Section 4-Liquidity Management.

Operational Risk

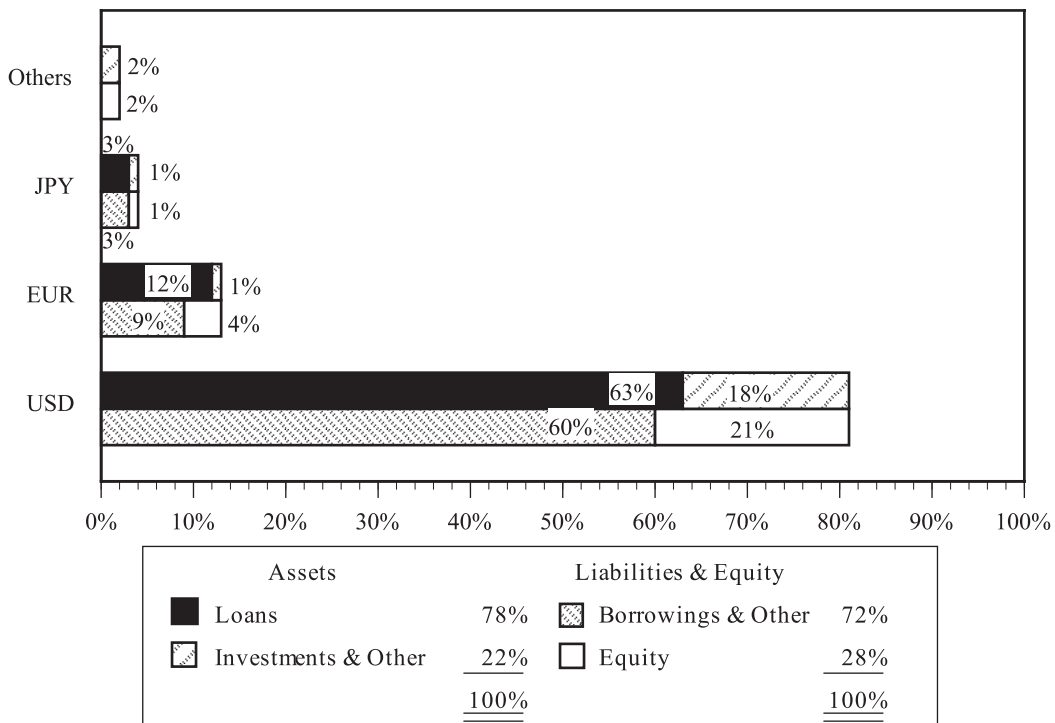
Operational risk is the potential for loss resulting from inadequate or failed internal processes or systems, human factors, or external events, and includes business disruption and system failure, transaction processing failures and failures in execution of legal, fiduciary and agency responsibilities. IBRD, like all financial institutions, is exposed to many types of operational risks.

IBRD attempts to mitigate operational risk by maintaining a system of internal control that is designed to keep that risk at appropriate levels in view of the financial strength of IBRD and the characteristics of the activities and markets in which IBRD operates. Since 1996, IBRD has used a COSO - based integrated internal control framework.

**Figure 9: Relative Currency Composition of Significant Balance Sheet Components—Current Value Basis
At June 30, 2007**



At June 30, 2006



The operational risk management framework used by IBRD involves the following core steps:

- Key operational risks and mitigating controls (including risks and controls over financial reporting) are identified and documented using a combination of tools including business process maps and risk and control self assessments. Tailored risk and control categories are also applied consistently across business units.
- Operational risks are evaluated based on likelihood of occurrence and the resulting financial impact using probability and severity parameters. The inherent risks of potential misstatements in financial reporting are also assessed.
- The design and operating effectiveness of key controls over financial reporting are evaluated using self assessment workshops, independent walk through tests of processes, independent compliance testing by IBRD's internal audit department, quality assurance testing by management and annual internal representation letters from business unit managers.
- Action plans are developed for issues identified and followed up on a periodic basis.
- Key risks and control weaknesses are evaluated on an annual basis by an internal panel. The panel evaluates and categorizes these to determine if they pose a threat to management's ability to make a positive assertion on the adequacy of internal controls surrounding IBRD's external financial reporting.
- The results of the work undertaken to evaluate the effectiveness of internal controls over financial reporting are reported to the Audit Committee through an annual report.
- On a periodic basis, operational risks and controls are assessed and reviewed to monitor significant changes.

