

INTERNATIONAL BANK FOR RECONSTRUCTION AND
DEVELOPMENT

MANAGEMENT'S DISCUSSION AND ANALYSIS
JUNE 30, 2009

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Throughout Management's Discussion and Analysis, terms in **boldface** type are defined in the Glossary of Terms on page 38.

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

Structure and Operations

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 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. During FY 2009, due to higher projected debt funding costs, IBRD increased the spread over **LIBOR** on all new IBRD Flexible Loans (IFL) with a fixed spread and also introduced differential pricing depending on the average maturity of loans with fixed spread terms. (see Section 3, Development Activities – Contractual Terms of Loans including **Tables 5** and **6** for loan pricing details).

To raise funds, IBRD issues debt securities in a variety of currencies to both institutional and retail investors. Proceeds from the debt issuance, 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 the purposes of financial statement reporting do not significantly impact IBRD's **risk-bearing capacity**.

Economic Environment

FY 2009 was characterized by turmoil in the global financial markets and the related credit crisis. The impact of these developments on IBRD's risk bearing capacity and operations is discussed below:

Capital Adequacy: As of June 30, 2009, IBRD's capital adequacy position remained strong in the face of the on-going financial markets turmoil, as indicated by the **equity-to-loans ratio**¹ (see **Table 11**), which remained above the target risk coverage range of 23 to 27 percent under the **Strategic Capital Adequacy Framework**. In addition, IBRD remains well-capitalized and supported by adequate liquidity levels which enabled it to meet increased lending requirements in FY 2009.

Lending Operations: IBRD has seen a significant increase in its lending in FY 2009, as reflected in the increase in commitments and net disbursements of \$19,443 million and \$10,473 million, respectively, compared to FY 2008. The substantial increase in the commitments was largely driven by an increase in demand for IBRD's loans as a result of the current financial crisis. The majority of the increase in commitments was to borrowing countries in the Latin America and Caribbean region and the Europe and Central Asia region.

Investment Activities: IBRD's liquid asset portfolio experienced positive returns for the year. Included in these returns were net mark-to-market losses of 24 basis points due to the market conditions experienced in FY 2009. Should conditions worsen, IBRD could experience lower investment returns, resulting in a reduction in its operating income in future periods. Given the deterioration in equity markets globally, IBRD's pension and other postretirement benefits assets have experienced a lower return than expected, resulting in higher post employment benefits costs in FY 2010 and beyond.

Net Loan Income: Due to the lower short-term interest rate environment, IBRD has experienced a decrease in loan income, net of funding costs, as compared to FY 2008. In the event of a sustained lower short-term interest rate environment, IBRD could experience lower operating income in future periods.

¹ The equity-to-loans ratio refers to the equity-to-loans, guarantees and long-term investment asset ratio.

Box 1: Selected Financial Data

As of or for the Years Ended June 30

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

Lending	2009	2008	2007	2006	2005
Commitments to member countries ^a	32,911	13,468	12,829	14,135	13,611
Gross Disbursements ^b	18,564	10,490	11,055	11,883	9,722
Net Disbursements ^b	8,344	(2,129)	(6,193)	(1,741)	(5,131)
Reported Basis	2009	2008	2007	2006	2005
Loans Income	3,835	5,497	5,467	4,864	4,155
Provision for Losses on Loans and Guarantees (increase) decrease	(284)	684	405	724	502
Investment Income	603	1,066	1,281	1,107	627
Borrowing Expenses	(2,739)	(4,017)	(4,519)	(3,987)	(3,037)
Net Noninterest Expense	(1,087)	(969)	(971)	(968)	(927)
Operating Income ^c	572	2,271	1,659	1,740	1,320
Board of Governors-Approved Transfers	(738)	(740)	(957)	(650)	(642)
Fair value adjustment on non-trading portfolios, net	3,280	(40)	(842)	(3,479)	2,511
Net Income (Loss)	3,114	1,491	(140)	(2,389)	3,189
Net Return on Average Earning Assets					
Based on Operating Income	0.45	1.87	1.34	1.34	0.96
Based on Net Income	2.38	1.23	(0.11)	(1.84)	2.32
Return on Equity					
Based on Operating Income	1.53	5.96	4.64	5.05	3.90
Based on Net Income	8.01	3.73	(0.37)	(6.84)	9.26
Equity-to-Loans Ratio ^d	34.53	37.62	35.05	32.96	31.45
Total Assets	275,420	233,311	207,601	211,982	221,609
Loans Outstanding	105,698	99,050	97,805	103,004	104,401
Accumulated Provision for Loan Losses ^e	(1,632)	(1,370)	(1,932)	(2,296)	(3,009)
Borrowings Outstanding ^f	110,040	87,402	87,460	95,491	100,898
Total Equity	40,037	41,548	39,796	36,474	38,588
Fair Value Basis	2009	2008	2007	2006	2005
Net (Loss) Income	(225)	1,135	900	640	402
Net Income Before Board of Governors-Approved Transfers	513	1,875	1,857	1,290	1,044
Net Return on Average Earning Assets ^g	0.40	1.52 ^h	1.49	0.98	0.74
Return on Equity ^g	1.41	4.93 ^h	5.21	3.74	3.04
Equity-to-Loans Ratio	35.26	36.71	34.47	32.44	30.83
Unrestricted Cash and Investments	38,579	23,103	22,258	24,929	26,435
Net Loans Outstanding	101,918	98,392	96,144	101,102	104,057
Borrowings Outstanding ^f	110,022	89,946	89,484	95,258	105,691
Total Equity	38,316	40,128	38,483	37,590	36,943
<p>a. Commitments are net of cancellations and include guarantee commitments and guarantee facilities.</p> <p>b. Amounts include transactions with the International Finance Corporation (IFC) and capitalized front-end fees.</p> <p>c. Operating income is defined as Income before fair value adjustment on non-trading portfolios, net and Board of Governors-Approved Transfers.</p> <p>d. Ratios are presented using usable equity and before applying the effects of fair value adjustments on non-trading portfolios, net and Board of Governors-Approved Transfers.</p> <p>e. Amount excludes accumulated provision for losses on guarantees and effective and undisbursed deferred drawdown option.</p> <p>f. Borrowings outstanding, excluding derivatives, net of premium/discount.</p> <p>g. Ratios exclude Board of Governors-Approved transfers.</p> <p>h. Ratios have been adjusted to exclude Board of Governors-Approved Transfers.</p>					

Financial Results

For the purposes of this document, Operating Income is defined as income before fair value adjustment on non-trading portfolios, net and Board of Governors-Approved Transfers. FY 2009 Operating Income was \$572 million; \$1,699 million lower than that in FY 2008 primarily due to the impact of the positive developments in the

nonaccrual loan portfolio in FY 2008 and lower loan margin in FY 2009.

FY 2009 was the first full year of the equity duration extension strategy. For FY 2009, this strategy generated \$246 million in net interest income which is reflected in operating income and unrealized mark-to-market gains of \$1,687 million which are

included in the fair value adjustment on non-trading portfolios, net.

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.

On July 10, 2009, IBRD's Board of Governors approved a \$55 million transfer from Surplus for the Trust Fund for Gaza and West Bank.

