

INTERNATIONAL BANK FOR RECONSTRUCTION AND  
DEVELOPMENT

MANAGEMENT'S DISCUSSION AND ANALYSIS  
JUNE 30, 2008

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Throughout Management's Discussion and Analysis, terms in **boldface** type are defined in the Glossary of Terms on page 42.

**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 borrowing member countries. The majority of IBRD's outstanding loans are priced on a cost pass-through basis. During FY 2008, IBRD implemented a new simplified and lowered loan and guarantee pricing structure for new loans, consisting of a lower, single contractual interest spread and a front-end fee (eliminating waivers and commitment fee charges) (See Section 3, Development Activities – Contractual Terms of Loans including **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 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 2008 were \$13.5 billion, reflecting an increase of \$0.7 billion from the FY 2007 level of \$12.8 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 gains (losses) on non-trading derivatives, loans and borrowings measured at fair value per **FAS 133 as amended**. FY 2008 Operating Income was \$2,271 million, \$612 million higher than that for FY 2007 primarily due to the income impact of the positive developments in the nonaccrual loan portfolio.

The current market turmoil had no major effect on IBRD's income or its financial strength.

To increase and stabilize its operating income in future years, IBRD implemented the following financial policy changes in FY 2008:

*New investment strategy:* Approval of a \$3 billion Long-Term Income Portfolio (LTIP), to be funded out of IBRD's capital, and implemented over a two to three-year timeframe commencing in FY 2009. Under this strategy, IBRD will for the first time invest in equity securities. LTIP is intended to be a long-term duration multicurrency portfolio, swapped back into U.S. dollars. The composition of the portfolio will be 60% developed market public equities and 40% developed market fixed-income securities.

*Equity duration extension:* A strategy to increase the duration of IBRD's equity to reduce income volatility and stabilize operating income by taking a greater exposure to long-term interest rates. This strategy is designed to reduce the sensitivity of IBRD's operating income to changes in short-term market interest rates, which has been increasing as more borrowers have chosen primarily floating rate terms since the introduction of **LIBOR**-based loans. The implementation of this strategy was completed by IBRD as of June 30, 2008, by entering into a number of **interest rate swaps** to extend the duration of equity using a 10-year ladder repricing profile.

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.

## 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

<b>Lending</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
Commitments to member countries <sup>a</sup>	13,468	12,829	14,135	13,611	11,045
Gross Disbursements <sup>b</sup>	10,490	11,055	11,883	9,722	10,109
Net Disbursements <sup>b</sup>	(2,129)	(6,193)	(1,741)	(5,131)	(8,408)
<b>Reported Basis</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
Loan Income	5,497	5,467	4,864	4,155	4,403
Release of Provision for Losses on Loans and Guarantees	684	405	724	502	665
Investment Income	1,066	1,281	1,107	627	304
Borrowing Expenses	(4,017)	(4,519)	(3,987)	(3,037)	(2,789)
Net Noninterest Expense	(959)	(975)	(968)	(927)	(887)
Operating Income	2,271	1,659	1,740	1,320	1,696
Board of Governors-Approved Transfers	(740)	(957)	(650)	(642)	(645)
Net unrealized (losses) gains on non-trading derivatives, loans and borrowings measured at fair value, per FAS 133 as amended	(40)	(842)	(3,479)	2,511	(4,100)
Net Income (Loss)	1,491	(140)	(2,389)	3,189	(3,049)
Net Return on Average Earning Assets <sup>c</sup>	1.87	1.34	1.34	0.96	1.18
after the effects Board of Governors-Approved Transfers and of FAS 133 as amended	1.23	(0.11)	(1.84)	2.32	(2.12)
Return on Equity <sup>c</sup>	5.96	4.64	5.05	3.90	5.21
after the effects Board of Governors-Approved Transfers and of FAS 133 as amended	3.73	(0.37)	(6.84)	9.26	(8.88)
Equity-to-Loans Ratio	37.62	35.05	32.96	31.45	29.35
Total Assets	233,599	207,900	212,326	222,008	228,910
Loans Outstanding	99,050	97,805	103,004	104,401	109,610
Accumulated Provision for Loan Losses	(1,370)	(1,932)	(2,296)	(3,009)	(3,505)
Borrowings Outstanding <sup>d</sup>	87,690	87,759	95,835	101,297	108,066
Total Equity	41,548	39,796	36,474	38,588	35,463
<b>Current Value Basis</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
Net Income	1,135	900	640	402	484
of which current value adjustment	(495)	222	(446)	(273)	(513)
Net Return on Average Earning Assets <sup>e</sup>	0.92	1.49	0.98	0.74	0.76
Return on Equity <sup>e</sup>	2.99	5.21	3.74	3.04	3.36
Equity-to-Loans Ratio	36.71	34.47	32.44	30.83	29.07
Unrestricted Cash and Liquid Investments	23,047	22,214	24,888	26,395	31,126
Loans Outstanding	100,174	98,516	103,885	107,549	112,608
Borrowings Outstanding <sup>d</sup>	89,946	89,484	95,258	105,691	109,675
Total Equity	40,128	38,483	37,590	36,943	36,421
<p><i>a. Effective FY 2005 commitments include guarantee commitments and guarantee facilities.</i></p> <p><i>b. Amounts include transactions with the International Finance Corporation (IFC) and capitalized front-end fees.</i></p> <p><i>c. Before the effects of Board of Governors-approved transfers and FAS 133 as amended.</i></p> <p><i>d. Borrowings outstanding, excluding derivatives, net of premium/discount.</i></p> <p><i>e. Excludes Board of Governors-approved transfers.</i></p>					

On August 7, 2008, the Executive Directors approved the following from FY 2008 net income: \$811 million to the General Reserve, \$117 million to the Pension Reserve and \$10 million to the Externally Financed Outputs Adjustment Account. In addition, the Executive Directors recommended to IBRD's Board of Governors the following transfers from FY 2008 unallocated net income: \$583 million to the International Development Association (IDA) and \$750 million to Surplus. Concurrently, they also recommended to IBRD's Board of Governors that they approve subsequent transfers from Surplus of

\$40 million and \$115 million to the Kosovo Sustainable Employment Development Trust Fund and the Food Price Crisis Response Trust Fund, respectively. The Executive Directors also approved waivers of loan charges for FY 2009 for all eligible borrowers with eligible loans.

## 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, in FY 2007 IBRD 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 and loan 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 collectively 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 application of **FAS 133 as amended**, carries all derivatives at fair value, with changes in the fair value being recognized in earnings. However, only a portion of the other financial instruments are measured at fair value, resulting in an asymmetry in the reported financial statements.

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. IBRD's funding operations are designed to meet a major organizational objective of providing lower cost funds to borrowing members. 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, reports all derivatives at fair value, with changes in the fair value being recognized in earnings. However, only a portion of the other financial instruments in IBRD's portfolio (loans and borrowings) are measured at fair value. Thus an asymmetry results in the reported financial statements.

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 FY 2000, 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 net unrealized mark-to-market adjustments from the investment portfolio of \$99 million, and the release of provision for losses on loans and guarantees of \$684 million are reversed from the reported operating income, to arrive at \$1,686 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 net negative Current Value adjustment of \$495 million for market risk and the release of provision for losses on loans and guarantees of \$684 million reflecting credit risk are added while the \$40 million effect of **FAS 133 as amended** is reversed. The prior year's Condensed Current Value Statement of Income is presented, with 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 IFC, 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 value of loans carried at fair value is determined based on market pricing.

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, except for loans carried at fair value which already incorporate a credit risk assessment.

At June 30, 2008, the \$1,124 million increase in IBRD's loan portfolio from the reported basis to the current value basis as shown in **Table 3** (\$711 million—June 30, 2007) 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 \$413 million increase in the current value

adjustment from June 30, 2007 was primarily due to the increase in the current value adjustment on U.S. dollar denominated loans, consistent with the decrease in the reference market yield curve for U.S. dollar during FY2008 as shown in **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.

At June 30, 2008, the \$1,207 million increase in IBRD's borrowing portfolio from the reported basis to the current value basis as shown in **Table 3** (\$998 million—June 30, 2007) reflects the average cost of the borrowing portfolio being higher than the rate at which IBRD could obtain funding at the reporting date. The \$209 million increase in the current value adjustment from June 30, 2007 was primarily due to the increase in the mark on U.S. dollar denominated debt, consistent with the decrease in the reference market yield curve for U.S. dollar during FY 2008 as shown in **Figure 11**.

#### **Other Derivatives**

The other derivatives portfolio is mainly comprised of **interest rate swaps** used principally to manage the interest rate characteristics of IBRD's equity, under its equity duration extension strategy. The current value represents the present value of cash flows on these instruments based on market rates.

At June 30, 2008, the \$396 million increase in the other derivatives portfolio largely reflects the increase in interest rates between the trade date and the reporting date.