Internal Control Over Financial Reporting

Since FY 1997 IBRD's management has made an annual assertion that, as of June 30 of each fiscal year, its system of internal control over its external financial reporting has met the criteria for effective internal control over external financial reporting as described in COSO. Concurrently since FY 1997, IBRD's external auditors have provided an attestation report that management's assertion regarding the effectiveness of internal control over external

financial reporting is fairly stated in all material respects.

Management has carried out an evaluation of internal control over external financial reporting for the purpose of determining if there were any changes made in internal controls during the fiscal year covered by this report, that had materially affected, or would be reasonably likely to materially affect IBRD's internal control over external financial reporting. As of June 30, 2007 no such significant changes occurred.

Disclosure Controls and Procedures

Disclosure controls and procedures are those processes which are designed to ensure that information required to be disclosed is accumulated and communicated to management, as appropriate to allow timely decisions regarding required disclosure by IBRD. Management has undertaken an evaluation of the effectiveness of such controls and procedures. Based on that evaluation, the President and the Chief Financial Officer have concluded that these controls and procedures were effective as of June 30, 2007.

7. CRITICAL ACCOUNTING POLICIES

The Notes to IBRD's financial statements contain a summary of IBRD's significant accounting policies. The following is a description of those accounting policies which involve significant management judgments that are difficult, complex or subjective and relate to matters that are inherently uncertain.

Provision for Losses on Loans and Guarantees

IBRD's accumulated provision for losses on loans and guarantees reflects the probable losses inherent in its nonaccrual and accrual portfolios. There are several steps required to determine the appropriate level of provisions for each portfolio. First, the total loan portfolio is segregated into the accrual and nonaccrual portfolios. In both portfolios, the exposure for each country (defined as loans outstanding plus the present value of guarantees) is then assigned a credit risk rating. With respect to loans in the accrual portfolio, these loans are grouped according to the assigned risk rating. Each risk rating is mapped to an expected default frequency using IBRD's credit migration matrix. The provision required is calculated by multiplying the outstanding exposure, by the expected default frequency (probability of default to IBRD) and by the assumed severity of the loss given default.

The determination of a borrower's risk rating is based on both quantitative and qualitative analyses of various factors, which include political risk, external debt and liquidity, fiscal policy and public debt burden, balance of payments risks, economic structure and growth prospects, monetary and exchange rate policy, financial sector risks and corporate sector debt and other vulnerabilities. IBRD periodically reviews such factors and reassesses the adequacy of the accumulated provision for losses on loans and guarantees accordingly. Actual losses may differ from expected losses due to unforeseen changes in any of the factors that affect borrowers' creditworthiness.

The accumulated provision for loan losses is separately reported in the balance sheet as a deduction from IBRD's total loans. The accumulated provision for losses on guarantees is included in other liabilities. Increases or decreases in the accumulated provision for losses on loans and guarantees are reported in the Statement of Income as provision for losses on loans and guarantees.

Additional information on IBRD's provisioning policy and the status of nonaccrual loans can be found in the Notes to Financial Statements—Note A—Summary of Significant Accounting and Related policies and Note D—Loans, Guarantees and Derivatives for Borrowers.

Fair Value of Financial Instruments

Under the current value basis of reporting, IBRD carries all of its financial assets and liabilities at estimated values. Under the reported basis, applying **FAS 133 as amended**, IBRD carries its investments, all derivatives, and qualifying hybrid debt instruments on a fair value basis. When possible, fair values are determined by quoted market prices. If quoted market prices are not available, then fair values are based on discounted cash flow models using market estimates of cash flows and discount rates.

All the financial models used for input to IBRD's financial statements are subject to both internal and periodic external verification and review by qualified personnel. These models use market sourced inputs, such as interest rates, exchange rates and volatilities. Selection of these inputs may involve some judgement. Imprecision in estimating these factors, and changes in assumptions, can impact net income and IBRD's financial position as reported in the financial statements.

IBRD believes its estimates of fair value are reasonable given its processes for obtaining external prices and parameters; ensuring that valuation models are reviewed and validated both internally and externally; and applying its approach consistently from period to period.