On August 5, 2009, the Executive Directors approved the following allocations from FY 2009 net income: \$36 million to the Long-Term Income Portfolio adjustment account, \$25 million to the Pension Reserve, and \$11 million to the restricted retained earnings. In addition, the Executive Directors recommended to IBRD's Board of Governors the transfer of \$783.3 million to International Development Association (IDA) of which \$500 million from FY 2009 unallocated net income and \$283.3 million from Surplus. The Executive Directors also approved waivers of loan charges for FY 2010 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), referred to in this document as the "reported basis".

Certain reclassifications of the prior years' reported figures have been made to conform with the current years' presentation.

Accounting Developments

Effective July 1, 2008, utilizing an election available under Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159), IBRD fair values all of the debt instruments in its borrowings portfolio. As a result of this election, all of the instruments in the investments, borrowings and asset/liability management portfolios are reported at fair value, with changes in fair value reported in earnings. However, IBRD still reports all of its loans at amortized cost (except for loans with embedded derivatives² which are reported at fair value). In conjunction with this change, IBRD also implemented Statement of Financial Accounting

² In accordance with the Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments, hybrid financial instruments, with embedded derivatives that otherwise would require bifurcation, can be carried at fair value.

Standards No. 157, *Fair Value Measurements* (FAS 157).

The combined effect of the adoption of FAS 157 and FAS 159 was to reduce opening retained earnings as of July 1, 2008, by \$2,566 million. (Refer to the Notes to the Financial Statements, Note O – Fair Value of Financial Instruments.)

Management Reporting

IBRD is a financial intermediary, borrowing funds in international capital markets for lending to its member countries. IBRD's funding operations are designed to meet a major organizational objective of providing low cost funds to borrowing members.

In implementing its risk management and funding strategies, IBRD makes extensive use of derivatives.

Because of the asymmetry created in the financial statements from fair valuing the derivatives and borrowings portfolio, while carrying the corresponding loans at amortized cost less a loan loss provision, management believes that reported net income does not capture the true economic income of IBRD. Therefore, for management reporting purposes, IBRD uses fair value financial statements, which present the effect of all financial assets and liabilities including the loans portfolio at fair value. **Table 1** presents all major financial asset and liability portfolios.

In prior years the management reporting basis was referred to as "current value". However, effective July 1, 2008, IBRD modified its valuation of the loans portfolio to be consistent with FAS 157. IBRD's loans portfolio valuation model was enhanced to incorporate **CDS** spreads for each borrower. Recovery levels were modified to incorporate IBRD's expected recovery rates. As a result, as of July 1, 2008, the fair value basis of reporting for the loans portfolio was \$1,451 million lower than the amount reported at June 30, 2008 on a current value basis. There were no other differences between the fair value and current value reporting bases as of that date.

The current market environment has seen large volatility in **CDS** spreads on sovereign debt. The **CDS** spreads provides a market indicator of the fair value of the portfolio at a point in time; however, the associated volatility does not provide a good basis for making income allocation decisions, which are based on a longer term view of the adequacy of IBRD's **risk bearing capacity**.

Income allocation and distribution decisions are based on reported income, excluding the impact of the fair value adjustments associated with

financial instruments (other than trading investments measured at fair value), Board of Governors-Approved Transfers, temporarily restricted income due to externally financed outputs and adjustments to the pension reserve. Additionally, when making decisions on income allocation and distribution, management monitors the fair value balance sheet, the results from the stress test, and considers projections of the **equity-to-loans ratio** as indicators of IBRD's financial health within an overall **Strategic Capital Adequacy Framework**.

Fair Value Basis

The Condensed Fair Value Balance Sheets in **Table 1** present IBRD's estimates of the fair value of its financial assets and liabilities, taking into account interest rate, currency and credit risks. The current year's Condensed Fair Value Balance Sheet is presented with a reconciliation to the reported basis. The prior year's Condensed Fair Value Balance Sheet is presented, with a reconciliation to the reported basis, in **Table 18** in Section 10. The prior year's Condensed Fair Value Statement of Income is presented, with reconciliation to the reported basis, in **Table 19** in Section 10.

Fair Value Balance Sheets

Loans 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.

At June 30, 2009, the fair value of loans, as shown in **Table 1**, was \$1,739 million lower than the reported basis, reflecting the incremental effects on fair value of incorporating prevailing **CDS** spreads and interest rates over the reported basis where the outstanding balance is reduced by the loan loss provisioning.

Investments Portfolio

For the investments portfolio, no additional fair value adjustment is necessary, since the investment securities and related financial instruments held in IBRD's trading portfolio are carried and reported at fair value under both the reported and fair value bases.

Borrowings Portfolio

For the borrowings portfolio, except for the transition adjustment reflecting the adoption of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133) on July 1, 2000, no additional adjustment is necessary, since the debt instruments and associated derivatives held in IBRD's borrowings portfolio are carried and reported at fair value under both the reported and fair value bases.

Fair Value Statements of Income

In FY 2009, net loss on a Fair Value basis was \$225 million, as compared to FY 2008 net income of \$1,135 million. The main factors contributing to the decrease in net income on a fair value basis are discussed below.

Income from Loans

Income from loans decreased by \$1,662 million in FY 2009 compared to FY 2008. This was primarily due to a decline in the short-term interest rates in FY 2009, particularly U.S. dollar (see **Figure 10**), as well as the impact of the positive developments in the nonaccrual loan portfolio in FY 2008.

Income from Investments

Income from investments decreased by \$463 million in FY 2009 compared to FY 2008, due to lower interest income consistent with the interest rate environment (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.

Table 1: Condensed Fair Value Balance Sheets at June 30, 2009 and 2008*In millions of U.S. dollars*

	June 30, 2009		June 30, 2008	
	Reported Basis	Additional Fair Value Adjustments	Fair Value Basis	Fair Value Basis
Due from Banks	\$ 3,044		\$ 3,044	\$ 890
Investments	41,045		41,045	26,598
Receivable from Derivatives				
Investments	18,467		18,467	5,857
Client Operations	\$19,559		19,559	20,269
Borrowings	82,793		82,793	76,098
Other	2,246		2,246	609
Net Loans Outstanding	103,657	\$(1,739)	101,918	98,392 ^a
Other Assets	4,609		4,609	5,722
Total Assets	\$275,420	\$(1,739)	\$273,681	\$234,435
Borrowings	\$110,040	\$(18) ^b	\$110,022	\$ 89,946
Payable for Derivatives				
Investments	18,923		18,923	6,309
Client Operations	19,551		19,551	20,263
Borrowings	76,321		76,321	69,152
Other	847		847	1,007
Other Liabilities	9,701		9,701	7,630
Total Liabilities	235,383	(18)	235,365	194,307
Paid in Capital Stock	11,491		11,491	11,486
Retained Earnings and Other Equity	28,546	(1,721)	26,825	28,642
Total Equity	40,037	(1,721)	38,316	40,128
Total Liabilities and Equity	\$275,420	\$(1,739)	\$273,681	\$234,435

a. Effective July 1, 2009, IBRD modified its loans valuation approach for consistency with FAS 157. Had the model been in place as of June 30, 2008, the fair value of loans would have been \$96,941 million, instead of \$98,392.

b. Amount represents transition adjustment reflecting the adoption of FAS 133.