**Table 1: Condensed Current Value Balance Sheets at June 30, 2008 and 2007***In millions of U.S. dollars*

	June 30, 2008			June 30, 2007	
	<i>Reported Basis</i>	<i>Reversal of FAS 133 Effects</i>	<i>Current Value Adjustments</i>	<i>Current Value Basis</i>	<i>Current Value Basis</i>
Due from Banks	\$ 834			\$ 834	\$ 765
Investments	26,598			26,598	23,336
Loans Outstanding	99,050		\$ 1,124	100,174	98,516
Less Accumulated Provision for Loan Losses and Deferred Loan Income	(1,782)			(1,782)	(2,372)
Receivable from Derivatives					
Investments	5,857			5,857	7,138
Client Operations	20,269	\$2,654	(2,654)	20,269	4,778
Borrowings	76,098	1,664	(1,664)	76,098	69,507
Other	609	(51)	51	609	13
Other Assets	6,066		(288)	5,778	6,631
<b>Total Assets</b>	<b>\$233,599</b>	<b>\$4,267</b>	<b>\$ (3,431)</b>	<b>\$234,435</b>	<b>\$208,312</b>
Borrowings	\$ 87,690	\$2,219	\$ 37	\$ 89,946	\$89,484
Payable for Derivatives					
Investments	6,309			6,309	7,527
Client Operations	20,263	2,653	(2,653)	20,263	4,776
Borrowings	69,152	783	(783)	69,152	62,850
Other	1,007	(447)	447	1,007	38
Other Liabilities	7,630			7,630	5,154
<b>Total Liabilities</b>	<b>192,051</b>	<b>5,208</b>	<b>(2,952)</b>	<b>194,307</b>	<b>169,829</b>
Paid in Capital Stock	11,486			11,486	11,486
Retained Earnings and Other Equity	30,062	(941)	(479)	28,642	26,997
<b>Total Equity</b>	<b>41,548</b>	<b>(941)</b>	<b>(479)</b>	<b>40,128</b>	<b>38,483</b>
<b>Total Liabilities and Equity</b>	<b>\$233,599</b>	<b>\$4,267</b>	<b>\$ (3,431)</b>	<b>\$234,435</b>	<b>\$208,312</b>

**Table 2: Condensed Current Value Statements of Income for the years ended June 30, 2008 and 2007***In millions of U.S. dollars*

	FY 2008		FY 2007	
	Reported Basis	Adjustments to Current Value	Current Value Comprehensive Basis	Current Value Comprehensive Basis
Income from Loans	\$5,497		\$5,497	\$5,467
Income from Investments	1,066	\$ 99	1,165	1,257
Other Income	300		300	264
Total Income	6,863	99	6,962	6,988
Borrowing Expenses	4,017		4,017	4,519
Administrative Expenses including contributions to Special Programs	1,258		1,258	1,237
Release of Provision for Losses on Loans and Guarantees	(684)	684		
Other Expenses	1		1	2
Total Expenses	4,592	684	5,276	5,758
Operating Income	2,271	(585)	1,686	1,230
Board of Governors-Approved Transfers	(740)		(740)	(957)
Current Value Adjustments		(495)	(495)	222
Release of Provision for Losses on Loans and Guarantees-Current Value		684	684	405
Net unrealized losses on non-trading derivatives, loans and borrowings at fair value, per FAS 133 as amended <sup>a</sup>	(40)	40		-
Net Income (Loss)	\$1,491	\$(356)	\$1,135	\$ 900

a. Net unrealized (losses) gains on derivatives in the investment trading portfolio are included in income from investments.

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

	Balance Sheet Effects as of June 30, 2008				Prior Years' Effects	Total Income Statement Effect	
	Loans	Borrowings	Other Asset/ Liability	Total		FY 2008	FY 2007
Current Value Adjustments on Balance Sheet due to Interest Rates	\$1,124	\$(1,207) <sup>a</sup>	\$(396)	\$(479)	\$314 <sup>b</sup>	\$ (165)	\$ (68)
Unrealized Losses on Investments <sup>c</sup>						(99)	24
Currency Translation Adjustment <sup>d</sup>	2,811	(2,225)	203	789		789	266
Pension Adjustment <sup>e</sup>						(1,020)	-
Total Current Value Adjustments						\$ (495)	\$222

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.

e. The pension adjustment primarily reflects the difference between the actual and expected return on plan assets, which as prescribed by Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit, Pension and Postretirement Plans (FAS 158), has been recognized in IBRD's Statement of Comprehensive Income.

## **Current Value Statements of Income**

Net income on a current value basis in FY 2008 was \$1,135 million, an increase of \$235 million compared to FY 2007 attributed primarily to lower borrowing expenses, lower Board of Governors-approved transfers, and a higher release of provision for losses on loans and guarantees, partially offset by a net negative current value adjustment.

### **Borrowing Expenses**

Borrowing expenses decreased by \$502 million in FY 2008 compared to FY 2007 primarily due to the lower average borrowing cost rate (see **Figure 10**) coupled with the lower average balance of the borrowings portfolio and higher buyback gains. With approximately two-thirds of borrowings based on short-term U.S. dollar interest rates, the decrease in U.S. dollar six-month LIBOR in FY 2008 resulted in lower borrowing costs.

### **Provision for Losses on Loans and Guarantees**

During FY 2008, there was a \$684 million release of provision for losses on loans and guarantees compared to a release of \$405 million during FY 2007, reflecting an increase in income of \$279 million over FY 2007. The release of provision in FY 2008 primarily reflects the impact of developments in the nonaccrual portfolio while that in FY 2007 primarily reflects the impact of a combination of changes in the credit quality of the loan portfolio, changes in the volume of loans and guarantees outstanding, net of translation adjustments, and the annual update of the expected default frequencies (probabilities of default to IBRD).

### **Board of Governors-Approved Transfers**

The Board of Governors-approved transfers were lower by \$217 million during FY 2008 compared to FY 2007. This was due primarily to the exceptional additional one-time transfer to IDA of \$300 million in FY 2007.

### **Income from Investments**

Income from investments decreased by \$92 million due mainly to lower average short-term interest rates in FY 2008 compared to FY 2007 (see **Figure 10**). IBRD primarily holds short-term U.S. dollar fixed income investments and other assets hedged into U.S. dollars with an average **duration** of less than three months.

### **Income from Loans**

Income from loans increased by \$30 million in FY 2008 compared to FY 2007. The clearance of all overdue interest and charges by Liberia and Cote d'Ivoire resulted in a \$269 million increase in income from loans. Of this amount, \$251 million represented income which would have been

recognized in previous fiscal years had these borrowers been in accrual status. This was partially offset by a \$242 million decrease in income from loans associated with the lower average balance and lower average loan rates in FY 2008 (see **Figure 10**).

### **Current Value Adjustments**

On December 13, 2007, the Executive Directors approved the extension of the duration of IBRD's equity with the objective of reducing the interest rate sensitivity of its operating income. As of June 30, 2008, IBRD had implemented the strategy by entering into a number of **interest rate swaps** to extend the duration of equity with notional value totaling \$35 billion, using a 10-year ladder repricing profile. The mark-to-market adjustment of \$459 million as of June 30, 2008 associated with lengthening the duration of IBRD's equity is reflected as part of the adjustment to equity under current value reporting. IBRD's risk management strategy of maintaining its **risk bearing capacity** by matching the currency composition of its equity to that of its loans remains unchanged.

The current value adjustment due to interest rate changes resulted in a decrease in net income of \$165 million in FY 2008 (decrease of \$68 million in FY 2007) as shown in **Table 3**. The significant appreciation of the euro and the Japanese yen against the U.S. dollar in FY 2008 resulted in a net positive currency translation adjustment of \$789 million (net positive \$266 million in FY 2007). The overall effect on the Statement of Income was a net negative current value adjustment of \$495 million in FY 2008, including a \$1,020 million pension adjustment arising from the application of FAS 158, compared to net positive current value adjustment of \$222 million in FY 2007.

#### *Impact of changes due to interest rates*

The current value adjustment effect on the Statement of Income of negative \$165 million in FY 2008 was due primarily due to the increase in the current value adjustment on the borrowings portfolio (\$209 million) and other assets and liabilities (\$369 million), partially offset by the increase in the current value adjustment on the loan portfolio (\$413 million). These adjustments have been explained under the Current Value Balance Sheet Section. Conversely, in FY 2007, IBRD's net income on a current value basis included a net negative current adjustment of \$68 million, due to the decrease in the current value mark on the loan portfolio associated primarily with the increase in the euro and Japanese yen reference market yield curves, 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 \$789 million was due to the appreciation of the euro (16.9%) and Japanese yen (13.6%) against the U.S. dollar in FY 2008. **Table 4** provides a summary of currency translation adjustments by portfolio. The loan portfolio contributed positive \$2,811 million towards this increase. The euro and the Japanese yen accounted for approximately 19% and 3% of the total loan portfolio, and 96% of total non-U.S. dollar denominated loans at June 30, 2008. The borrowing portfolio accounted for negative \$2,225 million. The euro and the Japanese yen accounted for approximately 15% and 3% of the total borrowing portfolio, and 96% of total non-U.S. dollar denominated borrowings at June 30, 2008.

**Table 4: Summary of Currency Translation Adjustments**  
In millions of U.S. dollars

	2008	2007
Loans	\$ 2,811	\$ 892
Borrowings	(2,225)	(636)
Net Other Assets and Liabilities	203	10
Total	\$ 789	\$ 266

In comparison, during FY 2007 the impact of exchange rate changes on IBRD's net assets resulted in a positive translation adjustment of \$266 million due to the appreciation of the euro (7.0%), partially offset by the depreciation of the Japanese yen (5.1%) against the U.S. dollar.

### 3. DEVELOPMENT ACTIVITIES

IBRD offers loans, derivatives, 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.

Over the last five years, IBRD has experienced a decrease in its outstanding loans portfolio, principally due to higher prepayments. In order to improve the benefits of its loans to borrowers, during FY 2008, IBRD implemented a new simplified and lowered loan and guarantee pricing structure for new loans, consisting of a lower, single contractual interest spread and a front-end fee (eliminating waivers and commitment fee charges), along with simplifications of processes, extension of available loan maturities and improved access to new risk management tools such as weather derivatives. IBRD continues to explore other mechanisms for local currency financing and is also considering innovative approaches for funding climate change and environmentally-responsible initiatives.

### Loans

From its establishment through June 30, 2008, IBRD had approved loans, net of cancellations, totaling \$391,104 million to borrowers in 133 countries. A summary of cumulative lending is presented in **Table 5**.

At June 30, 2008, the total volume of outstanding loans was \$99,050 million, \$1,245 million higher than the \$97,805 million of outstanding loans at June 30, 2007. This increase was due to positive currency translation adjustment of \$3,374 million owing to the significant appreciation of the euro and Japanese yen against the U.S. dollar in FY 2008, partially offset by negative **net disbursements** of \$2,129 million, including \$1,659 million of prepayments. Undisbursed balances at June 30, 2008 totaled \$38,176 million, reflecting an increase of \$2,736 million from June 30, 2007. The increase 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, 2008 and 2007**  
In millions of U.S. dollars

	2008	2007
Cumulative Approvals <sup>a</sup>	\$391,104	\$378,204
Cumulative Repayments <sup>b</sup>	\$260,914	\$248,646

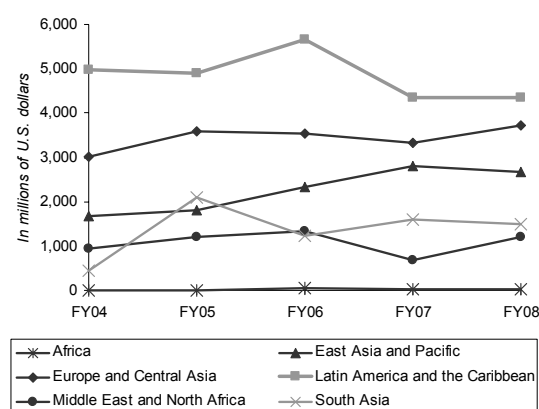
a. Net of cancellations

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 2008, new loans, guarantee commitments and guarantee facilities to member countries were \$13,468 million (\$12,829 million in FY 2007). During the five year period from FY 2004 to FY 2008, Latin America and the Caribbean region accounted for the largest share of commitments.