Pension and Other Postretirement Benefits

IBRD participates, along with IFC and MIGA, in pension and postretirement benefit plans that cover substantially all of their staff members. All costs, assets and liabilities associated with the plans are allocated between IBRD, IFC and MIGA based upon their employees' respective participation in the plans. Costs allocated to IBRD are subsequently shared between IBRD and IDA based on an agreed cost sharing ratio. The underlying actuarial assumptions used to determine the projected benefit obligations, fair value of plan assets and funded status associated with these plans are based on financial market interest rates, past experience, and management's best estimate of future benefit changes and economic conditions. For further details, please refer to Notes to Financial Statements—Note K—Pension and Other Postretirement Benefits.

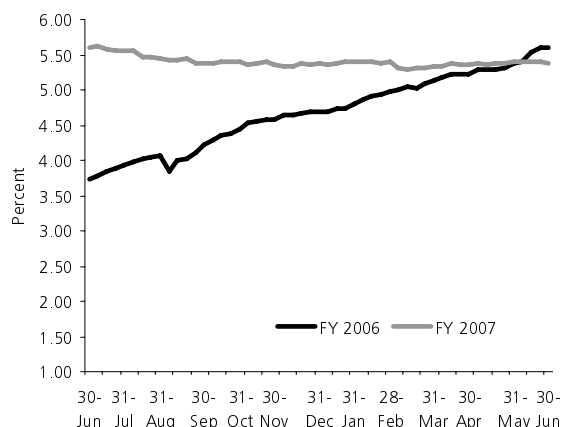
8. RESULTS OF OPERATIONS

In FY 2007, Operating Income decreased to \$1,659 million from \$1,740 million in FY 2006, driven by decreases in the release of provision for losses on loans and guarantees, and an increase in loan interest income, net of funding costs. Net loss on a reported basis was \$140 million in FY 2007 compared to a net loss of \$2,389 million in FY 2006. This decrease in net loss was primarily due to the reduction in net unrealized losses due to IBRD's application of **FAS 133 as amended**. For more details please refer to Net Unrealized (Losses) Gains on Non-trading Derivatives and Borrowings Measured at Fair Value per FAS 133 as Amended, discussed later in this section.

Interest Rate Environment

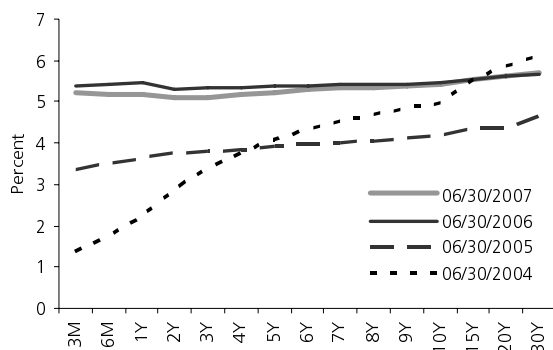
During FY 2007, short-term interest rates for the U.S. dollar were higher than for the comparative period in FY 2006. **Figure 10** illustrates these general trends for the six-month **LIBOR** U.S. dollar rates. It is this short-term interest rate structure which drives loan interest income.

Figure 10: Six-Month LIBOR Interest Rates U.S. Dollar



In contrast, the current value adjustment on the loan portfolio is based on interest rates which are dependent upon the term structure of the maturity profile of the loans. In the fiscal year ended June 30, 2007 there was a slight downward shift in these rates compared to the same period in FY 2006 (see Figure 11 for U.S. dollars). As a result there was a positive current value adjustment to the loan portfolio.

Figure 11: IBRD's U.S. Dollar Funding Curve



Operating Income

IBRD's Operating Income is broadly comprised of a net spread on interest-earning assets, plus the contribution of equity, less provisions for losses on loans and guarantees and administrative expenses. Table 18 shows a breakdown of income, net of funding costs, on a reported basis.

FY 2007 versus FY 2006

The decrease of \$81 million in Operating Income is explained by the following factors.

- A \$319 million decrease in the release of provision for losses on loans and guarantees. During FY 2007, provisioning requirements were reduced by \$405 million in comparison with the reduction of \$724 million during FY2006. This reflects the combined impact of changes in the creditworthiness of the loan portfolio, changes in the volume and distribution of loans and guarantees outstanding, the annual update of the expected default frequencies (probability of default to IBRD) and developments in the nonaccrual portfolio.
- A \$269 million increase in loan interest income, net of funding costs as a result of higher returns on equity funded loans resulting from the higher average short-term interest rates.