Table 2: Condensed Fair Value Statements of Income for the years ended June 30, 2009 and 2008*In millions of U.S. dollars*

	FY 2009		FY 2008	
	Reported Basis	Adjustments to Fair Value	Fair Value Comprehensive Basis ^a	Fair Value Comprehensive Basis ^a
Income from Loans	\$3,835		\$3,835	\$5,497
Income from Investments, net ^b	603		603	1,066
Other Income	599		599	300
Total Income	5,037		5,037	6,863
Borrowing Expenses	2,739		2,739	4,017
Administrative Expenses including contributions to Special Programs	1,441		1,441	1,258
Provision for Losses on Loans and Guarantees	284	\$ (284)	-	-
Other Expenses	1		1	1
Total Expenses	4,465	(284)	4,181	5,276
Operating Income	572	284	856	1,587
Board of Governors-Approved Transfers	(738)		(738)	(740)
Fair Value Adjustment on Non-Trading Portfolios, net	3,280		3,280	(443)
Fair Value Adjustment on Loans		(1,738)	(1,738)	983
Changes to Other Comprehensive Income		(1,885)	(1,885)	(252)
Net Income (Loss)	\$3,114	\$(3,339)	\$(225)	\$1,135

a. Comprehensive basis comprises net income on a reported basis as well as the components of other comprehensive income as reported in the financial statements.

b. Unrealized gains(losses) on derivatives in the investment trading portfolio are included in Income from Investments, net.

Borrowing Expenses

Borrowing expenses decreased by \$1,278 million in FY 2009 compared to FY 2008 primarily due to the decrease in the short-term interest rates, particularly the U.S. dollar (see **Figure 10**). 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 2009 resulted in lower borrowing costs.

Fair Value Adjustment on Non-Trading Portfolios, net

The fair value adjustment on non-trading portfolios, net consists of the fair value adjustments on borrowings, loans with embedded derivatives, and derivatives other than those in the investments portfolio. The fair value adjustment on loans is reported on a separate line in the Condensed Fair Value Statement of Income.

During FY 2009, IBRD experienced net unrealized gains of \$3,280 million primarily due to the following factors:

- \$1,687 million gains from the asset/liability management portfolio primarily due to gains from the interest rate swaps due to lower interest rates (see **Figure 11** in Section 8) related to the equity duration extension strategy implemented in FY 2008; and
- \$1,624 million of gains on the borrowing portfolio reflecting the widening of IBRD's credit spreads, partially offset by the effect of lower interest rates.

During FY 2008, the effect of fair value was a net unrealized loss of \$443 million as a result of declining interest rates particularly in the U.S. dollar.

Fair Value Adjustments on Loans

The fair value adjustment on loans, including the reversal of reported basis provision on loan losses for FY 2009, was a charge of \$1,454 million. This adjustment reflects changes in both interest rates and credit risk. The change in the fair value adjustment for loans was primarily driven by the widening of **CDS** spreads, partially offset by fair value gains due to the decline in interest rates. In contrast, the 'current value' adjustment in FY 2008 was a credit of \$983 million primarily due to mark-to-market gains from the decrease in reference interest rates.

Changes to Other Comprehensive Income

Changes to other comprehensive income for FY 2009 were a reduction in income of \$1,885, a decrease of \$1,633 million from June 30, 2008. This decrease was primarily due to the negative currency translation adjustment of \$1,080 million between the two periods. The negative currency translation adjustments in FY 2009 were due to the depreciation of the euro (10.59%), slightly offset by the appreciation of the Japanese yen (12.95%) against the U.S. dollar in FY 2009. **Table 3** provides a summary of currency translation adjustments by portfolio. The loans portfolio contributed negative \$1,657 million towards this decrease. The euro and the Japanese yen accounted for approximately 18% and 2% of the total loans portfolio, and 92% of total non-U.S. dollar denominated loans at June 30, 2009. The borrowings portfolio accounted for positive \$887 million. The euro and the Japanese yen accounted for approximately 15% and 2% of the total borrowing portfolio, and 92% of total non-U.S. dollar denominated borrowings at June 30, 2009.

Table 3: Summary of Currency Translation Adjustments^a

<i>In millions of U.S. dollars</i>		
	2009	2008
Loans	\$(1,657)	\$ 3,391
Borrowings	887	(2,380)
Net Other Assets and Liabilities	444	(257)
Total	\$(326)	\$ 754

a. Currency translation adjustments are on a fair value basis.

In comparison, in FY 2008 the impact of exchange rate changes on IBRD's net assets resulted in a positive currency translation adjustment was due to the appreciation of the euro (16.9%) and Japanese yen (13.6%) against the U.S. dollar.

Changes to other comprehensive income also consist of the transition adjustment upon adoption of FAS 133, and pension related items as prescribed by Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit, Pension and Postretirement Plans.

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, advisory and other services to support poverty reduction in these countries.

Loans

From its establishment through June 30, 2009, IBRD had approved loans, net of cancellations, totaling \$422,435 million to borrowers in 135 countries. A summary of cumulative lending is presented in **Table 4**.

Table 4: Lending Status at June 30, 2009 and 2008

<i>In millions of U.S. dollars</i>		
	2009	2008
Cumulative Approvals ^a	\$422,435	\$391,104
Cumulative Repayments ^b	\$270,972	\$260,914

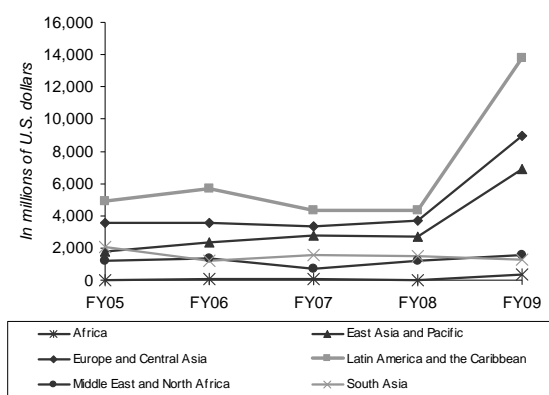
a. Net of cancellations

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.

At June 30, 2009, the total volume of outstanding loans was \$105,698 million, \$6,648 million higher than the \$99,050 million of outstanding loans at June 30, 2008. This increase was primarily due to positive **net disbursements** of \$8,344 million, partially offset by negative currency translation adjustment of \$1,689 million owing to the depreciation of the euro against the U.S. dollar in FY 2009. Undisbursed balances at June 30, 2009 totaled \$51,125 million, reflecting an increase of \$12,949 million from June 30, 2008.

During FY 2009, new loans, guarantee commitments and guarantee facilities to member countries were \$32,911 million (\$13,468 million in FY 2008). This significant increase in demand was driven by the global financial turmoil.

Figure 1: Commitments including Guarantee Facilities by Region



During the five year period from FY 2005 to FY 2009, Latin America and the Caribbean region accounted for the largest share of commitments.

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, 2009, outstanding loans and callable guarantees totaled \$105,741 million, equal to 49% of the **statutory lending limit** of \$217,856 million at June 30, 2009.

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 2**. 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 exceptions³, 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.

³ 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.