**Figure 1** presents the regional composition of commitments from FY 2004 to FY 2008.

**Figure 1: Commitments including Guarantee Facilities by Region**



### 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 macroeconomic 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 pilot programs approved by the Executive Directors, IBRD considers the use of borrower country procurement, and environmental and social safeguard systems in selected operations where these systems are assessed by IBRD as being equivalent to IBRD's systems and where the borrower's policies and procedures, implementation practices, track record, fiduciary and safeguard risks and capacity are considered acceptable to IBRD.

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, 2008, outstanding loans and callable guarantees (net of the accumulated provision for losses on loans and guarantees) totaled \$97,819 million, equal to 45% of the **statutory lending limit** of \$217,333 million at June 30, 2008.

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.

#### 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<sup>1</sup>, 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 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.

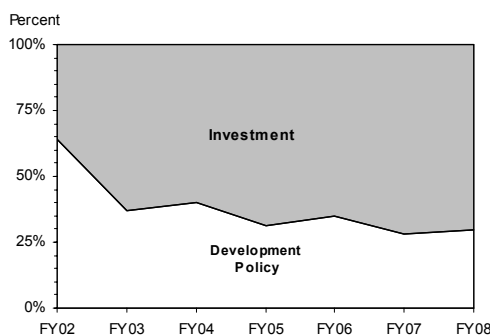
#### Lending Instruments

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

<sup>1</sup> 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.

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 2008, new IBRD commitments for development policy lending accounted for 29% of total commitments (28%–FY 2007; 35%–FY 2006).

### **Contractual Terms of Loans**

#### **Currently Available Loan Terms**

As of June 30, 2008, IBRD offers the IBRD Flexible Loan (IFL), a unified product line created in February 2008 from the consolidation of the Fixed Spread Loans (FSL) and Variable Spread Loans (VSL). The main characteristics of the IFL are that it allows borrowers to customize the repayment terms to meet their debt management or project needs and it includes options to manage the currency and/or interest rate risk over the life of the loan.

IFL has 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 terms, and fixed-spread terms. Variable-spread terms have a variable spread over **LIBOR** that is adjusted every six months and fixed-spread terms have a fixed spread over **LIBOR** that is fixed for the life of the loan.

Summarized below are the changes in the contractual terms of IBRD's loans during FY 2008:

#### ***New pricing terms***

On September 27, 2007 the Executive Directors approved a new simplified and lowered pricing structure for all loans approved after that date, with borrowers signing loans between May 16, 2007 and September 27, 2007 having the option to elect to convert to the new terms. The new structure reduced the complexity of loan pricing and removed the annual uncertainty over net loan charge levels, by

eliminating the system of a higher contractual loan spread, front-end fee, and commitment fee that were reduced by annually approved waivers and replacing it with a lower, single contractual interest spread and a front-end fee (eliminating waivers and commitment fee charges). However, penalty interest introduced on overdue principal replaces the previous waiver incentive to pay on time. The new pricing terms are summarized in **Table 6**.

#### ***Loan simplification and maturity extension***

On February 12, 2008, the Executive Directors approved the creation of IFL and the extension of the maximum maturity limits of loans and guarantees up to 30 years (with an average maturity of up to 18 years), for all borrowers equally, regardless of country per capita income.

Under the IFL (and previous FSLs) borrowers selecting the fixed-spread terms 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. Borrowers selecting the variable-spread terms under the IFL, who request a risk management transaction to manage the currency and/or interest rate risk would first need to convert their loan to the fixed-spread terms.

Prior to the introduction of the IFL, repayment terms for FSLs were more flexible than for VSLs, subject to certain constraints on the average repayment maturity and final maturity on a country basis. Within these constraints, borrowers had flexibility to configure grace periods and maturity profiles in a manner consistent with the purpose of the loan. Repayment profiles could be level repayment of principal, an annuity type schedule, a single lump-sum repayment, or a customized schedule. Repayment profiles could not be changed after a loan was signed.

#### ***Interest charges on overdue payments on fixed rate loans***

On July 10, 2007, IBRD's Executive Directors approved changes to the pricing policy for interest charges on overdue payments on fixed rate loans to more appropriately reflect IBRD's cost of funding the overdue amounts. Under the new policy, after the 30<sup>th</sup> day that a principal payment of a fixed rate loan is overdue, interest will be charged on the overdue principal at the variable rate applicable to FSLs (or IFLs) with similar approval dates. Previously, IBRD charged interest on overdue principal payment amounts at the original contractual rate specified in the loan contract.

**Table 6: Currently Available Loan Terms***Basis Points*

	<i>IBRD Flexible Loan (IFL)</i>		<i>Special Development Policy Loans</i>
	<i>Variable Spread Terms</i>	<i>Fixed Spread Terms</i>	
	Six month <b>LIBOR</b>	Six month <b>LIBOR</b>	
Reference Market Rate			Six month <b>LIBOR</b>
Spread			
Contractual Lending Spread <sup>a</sup>	30	30	400
Market Risk Premium	-	5	-
Funding Cost Margin	Weighted average spread to <b>LIBOR</b> of debt allocated to Variable Spread Term Loans	Projected funding spread to <b>LIBOR</b>	Six-month <b>LIBOR</b>
Charges			
Front-end fee <sup>a</sup>	25	25	100
Late service charge on principal payments received after 30 days of due date	50	50	-
Final Maturity	30 years	30 years	5 years

a. There are no waivers on interest and front-end fee under the new pricing terms.

*Local Currency Financing*

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 carry fixed spread terms. The balance of such loans outstanding at June 30, 2008 was \$369 million (\$49 million – June 30, 2007).

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, 2008, 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 borrowers the option of deferring the loan's disbursement for up to three years, which may be renewed for additional period of up to three years under the enhanced DDO for development loans. The recently introduced catastrophic risk DDO may be renewed up to four times. During FY 2008, the pricing of loans with a DDO was revised to reflect the simplified pricing structure of IBRD loans approved by the Executive Directors on September 27, 2007; this comprises a

front-end fee of 25 basis points, payable at effectiveness, and a contractual lending spread of 30 basis points over the IBRD's cost of funding. At June 30, 2008, the loan approvals with a DDO not yet drawn down totaled \$1,051 million.

**Derivatives**

IBRD also offers derivative products to borrowers, IDA and non-affiliated organizations as part of financial intermediation.

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

**Affiliated Organizations:** During FY 2008, IBRD executed a number of currency forward transactions with IDA. Concurrently, IBRD entered into offsetting transactions with market counterparties. As of June 30, 2008, the balances of these transactions included in Receivable from Derivatives and Payable for Derivatives on IBRD's Balance Sheet under Client Operations totaled \$13,474 million and \$13,474 million, respectively.

**Non-affiliated Organizations:** Since FY 2007, a number of **currency swaps** and **interest rate swaps** have been executed between IBRD and the International Finance Facility for Immunisation (IFFIm), a AAA-rated non-affiliated organization,

with whom IBRD has a master derivatives agreement and a treasury management contract. Concurrently, IBRD entered into offsetting swap transactions with market counterparties. IBRD's intermediation charges to IFFIm are 1 basis point per year for **interest rate swaps** and 2 basis points per year for **currency swaps**. 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 F-Derivatives for Client Operations.

#### **Previously Available Loan Terms**

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

**Table 7** summarizes the contractual terms for variable-rate multicurrency and single-currency pool loans, fixed-rate single-currency loans, variable spread loans and fixed spread 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 occurring on or after January 1, 2007. Loans that were amended to these new terms are not eligible for interest waivers. At June 30, 2008, 21% of the outstanding balance of variable rate multicurrency pool and variable rate U.S. dollar had been so modified.

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.

**Table 7: Previously Available Loan Terms**

*Basis Points*

	<i>Variable Spread Loans (1993-2008)</i>	<i>Fixed Spread Loans (2000-2008)</i>	<i>Variable rate multicurrency pool loans (1982-2001)</i>	<i>Variable rate single currency pool loans<sup>a</sup> (1996-1998)</i>	<i>Fixed rate single currency Loans<sup>b</sup> (1995-1999)</i>
Cost Base	Six month <b>LIBOR</b>	Six month <b>LIBOR</b>	<i>Weighted average cost of allocated debt</i>	<i>Weighted average cost of allocated debt</i>	<i>LIBOR</i>
<b>Spread</b>					
Contractual Lending Spread	30 <sup>c</sup>	30 <sup>c</sup>	-	-	-
	75 (post-98 loans) 50 (pre-98 loans)	75 -	75 (post-98 loans) <sup>d</sup> 50 (pre-98 loans) <sup>d</sup>	50 <sup>d</sup>	75 (post-98 loans) 50 (pre-98 loans)
Market Risk Premium	-	5 <sup>e</sup>	-	-	0-10
Funding Cost Margin	Weighted average spread to <b>LIBOR</b> of debt allocated to VSLs	Projected funding spread to <b>LIBOR</b>	-	-	IBRD's funding spread to <b>LIBOR</b>
<b>Charges</b>					
Commitment charge on undischursed balances	75	75 <sup>f</sup>	75	75	75
Front-end fee on effective loans	100 (post-98 loans)	100	100 (post-98 loans)	-	100 (post-98 loans)
Eligible for Waivers <sup>g</sup>					
Interest	Yes	Yes	Yes	Yes	Yes
Commitment	Yes	Yes	Yes	Yes	Yes
Front-end fee	Yes	Yes	No	No	No
Final Maturity	15-20 years	15-25 years	15-20 years	based on original loan agreement	12-20 years
Grace period	3-5 years	3-8 years	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. Apply to loans signed between May 16, 2007 and February 12, 2008 under the new loan pricing terms. Those loans had a contractual interest spread of 30 basis points, a front-end fee of 25 basis points and no commitment charge.

d. The modified loan terms offered are composite LIBOR + 100 basis points or fixed rate equivalent thereof and are not eligible for interest waivers.