FY 2006 versus FY 2005

FY 2006 Operating Income was \$1,740 million, compared to \$1,320 million for FY 2005. The increase in Operating Income is explained by the following factors.

- A \$274 million increase in loan interest income, net of funding costs as a result of higher returns on equity funded loans resulting from the rise in market interest rates.
- A \$222 million increase in the release of provision for losses on loans and guarantees. During FY 2006, provisioning requirements were reduced by \$724 million in comparison with the reduction of \$502 million during FY2005. This reflects the combined impact of changes in the creditworthiness of the loan portfolio, changes in the volume and distribution of loans and guarantees outstanding, the annual update of the expected default frequencies (probability of default to IBRD), and developments in the nonaccrual portfolio.

Table 18: Net Income*In millions of U.S. dollars*

	FY 2007	FY 2006	FY 2005
Loan interest income, net of funding costs			
Debt funded	\$ 225	\$ 278	\$ 291
Equity funded	1,907	1,585	1,298
Net interest income	<u>2,132</u>	<u>1,863</u>	<u>1,589</u>
Other loan income	20	41	63
Release of Provision for losses on loans and guarantees	405	724	502
Investment income, net of funding costs	72	76	93
Net noninterest expense	<u>(970)</u>	<u>(964)</u>	<u>(927)</u>
Operating Income	<u>1,659</u>	<u>1,740</u>	<u>1,320</u>
Board of Governors-Approved Transfers	(957)	(650)	(642)
Net unrealized (losses) gains on non-trading derivatives and borrowings measured at fair value, per FAS 133 as amended	(842)	(3,479)	2,511
Net (Loss) Income—Reported Basis	<u>\$ (140)</u>	<u>\$ (2,389)</u>	<u>\$3,189</u>

Net Interest Income***FY 2007 versus FY 2006***

Loan interest income, net of funding costs, increased by \$269 million largely due to higher returns on the equity funded component of loans resulting from the rise in market rates.

FY 2006 versus FY 2005

Loan interest income, net of funding costs, increased by \$274 million largely due to higher returns on the equity funded component of loans resulting from the rise in market rates. In FY 2005, loan interest income net of funding costs were lower primarily due to the negative impact of the re-pricing lag on pool loans.

Net Noninterest Expense

The main components of net noninterest expense are presented in Table 19.

FY 2007 versus FY 2006

Net noninterest expense increased by \$6 million primarily due to a \$21 million increase in contractual services and equipment and building expenses partially offset by a decrease of \$14 million in pension and other postretirement benefits.

FY 2006 versus FY 2005

Net noninterest expense increased by \$37 million primarily due to a \$28 million increase in pension and other postretirement benefits and a \$10 million increase in other expenses.

NET UNREALIZED (LOSSES) GAINS ON NON-TRADING DERIVATIVES AND BORROWINGS MEASURED AT FAIR VALUE, PER FAS 133 AS AMENDED

IBRD's application of FAS 133 as amended results in accounting for all derivatives and certain debt instruments at fair value. IBRD is a net U.S. dollar variable rate payer on U.S. dollar interest rate swaps and currency swaps. IBRD is thus effectively short interest rates. During FY 2007, IBRD experienced net unrealized losses of \$842 million. Most of the losses for FY 2007 resulted from British pound-U.S. dollar, euro-U.S. dollar, and U.S. dollar-South African rand currency swaps. Since IBRD is typically a fixed rate receiver in British pound, euro and South African rand currency swaps, the rise in the yields of these currencies resulted in unrealized losses. Some of these losses were offset by gains in U.S. dollar interest rate swaps where IBRD is a net variable-rate payer. Since U.S. dollar yields, particularly at the short-end declined in FY 2007 IBRD experienced gains on its U.S. dollar interest rate swaps. Similarly, the effects of applying FAS 133 as amended resulted in net unrealized losses in FY 2006 primarily as a result of rising interest rates in the applicable currencies. It should be noted that at June 30, 2006, prior to the adoption of Statement of Financial Accounting Standards No.155, embedded derivatives were bifurcated and fair valued under the reported basis, while the host instruments were accounted for on an amortized cost basis.