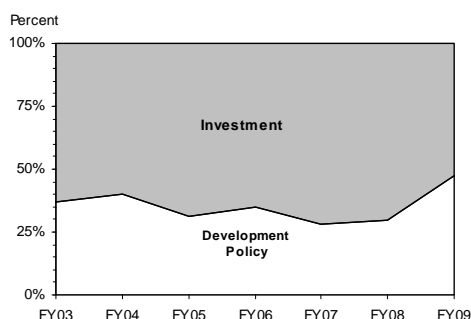
Box 2: Lending Operations Principles

- (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.

Lending Instruments

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

Figure 2: IBRD Lending Commitments



In FY 2009, new IBRD commitments to investment lending and development policy lending were 53% (FY 2008 – 71%) and 47% (FY 2008 – 29%), respectively. The increase in development policy lending in FY 2009 reflects the needs of borrowing countries for rapidly disbursing loans during the global financial turmoil.

Contractual Terms of Loans

Currently Available Loan Terms

As of June 30, 2009, IBRD offers the IBRD Flexible Loan (IFL), that allows borrowers to customize the repayment terms to meet their debt management or project needs and also 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: variable-spread terms and fixed-spread terms. Each type of loan may be denominated in the currency or currencies chosen by the borrower provided it is a currency in which IBRD can efficiently intermediate. 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.

Table 5: Currently Available Loan Terms*Basis Points*

	<i>IBRD Flexible Loan (IFL)</i>		<i>Special Development Policy Loans</i>
	<i>Fixed Spread Terms</i>	<i>Variable Spread Terms</i>	
Final Maturity	All Maturities	30 years	5 years
Reference Market Rate	Six-month LIBOR	Six-month LIBOR	Six-month LIBOR
Spread			
Contractual Lending Spread	30	30	400
Market Risk Premium	10-15 ^a	-	-
Funding Cost Margin	Projected funding spread to LIBOR ^c	Weighted average spread to LIBOR of debt allocated to Variable Spread Term Loans	Six-month LIBOR
Charges			
Front-end fee ^b	25	25	100
Late service charge on principal payments received after 30 days of due date	50	50	-

a. For loans with a maturity greater than 14 years, 15 basis points is charged.

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

c. Projected funding spread to LIBOR is based on the average repayment maturity of the loan.

During FY 2009, IBRD increased the spread over **LIBOR** on all new IFLs with a fixed spread. The increase in the fixed spread reflects the extraordinary market conditions during the year, which resulted in an increase in IBRD's projected cost of borrowing at longer maturities. In addition, IBRD for the first time introduced differential pricing dependent on the average maturity of loans. The projected funding spread to **LIBOR** is measured by the average repayment maturity of the loan at commitment. This enables IBRD to price the loan based on its projected funding cost for each maturity tier. The new pricing terms are summarized in **Table 5**.

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, 2009 was \$1,172 million (\$392 million – June 30, 2008).

IBRD also has a Local Currency Loan Facility Agreement with IFC, which is capped at \$300 million, aimed at increasing the usability of local currency paid-in capital. Under this agreement, IBRD lends local currencies of its member countries, funded from paid-in capital, to IFC. These currencies are subsequently 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, 2009, 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 an additional period of up to three years under the enhanced DDO for development loans. The catastrophic risk DDO may be renewed up to four times. The pricing of loans with a DDO comprises a front-end fee of 25 basis points, payable at effectiveness, and a contractual lending spread of 30 basis points over IBRD's cost of funding. During the FY 2009, loans with DDO approved totaled \$4,810 million (FY 2008 – \$1,051 million). As of June 30, 2009, the outstanding amounts relating to loans with DDO totaled \$1,773 million (\$200 million – June 30, 2008).

Loan Terms for Previously Available Products

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

Table 6 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.

Table 6: Loan Terms for Previously Available Products*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^a (1996-1998)</i>	<i>Fixed rate single currency Loans^b (1995-1999)</i>
Cost Base	Six month LIBOR	Six month LIBOR	<i>Weighted average cost of allocated debt</i>	<i>Weighted average cost of allocated debt</i>	<i>LIBOR</i>
Spread					
Contractual Lending Spread	30 ^c 75 (post-98 loans) 50 (pre-98 loans)	30 ^c 75 -	- 75 (post-98 loans) 50 (pre-98 loans)	- 50	- 75 (post-98 loans) 50 (pre-98 loans)
Market Risk Premium	-	5 ^e	-	-	0-10
Funding Cost Margin	Weighted average spread to LIBOR of debt allocated to VSLs	Projected funding spread to LIBOR	-	-	IBRD's funding spread to LIBOR
Charges					
Commitment charge on undisbursed balances	75	75 ^f	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^g					
Interest	Yes	Yes	Yes ^d	Yes ^d	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 based on original loan agreement	12-20 years
Grace period	3-5 years	3-8 years	3-5 years	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. Loans converted from variable-rate multi-currency pool and variable rate U.S. dollar pool loan to composite LIBOR + 100 basis points or fixed rate equivalent thereof 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 7** for details.

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.

During FY 2006, IBRD's Executive Directors approved management's proposal to convert the variable rate multi-currency pool and variable rate U.S. dollar pool loan terms to composite LIBOR + 100 basis points or the fixed rate equivalent thereof (at the borrower's choice), subject to the borrowers consent to certain amendments to their loan agreements. This proposal was designed to adjust the applicable lending rates which were rising above the market rates in a manner not envisioned at the time that borrowers signed their loan agreements. These modified loan terms were offered to the borrowers from July 2006 through June 30, 2009 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, 2009, 51% of the outstanding balance of variable rate multi-currency pool and variable rate U.S. dollar loans had been modified. This does not

include amounts relating to the conversions for borrowers' requests received as of that date but not executed.