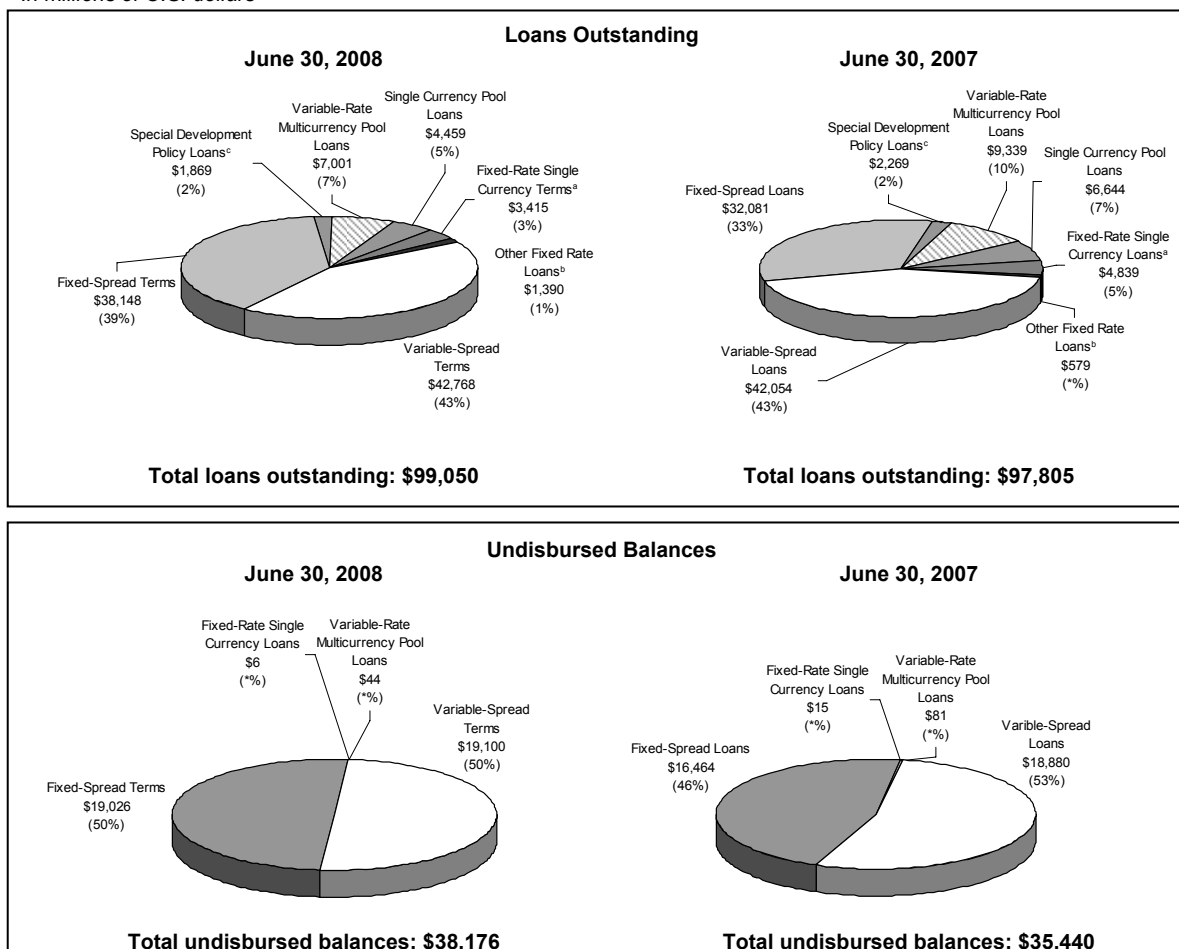
e. The market risk premium compensates IBRD for additional funding risk associated with this product.

f. 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 have a flat commitment charge of 75 basis points.

g. Waivers of a portion of charges and interest are determined annually, see **Table 8** for details. These apply to loans signed before May 16, 2007 or which were signed between May 16, 2007 and September 27, 2007 and not amended for the new pricing terms approved on September 27, 2007.

**Figure 3: Loan Portfolio by Loan Terms**

In millions of U.S. dollars



- a. Includes fixed-rate single currency loans for which the rate had not been fixed at fiscal year-end.
- b. Includes loans issued prior to 1980, loans to IFC, and currency pool loans and U.S. dollar single currency pool loans converted to fixed rate equivalent of composite LIBOR + 100 basis points.
- c. Includes loans with non-standard 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.

**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. In addition to loans signed before May 16, 2007, loans signed between May 16, 2007 and September 27, 2007, for which the borrowers elected not to convert to the new terms effective September 27, 2007, are also eligible for waivers. 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 8 presents a breakdown of IBRD's loan charge waivers. Further details on the Notes to Financial Statements-Note D-Loans and Guarantees.

**Table 8: Loan Charge Waivers**

Basis points	Interest Period Commencing	
	FY 2008	FY 2007
Commitment charge waivers	50	50
Interest waivers <sup>a</sup>		
Pre-98 loans	5	5
Post-98 loans	25	25
Average eligibility	99.7%	99.6%
Front-end fee waivers	100	100

a. On loans to eligible borrowers.

**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 commitment of enclave guarantees is limited to an aggregate guaranteed amount of \$300 million. As of June 30, 2008 commitments made under enclave guarantees were \$30 million.

IBRD's exposure at June 30, 2008 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

	FY 2008	FY 2007	FY 2006
Partial risk <sup>a</sup>	\$274	\$270	\$248
Partial credit	444	538	523
Policy based	49	79	154
Total	\$767	\$887	\$925

a. Includes enclave guarantees totaling \$19 million.

## Grants

IBRD also supports development activities by making grants to various recipients through the Development Grant Facility and through Board of Governors-approved transfers.

## Other Activities

In addition to its financial operations, IBRD is also involved in the following other activities:

**Consultation:** 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 K-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 K-Management of External Funds.

**Externally Financed Outputs (EFOs):** During FY 2008, IBRD introduced a product through which donors may contribute to IBRD outputs. Contributions received must be utilized for the purposes specified by the donors and are therefore considered restricted until applied by IBRD for the donor-specified purposes.

#### 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, 2008, 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, 2008 with another independent financial institution. The terms of this facility provided for a basic annual overdraft usage fee of \$0.3 million 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 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 2009 prudential minimum liquidity level has been set at \$19 billion, an increase of \$3 billion from that set for FY 2008. This increase primarily reflects the upcoming maturities of a relatively large volume of borrowings in FY 2009. 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.

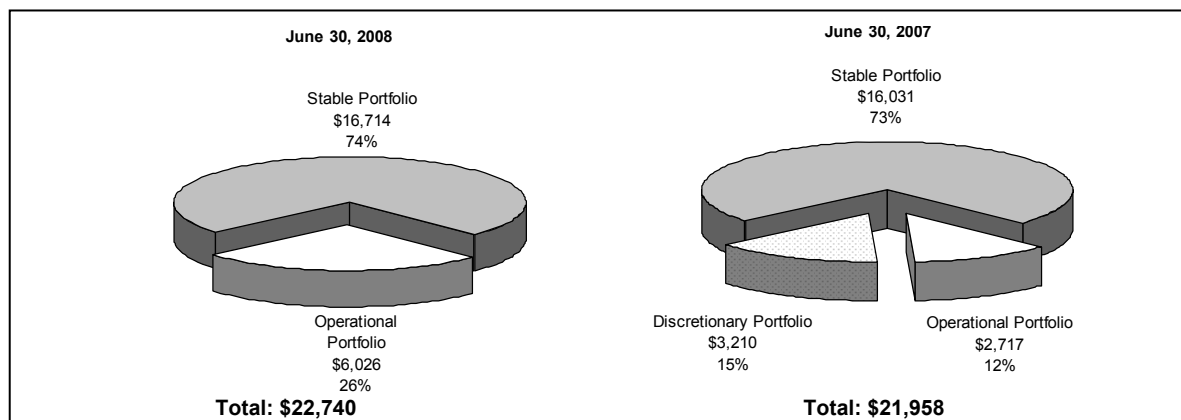
The stable portfolio is principally an investment portfolio holding the prudential minimum level of liquidity, which is set at the beginning of each fiscal year. Investment of up to 20% of the stable portfolio may be contracted out to external managers. Separate investment guidelines which conform to 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 2008 and FY 2007, excluding investment assets associated with certain other postemployment benefits. Effective November 30, 2007, the Operational and Discretionary portfolios were combined, resulting in transfers of holdings from the Discretionary portfolio into the Operational portfolio.

**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 2008	FY 2007	FY 2008	FY 2007
IBRD Overall Portfolio	\$22,635	\$22,256	4.15	5.24
Stable	16,385	15,939	4.19	5.39
Operational	4,462	3,190	3.55	4.35
Discretionary	1,788	3,127	5.36 <sup>a</sup>	5.34

a. Effective November 30, 2007, the holdings in the Discretionary portfolio were transferred into the Operational portfolio. The FY2008 return for the Discretionary portfolio is therefore a short period return that is annualized.

At June 30, 2008, the aggregate size of the IBRD liquid asset portfolio was \$22,740 million, reflecting an increase of \$782 million from June 30, 2007.

IBRD's liquid asset portfolio is largely composed of assets denominated in and hedged into 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).

The returns and average balances of the liquid asset portfolio in FY 2008 compared to FY 2007 are presented in **Table 10**. These returns exclude investment assets funding certain other postemployment benefits.

The lower returns in FY 2008 were due mainly to lower average short-term interest rates in FY 2008 compared to FY 2007 (see **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, 2008. 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 cost sharing and service arrangements (additional information can be found in the Notes to Financial Statements-Note J-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	\$90,980	\$25,573	\$22,139	\$6,865	\$36,403
Operating leases	442	46	72	41	283
Contractual purchases and capital expenditures	67	53	14	-	-
Other long-term liabilities	439	99	82	87	171
<b>Total</b>	<b>\$91,928</b>	<b>\$25,771</b>	<b>\$22,307</b>	<b>\$6,993</b>	<b>\$36,857</b>

## 5. FUNDING RESOURCES

### Equity

Total shareholders' equity, as reported in IBRD's balance sheet at June 30, 2008, was \$41,548 million compared to \$39,796 million at June 30, 2007. The \$1,752 million increase from FY 2007 primarily reflects the net income for the year of \$1,491 million.