Table 19: Net Noninterest Expense*In millions of U.S. dollars*

	<i>FY 2007</i>	<i>FY 2006</i>	<i>FY 2005</i>
Gross Administrative Expenses			
Staff Costs	\$ 492	\$ 493	\$ 494
Operational Travel	101	99	104
Consultant Fees	98	102	94
Pension and other postretirement benefits	50	64	36
Contributions to Special Programs	171	173	173
Communications and IT	77	76	79
Contractual Services	68	61	61
Equipment and Buildings	143	129	129
Other Expenses	36	34	24
Total Gross Administrative Expenses	<u>1,236</u>	<u>1,231</u>	<u>1,194</u>
Less: Contribution to Special Programs	<u>171</u>	<u>173</u>	<u>173</u>
Total Net Administrative Expenses	<u>1,065</u>	<u>1,058</u>	<u>1,021</u>
Contribution to Special Programs	171	173	173
Service Fee Revenues	(261)	(243)	(228)
Net Other Income	<u>(5)</u>	<u>(24)</u>	<u>(39)</u>
Total Net Noninterest Expense	<u>\$ 970</u>	<u>\$ 964</u>	<u>\$ 927</u>

Economically, increases or decreases in the values of the derivatives are generally offset by corresponding decreases or increases in the values of the related borrowings and loans to the extent that such borrowings and loans are all marked-to-market. **FAS 133 as amended**, requires that all derivatives and certain debt instruments be marked-to-market. Thus, an asymmetry results in the reported financial statements when the value of economically offsetting transactions is reported on different bases. For management reporting purposes, IBRD has disclosed the Current Value financial statements in **Tables 1 and 2** and believes that these statements make fully evident the risk management strategy employed by IBRD.

9. GOVERNANCE

General Governance

Management Changes

The Executive Directors are charged, under the Articles of Agreement with the selection of IBRD's President. Mr. Paul Wolfowitz resigned on June 30, 2007. The Executive Directors have unanimously selected Mr. Robert Zoellick to be the next President; his appointment became effective July 1, 2007.

Board Membership

In accordance with its Articles of Agreement, members of IBRD's Executive Directors are appointed or elected by their member governments. These Executive Directors are neither officers nor staff of IBRD. The President is the only management member of the Board of Executive Directors, serving as a non-voting member and as Chairman of the Board. The Executive Directors have established several Committees including:

- Committee on Development Effectiveness
- Audit Committee
- Budget Committee
- Personnel Committee
- Ethics Committee
- Committee on Governance and Administrative Matters

The Executive Directors and their Committees function in continuous session at the principal offices of IBRD, as business requires. Each Committee's terms of reference establishes its respective roles and responsibilities. As Committees do not vote on issues, their role is primarily to serve the full Board of Executive Directors in discharging its responsibilities.

Audit Committee

Membership

The Audit Committee consists of eight members of the Board of Executive Directors. Membership on the Committee is determined by the Board of Executive Directors, based upon nominations by the Chairman of the Board, following informal consultation with the Executive Directors. In addition, membership of the Committee is expected to reflect the economic and geographic diversity of IBRD's member countries. Other relevant selection criteria include seniority, continuity and relevant experience. Some or all of the responsibilities of individual committee members are performed by their alternates or advisors. Generally, Committee members are appointed for a two year term; reappointment to a second term, when possible, is desirable for continuity. Audit Committee meetings are generally open to any member of the Board who may wish to attend, and non-Committee members of the Board may participate in the discussion. In addition, the Chairman of the Audit Committee may speak in that capacity at meetings of the Board of Executive Directors, with respect to discussions held in the Audit Committee.

Key Responsibilities

The Audit Committee is appointed by the Board to assist it in the oversight and assessment of IBRD's finances and accounting, including the effectiveness of financial policies, the integrity of financial statements, the system of internal controls regarding finance, accounting and ethics (including fraud and corruption), and financial and operational risks. The Audit Committee also has the responsibility for reviewing the performance and recommending to the Board the appointment of the external auditor, as well as monitoring the independence of the external auditor and meeting with it in executive session. The Audit Committee participates in oversight of the internal audit function, including reviewing the responsibilities, staffing and the effectiveness of internal audit. The Committee also reviews the annual internal audit plan and meets with the Auditor General in executive session. In the execution of its role, the Committee discusses with management, the external auditors, and the internal auditors, financial issues and policies which have a bearing on the institution's financial position and **risk-bearing capacity**. The Audit Committee monitors the evolution of developments in corporate governance and the role of audit committees on an

ongoing basis and revised its terms of reference in FY 2004.