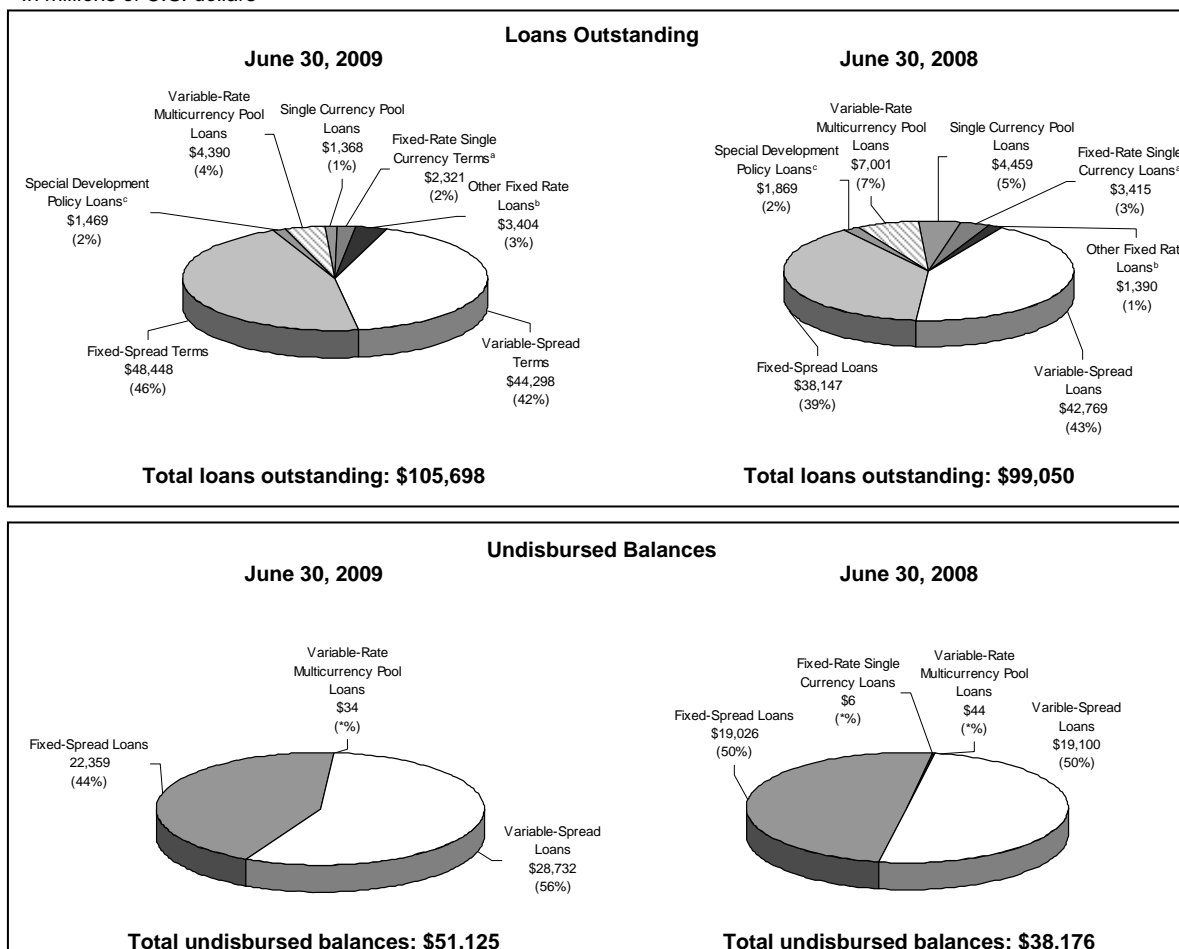
Any fixed-rate multicurrency pool loans that were converted to single currency pools continued to carry their fixed rate.

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.

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.

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.

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. Waivers apply to loans signed before May 16, 2007 and those 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. Eligibility for the partial waiver of interest is limited to borrowers that have made full payments of principal, interest and other charges within 30 calendar days of the due dates during the preceding six months, on all their loans. Waivers of a portion of the commitment charge owed on the undisbursed portion of loans are also determined annually and have been in effect since FY 1990. All borrowers receive the commitment charge waiver on their eligible loans. **Table 7** presents a breakdown of IBRD's loan charge waivers. Further details are included in the Notes to Financial Statements-Note D-Loans and Guarantees.

Table 7: Loan Charge Waivers

	Interest Period Commencing	
	FY 2009	FY 2008
Commitment charge waivers	50	50
Interest waivers ^a		
Pre-98 loans	5	5
Post-98 loans	25	25
Average eligibility	99.8%	99.7%
Front-end fee waivers	100	100

a. On loans to eligible borrowers.

Derivatives

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

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 conversion 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 under individually negotiated transactions.

Affiliated Organizations: IBRD executed a number of currency forward transactions with IDA. Concurrently, IBRD entered into offsetting transactions with market counterparties.

Non-affiliated Organizations: 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, have entered into a number of **currency swaps** and **interest rate swaps**. Concurrently, IBRD entered into offsetting swap transactions with market counterparties. IBRD charges an intermediation fee for these interest rate swaps and 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 Instruments.

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 general 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 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, 2009 commitments made under enclave guarantees were \$30 million.

Other Instruments: As discussed in Other Activities, IBRD has also committed to pay shortfalls associated with the Advance Market Commitment for Vaccines against Pneumococcal Diseases.

IBRD's exposure at June 30, 2009 on its guarantees (measured by discounting each guaranteed amount from its first call date) is detailed in **Table 8**. For additional information see the Notes to Financial Statements-Note D-Loans and Guarantees.

Table 8: Guarantee Exposure

	<i>In millions of U.S. dollars</i>		
	<i>FY 2009</i>	<i>FY 2008</i>	<i>FY 2007</i>
Partial risk ^a	\$233	\$274	\$270
Partial credit	122	444	538
Policy based	50	49	79
Other Instruments	1,256	-	-
Total	\$1,661	\$767	\$887

a. Includes enclave guarantees totaling \$16.2 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 J-Management of External Funds and Other Services.

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

Externally Financed Outputs (EFOs): IBRD offers donors the ability to contribute to IBRD's projects and programs. 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.

Advance Market Commitment (AMC) for Vaccines against Pneumococcal Diseases: AMC is a multi-lateral initiative. Its principal goal is to accelerate the creation of a market and sustainable production capacity for pneumococcal vaccines for developing countries, by financing the incremental capital cost associated with the development and production of qualifying vaccines. The \$1.5 billion of AMC donor pledged assets is funded by six donors. IBRD is providing the financial platform for the AMC by holding donor pledged assets as an intermediary agent and passing them on to GAVI Alliance when the conditions of the AMC are met. In addition, should a donor fail to pay or delay in paying any amounts coming due, IBRD has committed to paying from its own funds any amounts due and payable by the donor, to the extent there is a shortfall in total donor funds received. For further details on AMC see the notes to Financial Statements-Note J-Management of External Funds and Other Services.

4. INVESTMENT ACTIVITIES

IBRD manages its investments in two portfolios: a liquid asset portfolio and a long-term income portfolio.

Liquid Asset Portfolio

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 securities** (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.

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 2010

prudential minimum liquidity level has been set at \$20 billion, an increase of \$1 billion from that set for 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. At June 30, 2009 the liquid asset portfolio was 193% of the prudential minimum liquidity level primarily due to pre-funding of anticipated large loan disbursements in FY 2010.

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 2009 and FY 2008, excluding investment assets associated with certain other post-employment benefits.

At June 30, 2009, the aggregate size of the IBRD liquid asset portfolio was \$36,762 million, reflecting an increase of \$14,022 million from June 30, 2008,

consistent to the pre-funding activity discussed previously.

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).

Contractual Obligations

In the normal course of business, IBRD enters into various contractual obligations that may require future cash payments. **Table 9** summarizes IBRD's significant contractual cash obligations, by remaining maturity, at June 30, 2009. Debt includes all borrowings excluding derivatives, but does not include any adjustment for unamortized premiums, discounts or effects of fair value adjustments (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 I- Administrative Expenses, Contributions to Special Programs, and Other Income).