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.

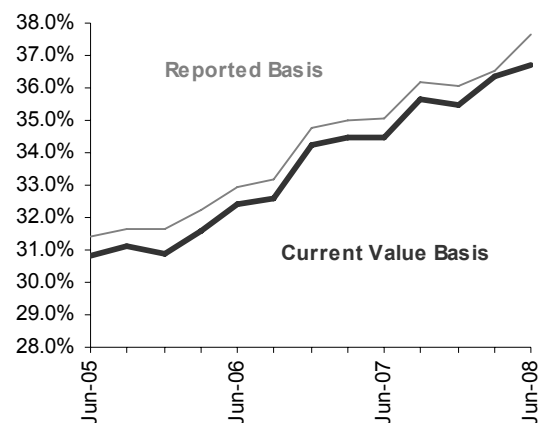
For management purposes, IBRD closely monitors equity as defined and utilized in the **equity-to-loans ratio**. **Table 12** presents the composition of this measure at June 30, 2008 and 2007, respectively.

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. On April 3, 2008, the Executive Directors approved management's proposal to create the LTIP as part of a strategy to increase IBRD's operating income going forward, to be funded by an initial \$3 billion out of IBRD's capital, and implemented over a two to three-year timeframe commencing in FY 2009. The risk assets that IBRD's equity will support going forward will therefore include loans and LTIP assets. Consequently, from FY 2009, the **equity-to-loans ratio** indicator of IBRD's **risk-bearing**

**capacity** will refer to equity-to-loans and long-term investment assets.

On December 13, 2007, the Executive Directors approved management's proposal to extend the duration of IBRD's equity as a means of stabilizing IBRD's operating income by restoring a greater exposure to long-term interest rates. The implementation of the equity duration extension program had been completed as of June 30, 2008.

**Figure 5: Equity-to-Loans Ratio**



As presented in **Figure 5**, IBRD's **equity-to-loans ratio** increased during FY 2008, on both a reported basis (excluding cumulative translation adjustments associated with the **FAS 133** adjustments) and a current value basis. The increase in **equity-to-loans ratio** on a reported basis to 37.62% at June 30, 2008 from 35.05% at June 30, 2007 was due primarily to the increase in equity, partially offset by the increase in loans outstanding and present value of guarantees, net of relevant accumulated provisions and deferred loan income in FY 2008.

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

	<i>June 30, 2008</i>	<i>June 30, 2007</i>
<b>Usable Capital</b>		
Paid-in Capital	\$11,486	\$11,486
Restricted Paid-in Capital	(2,443)	(2,448)
Net Payable for Maintenance of Value	853	236
<b>Total Usable Capital</b>	<b>9,896</b>	<b>9,274</b>
<b>Special Reserve</b>	293	293
<b>General Reserve</b> <sup>a</sup>	25,670	23,948
<b>Cumulative Translation Adjustment</b> <sup>b</sup>	1,029	239
<b>Equity used in Equity-to-Loans Ratio</b> <sup>c</sup>	<b>\$36,888</b>	<b>\$33,754</b>
Current Value Adjustments	(479)	(314)
<b>Equity used in Equity-to-Loans Ratio-Current Value Basis</b>	<b>\$36,409</b>	<b>\$33,440</b>
<b>Loans Outstanding and Present Value of Guarantees, net of Relevant Accumulated Provisions and Deferred Loan Income</b>	<b>\$98,053</b>	<b>\$96,309</b>
<b>Current Value Loans and Guarantees Outstanding, net of Accumulated Provision for Losses on Loans and Guarantees and Deferred Loan Income</b>	<b>\$99,177</b>	<b>\$97,020</b>
<b>Equity-to-Loans Ratio-Reported Basis</b> <sup>b</sup>	<b>37.62%</b>	<b>35.05%</b>
<b>Equity-to-Loans Ratio-Current Value Basis</b>	<b>36.71%</b>	<b>34.47%</b>

a. The June 30, 2008 amount includes proposed transfers to the General Reserve out of FY 2008 net income.

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.

## Capital

Shareholder support for IBRD is reflected in the capital backing it has received from its members. At June 30, 2008, 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, \$9,897 million was available for lending and \$1,589 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:

### 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) \$8,198 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, \$5,860 million of this amount was being used in IBRD's lending and investment operations at June 30, 2008.

- (iii) \$65 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 discharge 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, 2008, \$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, 2008. **Table 13** sets out the capital subscriptions of those countries and the callable amounts.

**Table 13: Capital Subscriptions of DAC Members of OECD Countries**

*In millions of U.S. dollars*

<i>Member Country<sup>a</sup></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
<b>Total</b>	<b>\$110,460</b>	<b>\$103,604</b>

a. See details regarding the capital subscriptions of all members of IBRD at June 30, 2008 in *Financial Statements-Statement of Subscriptions to Capital Stock and Voting Power*.

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.

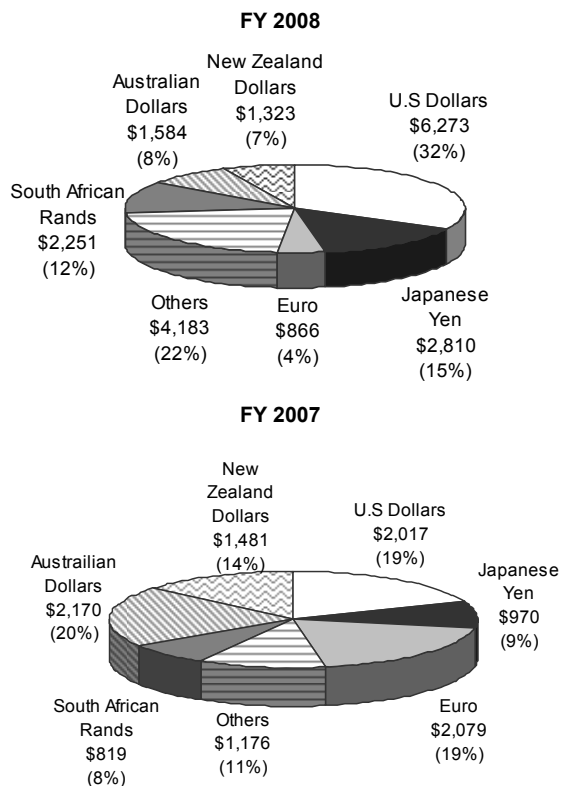
## Borrowings

### 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 2008, as compared to FY 2007, 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 2008, medium- and long-term debt raised directly in financial markets by IBRD amounted to \$19,290 million compared to \$10,712 million in FY 2007. **Table 14** summarizes IBRD's funding operations for FY 2008 and FY2007.

**Table 14: Funding Operations Indicators**

	FY 2008	FY 2007
Total Medium- and Long-term Borrowings (USD million)	\$19,290	\$10,712
Average Maturity <sup>a</sup> (years)	2.5	3.9
Number of Transactions	770	348
Number of Currencies	19	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 for future lending activities. IBRD determines its funding requirements based on a 3-year rolling horizon and funds one third of the projected amount in the current fiscal year. In FY2008, demand for IBRD short-dated bonds expanded considerably, as a result of investors' flight to quality and the general financial market outlook. Most of this funding had final maturities or maturities to first call between 1 and 3 years, shortening the average maturity of FY08's total borrowing portfolio and resulting in a higher volume of debt which will mature in FY 2009-10. As a result of these factors, funding in FY08 increased significantly compared to FY 2007.

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 2008, IBRD repurchased or called \$5,229 million of its outstanding borrowings (\$3,740 million in FY 2007).

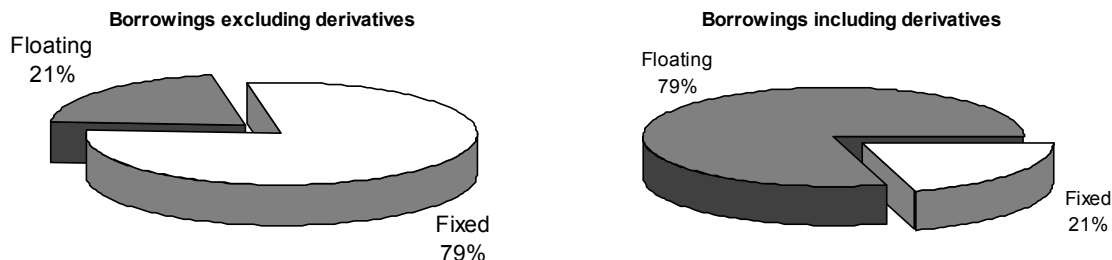
### Use of Derivatives

Generally, 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, 2008. IBRD does not enter into derivatives for speculative purposes in the borrowing portfolio.

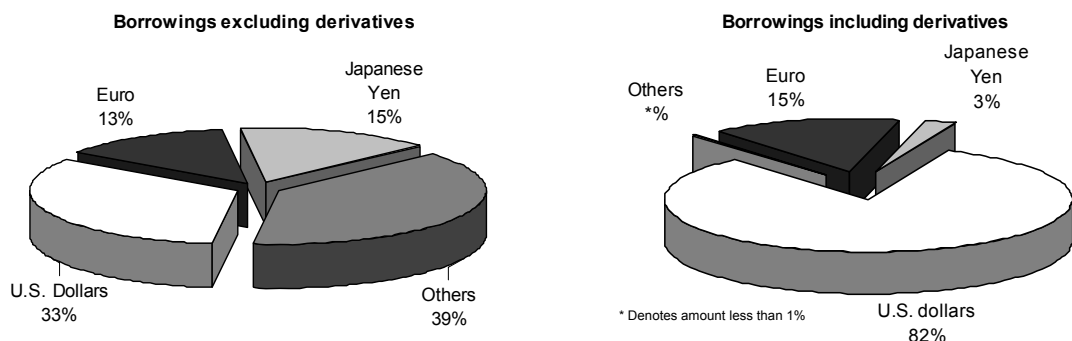
**Interest rate swaps** and **currency swaps** are also used for asset/liability management purposes to match the pool of liabilities as closely as possible to the interest rate and currency characteristics of liquid assets and loans. However, during FY 2008, IBRD has entered into a number of **interest rate swaps** as part of a strategy involving the extension of its equity duration aimed at managing the interest rate sensitivity of its operating income.