Communications

The Audit Committee communicates regularly with the full Board through distribution of the following:

- The minutes of its meetings.
- Reports of the Audit Committee prepared by the Chairman, which document discussions held. These Reports are distributed to the Executive Directors, Alternates, World Bank Group Senior Management and Vice Presidents of IBRD.
- "Statement(s) of the Chairman" and statements issued by other members of the Committee.
- The Annual Report to the Board of Executive Directors, which provides an overview of the main issues addressed by the Committee over the year.

The Audit Committee's communications with the external auditor are described in the Auditor Independence section.

Executive Sessions

Members of the Committee may convene in executive session at any time, without management present. Under the Committee's terms of reference, it meets separately in executive session with the external and internal auditors.

Access to Resources and to Management

Throughout the year, the Audit Committee receives a large volume of information, which supports the preparation of the financial statements. The Audit Committee meets both formally and informally throughout the year to discuss financial and accounting matters. Executive Directors have complete access to management. The Audit Committee reviews and discusses with management the quarterly and annual financial statements. The Committee also reviews with the external auditor the financial statements prior to their publication and recommends them for approval to the Board of Executive Directors.

The Audit Committee has the capacity, under exceptional circumstances, to obtain advice and assistance from outside legal, accounting or other advisors as deemed appropriate.

Code of Ethics

IBRD strives to foster and maintain a positive work environment that supports the ethical behavior of its

staff. To facilitate this effort, IBRD has in place a Code of Professional Ethics-Living our Values. The Code applies to all staff (including managers, consultants, and temporary employees) worldwide.

This Code is available in nine languages on IBRD's website, www.worldbank.org. Staff relations, conflicts of interest, and operational issues, including the accuracy of books and records, are key elements of the Code.

In addition to the Code, an essential element of appropriate conduct is compliance with the obligations embodied in the Principles of Staff Employment, Staff Rules, and Administrative Rules, the violation of which may result in disciplinary actions. In accordance with the Staff Rules, senior managers must complete a confidential financial disclosure instrument with the Office of Ethics and Business Conduct.

Guidance for staff is also provided through programs, training materials, and other resources. Managers are responsible for ensuring that internal systems, policies, and procedures are consistently aligned with IBRD's ethical goals. In support of its efforts on ethics, IBRD offers a variety of methods for informing staff of these resources. Many of these efforts are headed by the following groups:

- The Office of Ethics and Business Conduct provides leadership, management and oversight for IBRD's ethics infrastructure including the Ethics HelpLine, a consolidated conflicts of interest disclosure/resolution system, financial disclosure, ongoing training to both internal and external audiences, and communication resources.
- The Department of Institutional Integrity is charged with investigating allegations of fraud and corruption in IBRD-funded projects worldwide. The Department also investigates allegations of misconduct by IBRD staff, and trains and educates staff and clients in detecting and reporting fraud and corruption in IBRD-funded projects. The Department reports directly to the President and is composed of professionals from a range of disciplines including financial analysts, researchers, investigators, lawyers, prosecutors, forensic accountants, and IBRD staff with operational experience.

IBRD has in place procedures for the receipt, retention and treatment of complaints received regarding accounting, internal control and auditing matters.

IBRD offers both the Ethics HelpLine, as well as a Fraud and Corruption hotline run by an outside firm staffed by trained specialists. This third-party service offers numerous methods of communication in addition to a toll free hotline in countries where access to telecommunications may be limited. In addition there are other methods by which the Department of Institutional Integrity may receive allegations, including directly by email, anonymously, or through confidential submission through its website, as well as the postal service and telephone.

Auditor Independence

In FY 2003, the Board of Executive Directors adopted a set of principles applicable to the appointment of the external auditor for IBRD. Key features of those principles include:

- Prohibition of the external auditor from the provision of all non audit-related services.
- All audit-related services must be pre-approved on a case-by-case basis by the Board of Executive Directors, upon recommendation of the Audit Committee.
- Mandatory rebidding of the external audit contract every five years.
- Prohibition of any firm serving as external auditors for more than two consecutive five-year terms.
- Mandatory rotation of the senior partner after five years.
- An evaluation of the performance of the external auditor at the mid-point of the five year term.