Figure 4: Liquid Asset Portfolio Composition
In millions of U.S. dollars

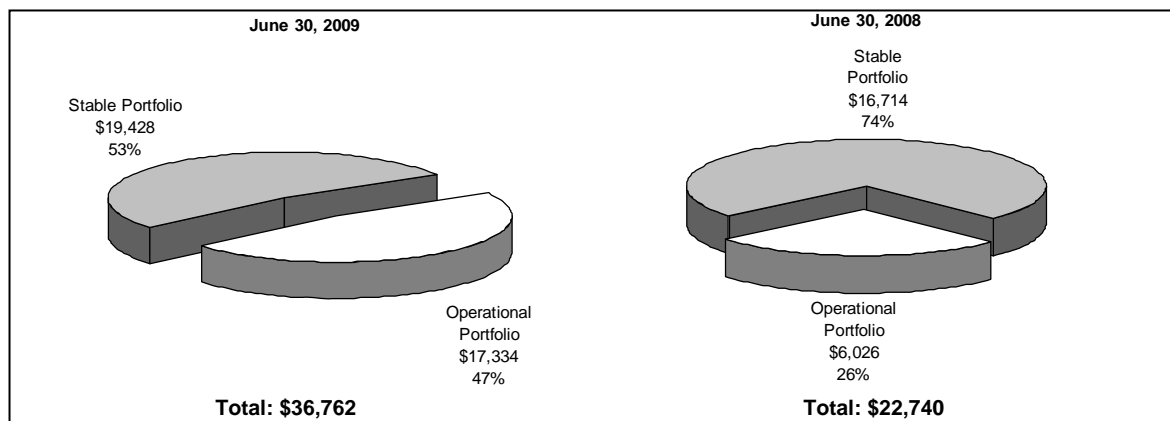


Table 9: Contractual Cash Obligations*In millions of U.S. dollars*

	<i>Payments due by period</i>				
	<i>Total</i>	<i>Less than 1 year</i>	<i>1-3 years</i>	<i>3-5 years</i>	<i>More than 5 years</i>
Debt-principal only	\$110,095	\$31,138	\$27,582	\$10,593	\$40,782
Operating leases	595	59	99	82	355
Contractual purchases and capital expenditures	59	46	13	-	-
Other long-term liabilities	378	90	69	79	140
Total	\$111,127	\$31,333	\$27,763	\$10,754	\$41,277

Table 10: Liquid Asset Portfolio and LTIP Returns and Average Balances*In millions of U.S. dollars*

	<i>Average Balances</i>		<i>Financial Return (%)</i>	
	<i>FY 2009</i>	<i>FY 2008</i>	<i>FY 2009</i>	<i>FY 2008</i>
IBRD Overall Portfolio	\$29,994	\$22,635	1.73	4.15
Liquid Asset Portfolio				
Stable	19,127	16,385	2.03	4.19
Operational	10,416	4,462	1.02	3.55
Discretionary	-	1,788	-	5.36 ^a
LTIP	451	-	12.10 ^b	-

a. Effective November 30, 2007, the holdings in the Discretionary portfolio were transferred into the Operational portfolio.

The FY2008 return for the Discretionary portfolio was therefore a short period return that has been annualized.

b. LTIP was implemented in November 28, 2008; therefore, the FY2009 return for LTIP has been annualized.

Excluded from **Table 9** 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, cash received under agency arrangements, and payable for transfers approved by the Board of Governors.

Long-Term Income Portfolio

During FY 2009, IBRD started implementing the Long-Term Income Portfolio (LTIP). The objective of the LTIP program is to increase IBRD's income over the long-term by investing part of its capital in a diversified portfolio of risk assets, including listed equity securities. LTIP is intended to be a long-term multicurrency portfolio, swapped back into U.S. dollars. As of June 30, 2009, the market value of the portfolio is \$1,061 million, reflecting \$61 million of unrealized capital gains to IBRD and is comprised of 62% developed market public equities and 38% developed market fixed income securities.

As of June 30, 2009, \$1 billion of assets had been invested in the LTIP portfolio. Originally the Executive Directors approved management's proposal for a \$3 billion portfolio to be implemented over two to three years. In response to the global financial turmoil and the resulting increase in loan commitments, management has decided to temporarily limit the funding of the LTIP portfolio at \$1 billion.

The returns and average balances of IBRD's investments portfolios in FY 2009 compared to FY 2008 are presented in **Table 10**. These returns exclude investment assets funding certain other postemployment benefits. The lower returns in FY 2009 were due mainly to lower average short-term interest rates in FY 2009 compared to FY 2008 (see **Figure 10**).

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

5. FUNDING RESOURCES

Equity

Total shareholders' equity, as reported in IBRD's balance sheet at June 30, 2009, was \$40,037 million compared to \$41,548 million at June 30, 2008. The \$1,511 million decrease from FY 2008 primarily reflects the \$2,566 million negative impact of cumulative effect of adoption of FAS 159 and \$1,581 million charge to other comprehensive income related to net actuarial losses on benefit plans, partially offset by the net income for the year of \$3,114 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 11** presents the composition of this measure at June 30, 2009 and 2008, 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.

As presented in **Figure 5**, IBRD's **equity-to-loans ratio** decreased during FY 2009, on both a reported basis (excluding cumulative translation adjustments and fair value adjustment on non-trading portfolio, net) and a Fair Value basis. The decrease in **equity-to-loans ratio** on a reported basis to 34.53% at June 30, 2009 from 37.62% at June 30, 2008 was due primarily to the increase in lending.

Figure 5: Equity-to-Loans Ratio

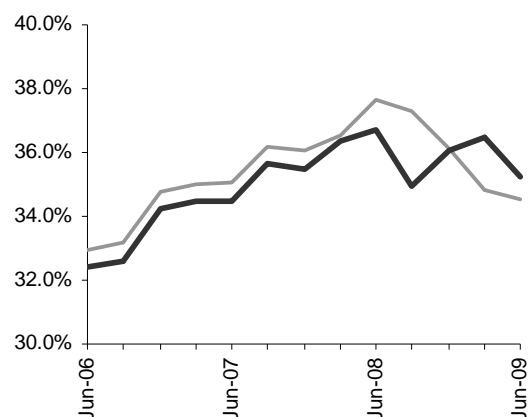


Table 11: Equity Capital

In millions of U.S. dollars

	<u>June 30, 2009</u>	<u>June 30, 2008</u>
Usable Capital		
Paid-in Capital	\$11,491	\$11,486
Restricted Paid-in Capital	(1,979)	(2,443)
Net Payable for Maintenance of Value	371	853
Total Usable Capital	9,883	9,896
Special Reserve	293	293
General Reserve ^a	25,670	25,670
Cumulative Translation Adjustment ^b	457	1,029
Equity used in Equity-to-Loans Ratio ^c	\$36,303	\$36,888
Fair Value Adjustments	151	(479)
Equity used in Equity-to-Loans Ratio-Fair Value Basis	\$36,454	\$36,409
Loans Outstanding, Present Value of Guarantees and LTIP assets, net of Relevant Accumulated Provisions (including DDOs) and Deferred Loan Income	\$105,145	\$98,053
Fair Value of Loans outstanding, Present Value of Guarantees and LTIP assets, net of Provision for Guarantees ^d	\$103,393	\$99,177
Equity-to-Loans Ratio-Reported Basis ^b	34.53%	37.62%
Equity-to-Loans Ratio-Fair Value Basis	35.26%	36.71%

a. The June 30, 2008 amount includes proposed transfers to the General Reserve out of FY 2008 net income. No transfers to the General Reserve are proposed in FY 2009.

b. Excluding cumulative translation amounts associated with fair value adjustment on non-trading portfolios, net.

c. Before the effects of fair value adjustment on non-trading portfolios, net and Board of Governors-Approved Transfers.

d. Prior year amount is net of Accumulated Provision for Losses on Loans and Deferred Loan Income under the previous current value methodology..