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

**Figure 7a: Effect of Derivatives on Interest Rate Structures on the Borrowing Portfolio—June 30, 2008**



**Figure 7b: Effect of Derivatives on Currency Composition on the Borrowing Portfolio—June 30, 2008**



## 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

A Risk Management governance structure supports 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.

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 Strategy, Performance and Risk Subcommittee, the Credit Risk Subcommittee and the Finance Initiatives Subcommittee.

The Strategy, Performance and Risk 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. In addition, the Subcommittee meets quarterly to formally review current and proposed business strategy and risk limits/policies, along with business results, and financial risk profile to facilitate alignment between business and risk management. 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 Finance Initiatives Subcommittee reviews the financial, organizational and implementational implications of new initiatives that may impact IBRD.

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's 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 Executive

Directors review 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 lending operations. During FY 2008, IBRD reviewed its capital adequacy in the context of its long-term developmental mission and proposed to its Executive Directors a strategic capital adequacy framework. The framework establishes a target risk coverage range for the **equity-to-loans ratio** of 23 to 27 percent<sup>2</sup>. In light of IBRD's current **equity-to-loans ratio** being comfortably above the target range, on April 3, 2008, the Executive Directors approved the implementation of a \$3 billion LTIP starting in FY 2009. This program is aimed at increasing IBRD's operating income in future years by investing in developed market public equities and developed market fixed-income investments. Going forward, the strategic capital adequacy framework will be used to inform IBRD's long-term financial and strategic planning, and to evaluate alternative

<sup>2</sup> The target risk coverage range considers long-term investment assets from FY 2009 onwards.

uses for its available capital capacity in a strategic context. From FY 2009, the risk assets that IBRD's equity will support going forward will include loans as well as LTIP assets. Consequently, from FY 2009, the **equity-to-loans ratio** indicator of IBRD's **risk-bearing capacity** refer to equity-to-loans and long-term investment assets. Similarly, IBRD's stress test has been updated to include a shock on the LTIP return in addition to a large nonaccrual shock on the loan portfolio.

IBRD strives to immunize its **risk-bearing capacity** from fluctuations in exchange rates by matching the currency composition of its equity capital with that of its loan portfolio. Thus the **equity-to-loans ratio** is also protected from exchange rate movements.

The sensitivity of IBRD's operating income to short-term interest rate movements arises primarily due to the nature of asset the equity funds. 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. As a result, IBRD's operating income has become more volatile and vulnerable to low short-term interest rates. Against this backdrop, on December 13, 2007, the Executive Directors approved management's proposal to extend the duration of IBRD's equity as a means of stabilizing IBRD's operating income by restoring a greater exposure to long-term interest rates. The implementation of the equity duration extension program by IBRD's entering into a number of **interest rate swaps** to extend the duration of equity with notional value totaling \$35 billion, using a 10-year ladder repricing profile, had been completed as of June 30, 2008.

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

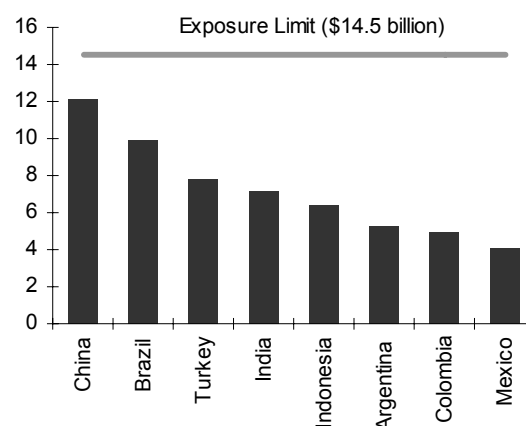
Country credit risk is the risk of loss due to a country not meeting its contractual obligations. IBRD's Credit Risk Department continuously reviews the credit risk of its borrowing member countries. These reviews are taken into account in determining IBRD's overall country programs and lending operations, 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 2008, the Single Borrower Limit was \$14.5 billion and the Equitable Access Limit at June 30, 2008 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 \$12.1 billion at June 30, 2008.

**Figure 8: Top Eight Country Exposures at June 30, 2008**

*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.

For FY 2009, the Single Borrower Limit has been set at \$15.5 billion, an increase of \$1 billion over the limit at June 30, 2008.

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, 2008 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**.

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, 2008.

#### **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 \$562 million (**Table 15**). This decrease comprises a release of provision for losses on loans (excluding guarantees) of \$680 million partially offset by a positive translation adjustment of \$118 million during FY 2008. The release of provision for losses on loans was primarily due to the developments in the nonaccrual portfolio. It also reflects the net impact of changes in the credit quality of the loan portfolio, changes in borrower eligibility, changes in the volume and distribution of loans outstanding and the annual update of the expected default frequencies (probability of default to IBRD).

#### 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 for loans signed before May 16, 2007. Loans signed between May 16, 2007 and September 27, 2007 will also lose waiver eligibility if the borrowers elected not to convert the terms of their loans to the new pricing terms effective September 27, 2007. For loans with the new pricing terms applicable from May 16, 2007, an overdue interest penalty will be charged at a rate of 50 basis points on overdue principal.
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. Additionally, all borrowers in the country will lose eligibility for any waivers of interest in effect at the time.
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. Under exceptional circumstances, disbursements could be made to a member country upon approval by the Executive Directors.
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.

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

	2008			2007		
	<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	\$98,586	\$1,138	1.2%	\$96,735	\$1,085	1.1%
Nonaccrual Portfolio	464	232	0.2%	1,070	847	0.9%
Total Loans Outstanding	<u>\$99,050</u>	<u>\$1,370</u>	<u>1.4%</u>	<u>\$97,805</u>	<u>\$1,932</u>	<u>2.0%</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.

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. Under the mark-to-market collateral arrangements, when IBRD is in a net receivable position, counterparties are required to post collateral with IBRD to mitigate its credit risk exposure to these counterparties. Collateral posted is in the form of certain approved highly liquid investment securities or cash. Where IBRD is permitted to repledge collateral received in the form of liquid investment securities in connection with swap agreements, the cash proceeds are subsequently invested in money market and other liquid financial instruments under terms substantially equivalent to those set forth in IBRD's Investment Guidelines, and are included under Investments - Trading on the Balance Sheet.

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 H-Credit Risk.

**Table 16** provides details of IBRD's estimated credit exposure on its investments (including on its externally-managed assets totaling \$1,535 million at June 30, 2008) and swaps net of collateral held, by counterparty rating category.

The increase in credit exposure reflects (i) an increase in the size of the IBRD investment program and (ii) the inclusion of investments from the proceeds of the externally-managed swap collateral management program offset by (iii) a decrease in IBRD's net swap exposure. In addition, the credit composition of the portfolio has changed due to (i) new investments in "A"-rated sovereign debt, (ii) an increase in "AA"-rated bank investments and in "AAA"-rated Asset-Backed Securities' investments, offset by (iii) a decrease in "A"-rated bank deposits. After the effects of exposure netting arrangements across multiple transactions with a single counterpart, the credit exposure from swaps increased from \$6,417 million at June 30, 2007 to \$7,312 million at June 30, 2008. The swap credit exposure of \$7,312 million is offset by collateral of \$5,828 million which results in a total net swap exposure of \$1,484 million.

### 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.

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

### 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 as well as to adjust the duration of its equity.

**Table 16: Credit Exposure, Net of Collateral Held, by Counterparty Rating<sup>a</sup>**  
In millions of U.S. dollars

Counterparty Rating	At June 30, 2008			At June 30, 2007		At June 30, 2006			
	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	\$ 385	\$ 7,348	\$ 190	\$ 7,923	30	\$ 7,127	30	\$ 7,321	29
AA	94	14,744	1,293	16,131	61	14,304	60	14,011	55
A	954	1,426	1	2,381	9	2,337	10	3,991	16
BBB	-	3	-	3	*	-	-	-	-
BB	-	1	-	1	*	-	-	-	-
Total	\$1,433	\$23,522	\$1,484	\$26,439	100	\$23,768	100	\$25,323	100

a. Excludes exposures due to swaps executed with IBRD's clients including (i) borrowing member countries (\$18 million swap exposure) and (ii) IFFIm, a AAA-rated non-affiliated organization (\$150 million swap exposure).

\* Denotes less than 1%.

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

	At June 30, 2008			At June 30, 2007		
	Carrying Value	Contractual Yield	Current Value Adjustments	Carrying Value	Contractual Yield	Current Value Adjustments
<b>Loans<sup>a</sup></b>	<b>\$99,050</b>	<b>4.23%</b>	<b>\$1,124</b>	<b>\$97,805</b>	<b>5.66%</b>	<b>\$ 711</b>
Variable-Rate Multicurrency Pool Loans	7,002	6.58	726	9,339	6.01	890
Single Currency Pool Loans	4,458	6.73	189	6,644	6.35	189
Variable-Spread Loans <sup>b</sup>	42,768	3.43	(15)	42,075	5.50	(20)
Fixed-Rate Single Currency Loans	3,415	5.92	97	4,818	5.97	(3)
Special Development Policy Loans <sup>c</sup>	1,869	3.65	(1)	2,269	6.13	(2)
Fixed-Spread Loans	38,148	4.25	89	32,082	5.53	(350)
Other Fixed Rate Loans <sup>f</sup>	1,390	4.81	39	578	6.05	7
<b>Borrowings Allocation (including derivatives)<sup>d</sup></b>	<b>\$83,533</b>	<b>3.51%</b>	<b>\$1,207</b>	<b>\$83,952</b>	<b>5.21%</b>	<b>\$ 998</b>
Variable-Rate Multicurrency Pools	6,119	7.06	1,746	6,209	6.90	1,551
Single Currency Pools	2,490	6.17	158	3,936	6.44	165
Variable-Spread	24,162	2.92	(62)	25,250	4.96	(114)
Fixed-Rate Single Currency	1,989	6.77	73	4,166	5.52	(12)
Special Development Policy	2,013	2.73	1	2,538	5.17	(3)
Fixed-Spread	22,261	3.61	(104)	18,520	4.69	(355)
Other Debt <sup>e</sup>	24,499	2.58	(605)	23,333	4.98	(234)

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, 2008 and June 30, 2007.

f. Includes currency pool loans and U.S. dollar single currency pool loans converted to fixed rate equivalent of composite LIBOR + 100 basis points.