In FY 2004, IBRD's external auditor, Deloitte and Touche, began a new five-year term and will have served 11 years as auditor upon completion of that term, pursuant to a one-time grandfathered exemption from the above-referenced ten-year limit. Even within a five-year term the service of the external auditors is subject to recommendation by the Audit Committee for annual reappointment and approval of a resolution by the Board of Executive Directors.

As a standard practice, the external auditor is present as an observer at virtually all Audit Committee meetings and is frequently asked to present its perspective on issues. In addition, the Audit Committee meets periodically with the external auditor in private session without management present. Communication between the external

auditor and the Audit Committee is ongoing, as frequently as is deemed necessary by either party. IBRD's auditors follow the communication requirements with audit committees set out under U.S. generally accepted auditing standards. In keeping with these standards, significant formal communications include:

- Quarterly and annual financial statement reporting.
- Annual appointment of the external auditors.
- Presentation of the external audit plan.
- Presentation of control recommendations and discussion of the COSO attestation and report.

- Presentation of a statement regarding independence.

In addition to Committee meetings, individual members of the Audit Committee have independent access to the external auditor.

10. RECONCILIATION OF PRIOR YEAR CURRENT VALUE FINANCIAL STATEMENTS TO REPORTED BASIS

IBRD's Condensed Current Value Balance Sheet at June 30, 2006 is presented, with a reconciliation to the reported basis, in Table 20 below. Similarly, IBRD's Condensed Current Value Statement of Income for the year ended June 30, 2006 is presented, with a reconciliation to the reported basis, in Table 21.

Table 20: Condensed Current Value Balance Sheet at June 30, 2006

In millions of U.S. dollars

	<i>June 30, 2006</i>			<i>Current Value Basis</i>
	<i>Reported Basis</i>	<i>Reversal of FAS 133 Effects</i>	<i>Current Value Adjustments</i>	
Due from Banks	\$ 758			\$ 758
Investments	25,826			25,826
Loans Outstanding	103,004		\$881	103,885
Less Accumulated Provision for Loan Losses and Deferred Loan Income	(2,783)			(2,783)
Receivable from Derivatives				
Investments	7,525			7,525
Client Operations	87	\$ 2	*	89
Borrowings	70,036	24	(24)	70,036
Other Asset/Liability	835	(94)	94	835
Other Assets	7,038		(344)	6,694
Total Assets	<u>\$212,326</u>	<u>\$(68)</u>	<u>\$607</u>	<u>\$212,865</u>
Borrowings	\$95,835	\$(1,033)	\$456	\$95,258
Payable for Derivatives				
Investments	7,960			7,960
Client Operations	84	*		84
Borrowings	65,819	(252)	252	65,819
Other Asset/Liability	1,014	(145)	145	1,014
Other Liabilities	5,140			5,140
Total Liabilities	<u>175,852</u>	<u>(1,430)</u>	<u>853</u>	<u>175,275</u>
Paid in Capital Stock	11,483			11,483
Retained Earnings and Other Equity	24,991	1,362	(246)	26,107
Total Equity	<u>36,474</u>	<u>1,362</u>	<u>(246)</u>	<u>37,590</u>
Total Liabilities and Equity	<u>\$212,326</u>	<u>\$(68)</u>	<u>\$607</u>	<u>\$212,865</u>

* Indicates amounts less than \$0.5 million.

Table 21: Condensed Current Value Statement of Income for the year ended June 30, 2006*In millions of U.S. dollars*

	<i>FY 2006</i>		
	<i>Reported Comprehensive Basis</i>	<i>Adjustments to Current Value</i>	<i>Current Value Comprehensive Basis</i>
Income from Loans	\$ 4,864		\$4,864
Income from Investments, net	1,057	\$ (4)	1,053
Other Income	267		267
Total Income	<u>6,188</u>	<u>(4)</u>	<u>6,184</u>
Borrowing Expenses	3,941		3,941
Administrative Expenses including contributions to Special Programs	1,231		1,231
Release of Provision for Losses on Loans and Guarantees	(724)	724	
Total Expenses	<u>4,448</u>	<u>724</u>	<u>5,172</u>
Operating Income	1,740	(728)	1,012
Board of Governors-Approved Transfers	(650)		(650)
Current Value Adjustments		(446)	(446)
Release of Provision for Losses on Loans and Guarantees— Current Value		724	724
Net unrealized (losses) gains on non-trading derivatives and borrowings at fair value, per FAS 133 as amended	(3,479)	3,479	
Net (Loss) Income	<u><u>\$(2,389)</u></u>	<u><u>\$3,029</u></u>	<u><u>\$640</u></u>

GLOSSARY OF TERMS

Asset-backed Securities: Asset-backed securities are instruments whose cash flow is based on the cash flows of a pool of underlying assets managed by a trust.