Capital

Shareholder support for IBRD is reflected in the capital backing it has received from its members. At June 30, 2009, the authorized capital of IBRD was \$190,811 million, of which \$189,918 million had been subscribed. Of the subscribed capital, \$11,491 million had been paid-in and \$178,427 million was callable. Of the paid-in capital, \$9,883 million was available for lending and \$1,608 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) \$8,234 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, \$5,704 million of this amount was being used in IBRD's lending and investment operations at June 30, 2009.
- (iii) \$34 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) \$151,934 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) \$26,493 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, 2009, \$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, 2009. **Table 12** sets out the capital subscriptions of those countries and the callable amounts.

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

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

Table 12: Capital Subscriptions of DAC Members of OECD Countries

In millions of U.S. dollars

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

a. See details regarding the capital subscriptions of all members of IBRD at June 30, 2009 in Financial Statements-Statement of Subscriptions to Capital Stock and Voting Power.

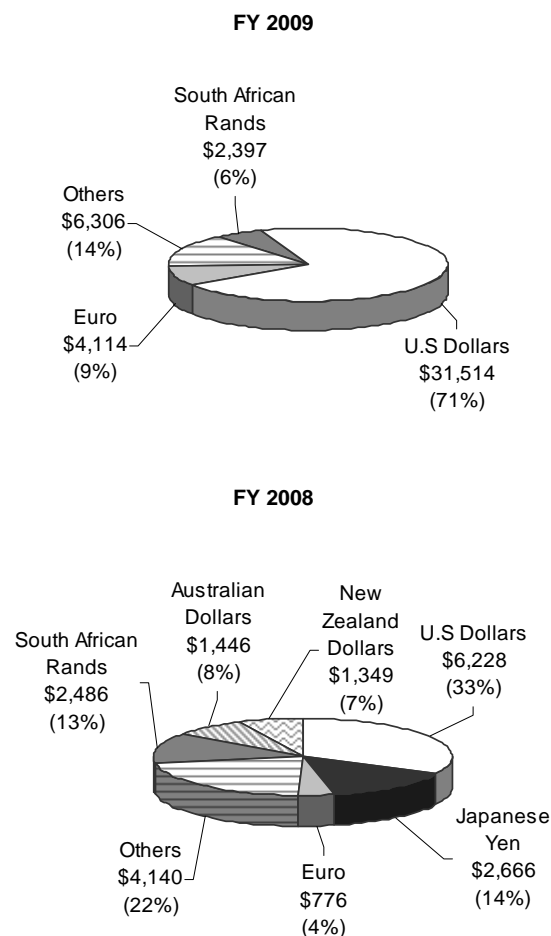
Borrowings

Source of Funding

IBRD diversifies its sources of funding by offering its securities to institutional and retail investors around the world, both through global offerings and by way of bond issues designed to meet the needs of specific markets or types of investors. Under its Articles, IBRD may borrow only with the approval of the member in whose markets the funds are raised and the member in whose currency the borrowing is denominated, and only if each such member agrees that the proceeds may be exchanged for the currency of any other member without restriction.

Medium- and long-term funding raised excluding derivatives by currency for FY 2009, as compared to FY 2008, 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 2009, medium- and long-term debt raised directly in financial markets by IBRD amounted to \$44,331 million compared to \$19,091 million in FY 2008. **Table 13** summarizes IBRD's funding operations for FY 2009 and FY 2008.

Table 13: Funding Operations Indicators

	<i>FY 2009</i>	<i>FY 2008</i>
Total Medium- and Long-term Borrowings (USD million)	\$44,331	\$19,091
Average Maturity ^a (years)	3.16	2.40
Number of Transactions	374	750
Number of Currencies	19	19

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 FY 2009, IBRD funding increased significantly to fulfill larger loan commitments by member countries due to the global financial crisis.

IBRD strategically repurchases calls its debt to reduce the cost of borrowings, reduce exposure to refunding requirements in a particular year, or to meet other operational or strategic needs. During FY 2009, IBRD repurchased or called \$2,902 million of its outstanding borrowings (\$4,376 million in FY 2008).

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 borrowings portfolio at June 30, 2009. IBRD does not enter into derivatives for speculative purposes in the borrowings 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 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.

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.

Figure 7a: Effect of Derivatives on Interest Rate Structures on the Borrowing Portfolio—June 30, 2009

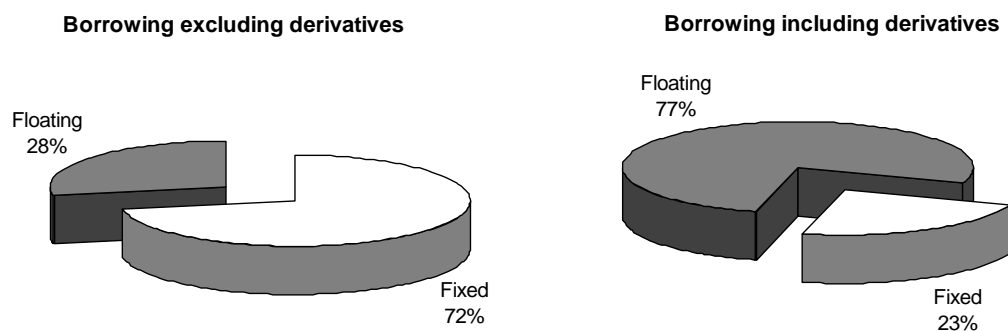
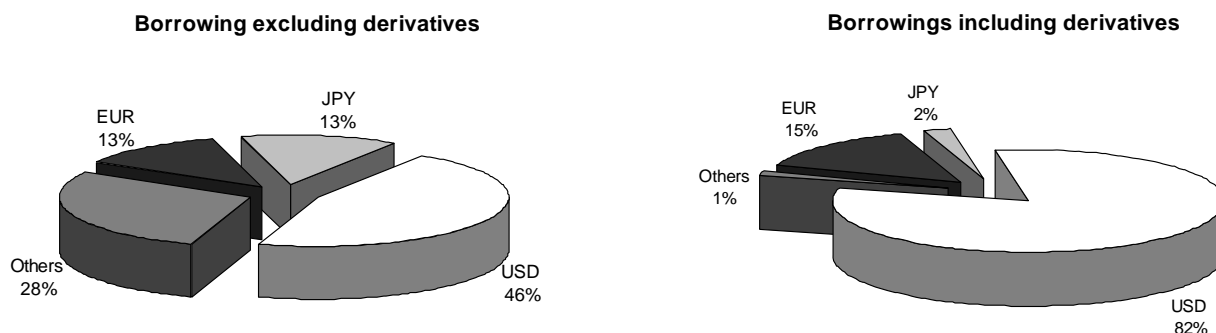


Figure 7b: Effect of Derivatives on Currency Composition on the Borrowing Portfolio—June 30, 2009



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 implications of implementing 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 Vice-President, Corporate Finance and Risk Management. This unit is independent from IBRD's operational 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 Vice-

President, Corporate Finance and Risk Management. 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 borrowings 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 **equity-to-loans ratio** is guided by the **Strategic Capital Adequacy Framework** with a target risk coverage range for the **equity-to-loans ratio** of 23 to 27 percent.