## 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 has shifted from pool loans to LIBOR based loans in recent years, the sensitivity of IBRD's operating income to changes in market interest rates has increased. This has caused IBRD to implement an equity duration extension strategy during FY 2008 aimed at reducing the interest rate sensitivity of its operating income going forward.

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. At June 30, 2008, such cost pass-through loans account for 55% of the outstanding loan portfolio (59% at June 30, 2007). 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 in FY 2011 and FY 2014. 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, 2008, the overhang was within acceptable guidelines. Should the amount of debt overhang remain at the currently projected levels, IBRD does not anticipate executing additional forward-starting swaps. This is subject to there being no significant

prepayments of the multicurrency loan pool that would generate further debt overhang, which may need to be swapped to floating-rate liabilities. At June 30, 2008, the accumulated cost of executing these defeasance swaps was \$708 million. The cost of the debt overhang varies with interest rates and prepayments.

Interest rate risk on non-cost pass-through products, which accounted for 45% of the loan portfolio at June 30, 2008 (41% at June 30, 2007), is managed by using **interest rate swaps** to closely align the rate sensitivity characteristics of the loan portfolio with those of their underlying funding, except for the component affected by IBRD's equity duration extension strategy implemented during FY 2008. 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**.

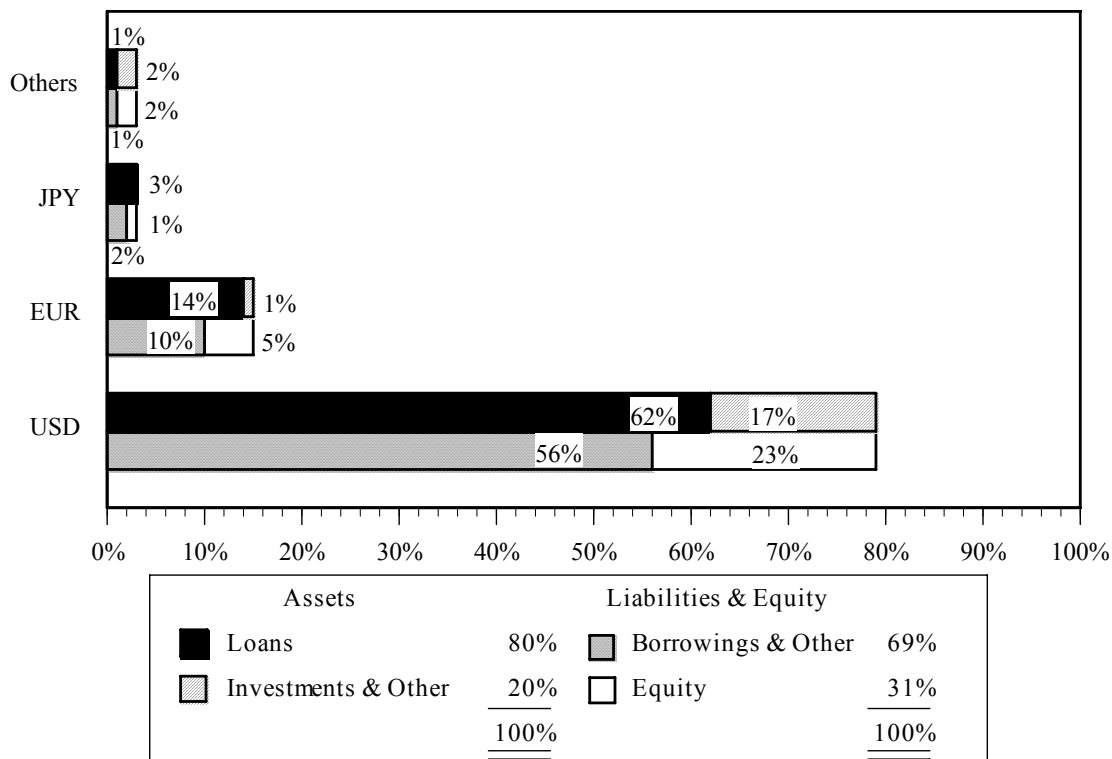
### **Exchange Rate Risk**

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.

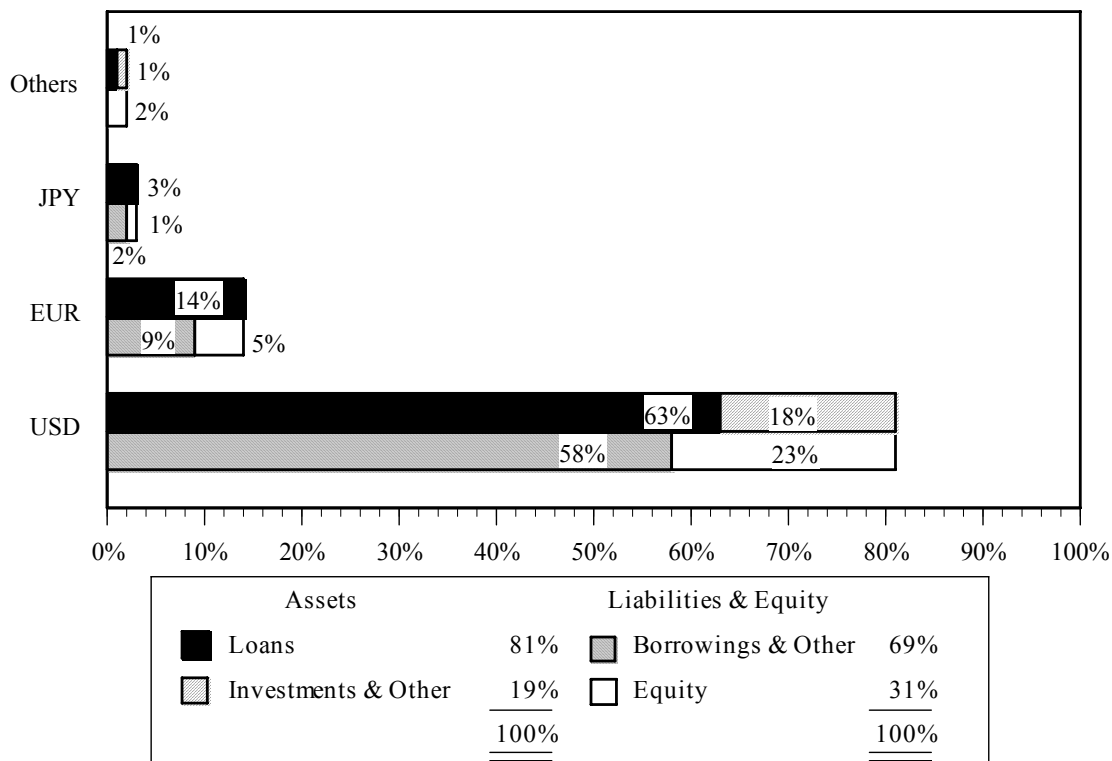
**Figure 9** presents the currency composition of significant balance sheet components (net of swaps) at June 30, 2008 and June 30, 2007.

**Figure 9: Relative Currency Composition of Significant Balance Sheet Components—Current Value Basis**

**At June 30, 2008**



**At June 30, 2007**



## **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.

The operational risk management framework used by IBRD is based on the Integrated Risk Management Framework approved by the Board in January 2003 and involves the following core steps:

- Key operational risks are identified annually and documented using a combination of tools including business process maps and risk and control self assessments.
- Operational risks are evaluated based on likelihood of occurrence and the resulting financial impact using probability and severity parameters.
- The effectiveness of controls are evaluated using a combination of processes including self assessment workshops, independent walk through tests of processes, independent compliance testing by IBRD's internal audit department, quality assurance testing by management, project reviews undertaken by the Independent Evaluation Group and annual internal representation letters from business unit managers.
- The results of the work undertaken to evaluate the effectiveness of internal controls are reported to the Audit Committee through an annual report.

## **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, 2008 no such significant changes had 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, 2008.

## **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. For

loans that are carried at fair value, the credit risk assessment is incorporated in the determination of fair value.

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 and loan 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 L-Pension and Other Postretirement Benefits.

## **8. RESULTS OF OPERATIONS**

In FY 2008, Operating Income increased by \$612 million from \$1,659 million in FY 2007 to \$2,271 million, primarily reflecting the impact of the positive developments in the nonaccrual loan portfolio which resulted in higher other loan income and higher release of provision for losses on loans and guarantees.

Net income on a reported basis was \$1,491 million in FY 2008 compared to a net loss of \$140 million in FY 2007. This was primarily due to lower net unrealized losses of \$40 million due to IBRD's application of **FAS 133 as amended** in FY 2008 compared to net unrealized losses of \$842 million in FY 2007. For more details please refer to Net Unrealized Gains (Losses) on Non-trading Derivatives, Loans and Borrowings Measured at Fair Value per FAS 133 as Amended, discussed later in this section.

### **Interest Rate Environment**

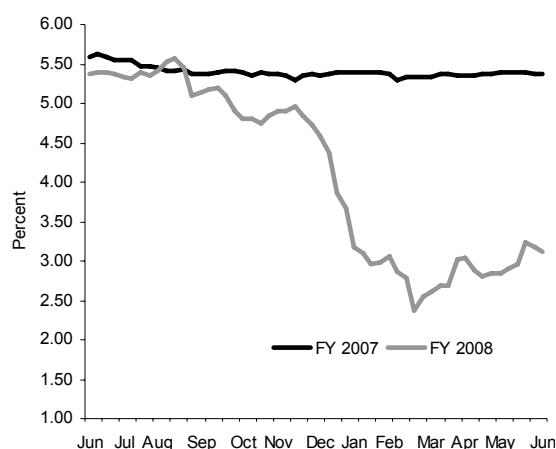
During FY 2008, short-term interest rates for the U.S. dollar were lower than those in FY 2007.