COSO: Committee of Sponsoring Organizations of the Treadway Commission.

Currency Swaps (including Currency Forward Contracts): Currency swaps are agreements between two parties to exchange cash flows denominated in different currencies at one or more certain times in the future. The cash flows are based on a predetermined formula reflecting rates of interest and an exchange of principal.

Duration: Duration provides an indication of the interest rate sensitivity of a fixed income security to changes in its underlying yield.

Equity-to-Loans Ratio: This ratio is the sum of usable capital plus the special and general reserves, cumulative translation adjustment (excluding amounts associated with applying the provisions of FAS 133 as amended) and the proposed transfer from unallocated net income to general reserves (where there are firm estimates available) divided by the sum of loans outstanding, the present value of guarantees, net of the accumulated provision for losses on loans and guarantees and deferred loan income.

Failed Trades: Failed trades are securities transactions that do not settle on the contractual settlement date.

FAS 133 as amended: FAS 133 as amended refers collectively to the Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended by subsequent standards.

Forward Starting Swaps: A forward starting swap is an agreement under which the cash flow exchanges of the underlying interest rate swaps would begin to take effect from a specified future date.

Futures: Futures are contracts for delivery of securities or money market instruments in which the seller agrees to make delivery at a specified future date of a specified instrument at a specified price or yield. Futures contracts are traded on U.S. and international regulated exchanges.

Government and Agency Obligations: These obligations include marketable bonds, notes and other obligations issued by governments.

Hedging: Hedging is a risk management technique of entering into offsetting commitments to eliminate or minimize the impact of adverse movements in value or cash flow of the underlying.

Interest Rate Swaps: Interest rate swaps are agreements involving the exchange of periodic interest payments of differing character, based on an underlying notional principal amount for a specified time.

LIBOR: London interbank offered rate.

Maintenance of Value: Agreements with members provide for the maintenance of the value, from the time of sub-

scription, of certain restricted currencies. Additional payments to (or from) IBRD are required in the event the par value of the currency is reduced (or increased) to a significant extent, in the opinion of IBRD.

Net Disbursements: Loan disbursements net of repayments and prepayments.

New Loans: Loans for which the invitation to negotiate was issued on or after July 31, 1998.

Old Loans: Loans for which the invitation to negotiate was issued prior to July 31, 1998.

Options: Options are contracts that allow the holder of the option the right, but not the obligation, to purchase or sell a financial instrument at a specified price within a specified period of time from or to the seller of the option. The purchaser of an option pays a premium at the outset to the seller of the option, who then bears the risk of an unfavorable change in the price of the financial instrument underlying the option.

Repurchase and Resale Agreements and Securities Loans: Repurchase agreements are contracts under which a party sells securities and simultaneously agrees to repurchase the same securities at a specified future date at a fixed price. The reverse of this transaction is called a resale agreement. A resale agreement involves the purchase of securities with a simultaneous agreement to sell back the same securities at a stated price on a stated date. Securities loans are contracts under which securities are lent for a specified period of time at a fixed price.

Return on Equity: This return is computed as net income divided by the average equity balance during the year.

Risk-bearing Capacity: The ability to absorb risks in the balance sheet while continuing normal operations without having to call on callable capital.

Short Sales: Short sales are sales of securities not held in the seller's portfolio at the time of the sale. The seller must purchase the security at a later date and bears the risk that the market value of the security will move adversely between the time of the sale and the time the security must be delivered.

Statutory Lending Limit: Under IBRD's Articles of Agreement, as applied, the total amount outstanding of loans, participations in loans, and callable guarantees may not exceed the sum of subscribed capital, reserves and surplus.

Swaptions: A swaption is an option which gives the holder the right to enter into an interest rate or currency swap at a certain future date.

Time Deposits: Time deposits include certificates of deposit, bankers' acceptances, and other obligations issued or unconditionally guaranteed by banks and other financial institutions.