**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 IBRD's loan interest income.

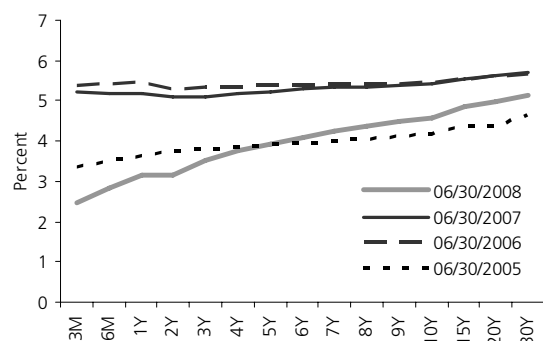
In contrast, the current value adjustment on the loan portfolio is based on interest rates which are dependent upon the term structure of the maturity profile of the loans. During FY 2008, there was a downward shift in these rates compared to those in

FY 2007 (see **Figure 11** for U.S. dollars), resulting in a positive current value adjustment to the loan portfolio.

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



**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, other loan income, the increase to or release from the provision 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 2008 versus FY 2007

The increase of \$612 million in Operating Income is explained by the following factors.

- A \$286 million increase in other loan income, of which \$269 million is associated with Liberia's and Cote d'Ivoire's clearance of all overdue interest and charges to IBRD.

- A \$279 million increase in the release of provision for losses on loans and guarantees. During FY 2008, there was a \$684 million release of provision for losses on loans and guarantees compared to a release of \$405 million during FY 2007. The release of provision in FY 2008 primarily reflects the impact of developments in the nonaccrual portfolio while that in FY 2007 reflects the impact of a combination of changes in the creditworthiness of the loan portfolio, changes in the volume of loans and guarantees outstanding, net of translation adjustments and the annual update of the expected default frequencies (probabilities of default to IBRD).
- A \$59 million increase in loan interest income, net of funding costs, as a result of higher loan spreads on the debt-funded portion of the pool loans associated with interest rate reset lag in a decreasing short-term interest rate environment.

The above increases were partially offset by

- A \$28 million decrease in investment income, net of funding costs, mainly due to the widening of the credit spreads in global bond markets.

### FY 2007 versus FY 2006

FY 2007 Operating Income was \$1,659 million, compared to \$1,740 million for FY 2006. The decrease in Operating Income \$81 million is explained by the following factors.

- A \$319 million decrease in the release of provision for losses on loans and guarantees. During FY 2008, 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. This was partially offset by;
- 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.

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

	FY 2008	FY 2007	FY 2006
Loan interest income, net of funding costs			
Debt funded	\$ 549	\$ 415	\$ 473
Equity funded	1,642	1,717	1,390
Net interest income	2,191	2,132	1,863
Other loan income	306	20	41
Release of Provision for losses on loans and guarantees	684	405	724
Investment income, net of funding costs	49	77	80
Net noninterest expense	(959)	(975)	(968)
<b>Operating Income</b>	<b>2,271</b>	<b>1,659</b>	<b>1,740</b>
Board of Governors-Approved Transfers	(740)	(957)	(650)
Net unrealized losses on non-trading derivatives, loans and borrowings measured at fair value, per FAS 133 as amended	(40)	(842)	(3,479)
<b>Net Income (Loss) - Reported Basis</b>	<b>\$1,491</b>	<b>\$ (140)</b>	<b>\$(2,389)</b>

## Net Interest Income

### FY 2008 versus FY 2007

Loan interest income, net of funding costs, increased by \$59 million due primarily to higher loan spreads on the debt-funded portion of the pool loans associated with interest rate reset lag in a decreasing short-term interest rate environment.

### 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 higher average short-term interest rates.

## Net Noninterest Expense

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

### FY 2008 versus FY 2007

Net noninterest expense decreased by \$16 million primarily due to a \$62 million decrease in pension and other postretirement benefits and a \$38 million increase in revenues and other income, partially offset by a \$79 million increase in staff costs, consultants fees and contractual services.

### 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.

## NET UNREALIZED (LOSSES) GAINS ON NON-TRADING DERIVATIVES, LOANS 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 and

loan 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 2008, IBRD experienced net unrealized losses of \$40 million resulting from a combination of factors with offsetting implications, namely: lower interest rates in U.S. dollar, Japanese yen and British pound but higher rates in several other currencies such as Euro, Australian dollar and South African rand; tightened credit spreads at the near-end but widened credit spreads beyond 7-years; significant weakening of the U.S. dollar against other currencies, and significant change in basis spreads. During FY 2007, IBRD experienced net unrealized losses of \$842 million primarily driven by marked-to-market adjustments on British pound-U.S. dollar, euro-U.S. dollar, and U.S. dollar-South African rand currency swaps associated with the rise in the yield of these currencies. These losses were partially 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.

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.

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

	<i>FY 2008</i>	<i>FY 2007</i>	<i>FY 2006</i>
Gross Administrative Expenses			
Staff Costs	\$ 538	\$ 492	\$ 493
Operational Travel	110	101	99
Consultant Fees	116	98	102
Pension and other postretirement benefits	(12)	50	64
Contributions to Special Programs	176	171	173
Communications and IT	80	77	76
Contractual Services	83	68	61
Equipment and Buildings	138	143	129
Other Expenses	29	36	34
Total Gross Administrative Expenses	1,258	1,236	1,231
Less: Contribution to Special Programs	176	171	173
Total Net Administrative Expenses	1,082	1,065	1,058
Contribution to Special Programs	176	171	173
Service Fee Revenues	(272)	(261)	(243)
Externally Funded Outputs Income	(11)	-	-
Net Other Income	(16)	-	(20)
<b>Total Net Noninterest Expense</b>	<b>\$ 959</b>	<b>\$ 975</b>	<b>\$ 968</b>

## 9. GOVERNANCE

### General Governance

#### *Management Changes*

During FY 2008, the following changes occurred in the senior management of IBRD:

Mr. Francois Bourguignon retired as Senior Vice President and Chief Economist of IBRD effective October 22, 2007.

Ms. Ngozi Okonjo-Iweala was appointed Managing Director of IBRD effective December 1, 2007.

Ms. Ana Palacio resigned as Senior Vice President and General Counsel of IBRD effective April 15, 2008.

Mr. Justin Lin was appointed Senior Vice President and Chief Economist of IBRD effective May 31, 2008.

#### *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](http://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.

In FY 2008 IBRD adopted an enhanced policy which clarifies and codifies the rights and obligations of staff in reporting suspected fraud, corruption or other misconduct that may threaten the operations or governance of the Bank Group; encourages staff to raise concerns by strengthening protections against retaliation; and sets out detailed procedures.

### **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.

External auditors are appointed to a five-year term of service. This is subject to annual reappointment based on the recommendation of the Audit Committee and approval of a resolution by the Executive Directors. Following a mandatory rebidding of the external audit contract during FY 2008, IBRD's Executive Directors approved the appointment of KPMG as IBRD's auditors for a five-year term commencing FY 2009.

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, 2007 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, 2007 is presented, with a reconciliation to the reported basis, in **Table 21**.

**Table 20: Condensed Current Value Balance Sheet at June 30, 2007**  
*In millions of U.S. dollars*

	June 30, 2007			
	<i>Reported Basis</i>	<i>Reversal of FAS 133 Effects</i>	<i>Current Value Adjustments</i>	<i>Current Value Basis</i>
Due from Banks	\$ 765			\$ 765
Investments	23,336			23,336
Loans Outstanding	97,805		\$ 711	98,516
Less Accumulated Provision for Loan Losses and Deferred Loan Income	(2,372)			(2,372)
Receivable from Derivatives				
Investments	7,138			7,138
Client Operations	4,778	\$ 175	(175)	4,778
Borrowings	69,507	13	(13)	69,507
Others	13	2	(2)	13
Other Assets	6,930		(299)	6,631
Total Assets	<u>\$207,900</u>	<u>\$ 190</u>	<u>\$ 222</u>	<u>\$208,312</u>
Borrowings	\$87,759	\$1,072	\$ 653	\$ 89,484
Payable for Derivatives				
Investments	7,527			7,527
Client Operations	4,776	174	(174)	4,776
Borrowings	62,850	(33)	33	62,850
Others	38	(24)	24	38
Other Liabilities	5,154			5,154
Total Liabilities	168,104	1,189	536	169,829
Paid in Capital Stock	11,486			11,486
Retained Earnings and Other Equity	28,310	(999)	(314)	26,997
Total Equity	<u>39,796</u>	<u>(999)</u>	<u>(314)</u>	<u>38,483</u>
Total Liabilities and Equity	<u>\$207,900</u>	<u>\$ 190</u>	<u>\$ 222</u>	<u>\$208,312</u>

**Table 21: Condensed Current Value Statement of Income for the year ended June 30, 2007**

*In millions of U.S. dollars*

	FY 2007		
	<i>Reported Comprehensive Basis</i>	<i>Adjustments to Current Value</i>	<i>Current Value Comprehensive Basis</i>
Income from Loans	\$ 5,467		\$5,467
Income from Investments	1,281	\$ (24)	1,257
Other Income	264		264
Total Income	<u>7,012</u>	<u>(24)</u>	<u>6,988</u>
Borrowing Expenses	4,519		4,519
Administrative Expenses including contributions to Special Programs	1,237		1,237
Release of Provision for Losses on Loans and Guarantees	(405)	405	
Other Expenses	2	-	2
Total Expenses	<u>5,353</u>	<u>405</u>	<u>5,758</u>
Operating Income	1,659	(429)	1,230
Board of Governors-Approved Transfers	(957)		(957)
Current Value Adjustments		222	222
Release of Provision for Losses on Loans and Guarantees Current Value		405	405
Net unrealized (losses) gains on non-trading derivatives and borrowings at fair value, per FAS 133 as amended	(842)	842	-
Net (Loss) Income	<u>\$ (140)</u>	<u>\$1,040</u>	<u>\$ 900</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 subscription, 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.

**Post-98 loans:** Loans for which the invitation to negotiate was issued on or after July 31, 1998 and that were signed before May 16, 2007 or which were signed between May 16, 2007 and September 27, 2007 and for which the borrowers elected not to convert the terms of their loans to the terms for the new loans introduced on September 27, 2007.

**Pre-98 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 Swap 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.