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 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, with the intent of protecting the **equity-to-loans ratio** 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, in FY 2008, IBRD implemented a program that extended the duration of its equity by entering into a number of **interest rate swaps** as a means of stabilizing operating income by restoring a greater exposure to long-term interest rates.

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.

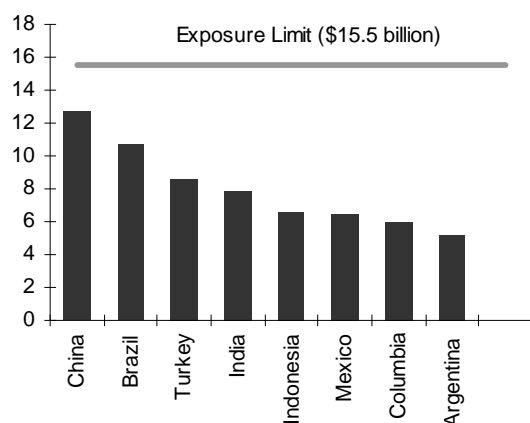
Portfolio concentration risk, which arises when a small group of borrowers account for a large share of loans outstanding, is a key concern for IBRD and is carefully managed, in part, through an exposure limit for loans outstanding plus the present value of guarantees to a single borrowing country. Under 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 2009, the Single Borrower Limit was \$15.5 billion and the Equitable Access Limit at June 30, 2009 was \$21.8 billion. As depicted in **Figure 8**, IBRD's largest exposure (including the present value of guarantees) to a single borrowing country was \$12.7 billion at June 30, 2009.

For FY 2010, the Single Borrower Limit has been set at \$16.5 billion, an increase of \$1 billion over the limit at June 30, 2009.

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.

Figure 8: Top Eight Country Exposures at June 30, 2009

In billions of U.S. dollars



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, 2009 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 3**. 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 3**.

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, 2009.

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.

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.

Box 3: 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, and those loans signed between May 16, 2007 and September 27, 2007 if the borrowers elected not to convert the terms of their loans to the pricing terms effective September 27, 2007. For loans with the 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.

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 notional principal 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 financial instruments or derivative 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 G-Credit Risk.

Table 14 provides details of IBRD's estimated credit exposure on its investments and swaps net of collateral held, by counterparty rating category.

The increase in credit exposure reflects an increase in the size of the IBRD investment program due to a large increase in held liquidity as a result of the market financial crisis offset by a significant decrease in IBRD's net swap exposure. Increases in the held portfolio size are reflected largely in the increase in holdings of sovereign and sovereign-guaranteed securities. In addition, the credit composition of the portfolio has changed due to significant ratings downgrades across all categories of IBRD's investment counterparties accompanied by an increase in "AA"-rated sovereign investments. After the effects of exposure netting arrangements across multiple transactions with a single counterpart, the credit exposure from swaps increased from \$7,312 million at June 30, 2008 to \$8,339 million at June 30, 2009. The swap credit exposure of \$8,339 million is offset by collateral of \$7,209 million which results in a total net swap exposure of \$1,130 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.

Table 14: Credit Exposure, Net of Collateral Held, by Counterparty Rating^a

In millions of U.S. dollars

Counterparty Rating	At June 30, 2009			At June 30, 2008			
	Investments		Net Swap Exposure	Total Exposure on Investments and Swaps		Total Exposure on Investments and Swaps	
	Sovereigns	Agencies, Banks & Corporates		% of Total	% of Total		
AAA	\$ 3,800	\$ 4,827	\$ 82	\$ 8,709	21	\$ 7,923	30
AA	11,462	13,273	907	25,642	63	16,131	61
A	783	5,768	141	6,692	16	2,381	9
BBB	-	4	-	4	*	3	*
BB	-	-	-	-	-	1	*
Total	<u>\$16,045</u>	<u>\$23,872</u>	<u>\$1,130</u>	<u>\$41,047</u>	<u>100</u>	<u>\$26,439</u>	<u>100</u>

a. Excludes (a) \$640 million of equity securities for the IBRD LTIP account and (b) exposures due to swaps executed with IBRD clients including (i) borrowing member countries (\$89 million swap exposure) and (ii) the International Finance Facility for Immunization (\$66 million). Swaps with the Caribbean Catastrophe Risk Insurance Facility and for IDA intermediation have no current exposure.

* Denotes less than 0.5%.

Table 15: Loan and Borrowing Portfolios*In millions of U.S. dollars*

	At June 30, 2009			At June 30, 2008		
	Face Value	Contractual Yield	Fair Value Adjustments	Face Value	Contractual Yield	Fair Value Adjustments
Loans ^a	\$105,711	2.84%	\$(3,556)^b	\$99,050	4.23%	\$1,124^c
Variable-Rate Multicurrency Pool Loans	4,390	6.47	267	7,001	6.58	726
Single Currency Pool Loans	1,368	6.03	71	4,459	6.73	189
Variable-Spread Loans ^d	44,298	1.92	(1,791)	42,769	3.43	(15)
Fixed-Rate Single Currency Loans	2,321	5.82	93	3,415	5.92	97
Special Development Policy Loans ^e	1,469	2.35	11	1,869	3.65	(1)
Fixed-Spread Loans	48,461	3.04	(2,219)	38,147	4.25	89
Other Fixed Rate Loans ^f	3,404	4.04	12	1,390	4.81	39
Borrowings Allocation (including derivatives) ^g	\$105,617	2.05%	\$573	\$83,533	3.51%	\$1,207
Variable-Rate Multicurrency Pools	5,103	7.09	1,626	6,119	7.06	1,746
Single Currency Pools	2,097	3.98	137	2,490	6.17	158
Variable-Spread	26,059	1.27	(476)	24,162	2.92	(62)
Fixed-Rate Single Currency	814	5.44	84	1,989	6.77	73
Special Development Policy	1,592	1.25	(8)	2,013	2.73	1
Fixed-Spread	29,474	2.62	(867)	22,261	3.61	(104)
Other Debt ^h	40,478	1.24	77	24,499	2.58	(605)

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

b. Fair Value adjustment of negative \$3,556 million is before the reported basis effects of loan loss provision and deferred loan income. After the effects of these reversals the additional fair value adjustment on the fair value balance is a negative \$1,739 million.

c. June 30, 2008 amounts are presented on a current value methodology; under the new methodology adopted by IBRD on July 1, 2008, the fair value adjustment would have been negative \$1,878 million before the reported basis effects of loan loss provision and deferred loan income. After the effects of these reversals the additional fair value adjustment on the fair value balance would have been negative \$1,451 million.

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

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

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

g. Carrying amounts and contractual yields are on a basis which includes accrued interest and any unamortized amounts, but does not include the effects of fair value.

h. Includes amounts not yet allocated at June 30, 2009 and June 30, 2008.

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 Fair Value information is used in the asset/liability management process. **Table 15** details the Fair Value information of each group of loan and debt products.

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.

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, 2009, such cost pass-through loans accounted for 49% of the outstanding loan portfolio (55% at June 30, 2008). 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 2012 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, 2009, 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.

Interest rate risk on non-cost pass-through products, which accounted for 51% of the loan portfolio at June 30, 2009 (45% at June 30, 2008), 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. 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**.

During FY 2008, IBRD implemented an equity duration extension strategy. This strategy seeks 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.

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, 2009 and June 30, 2008.

Liquidity Risk

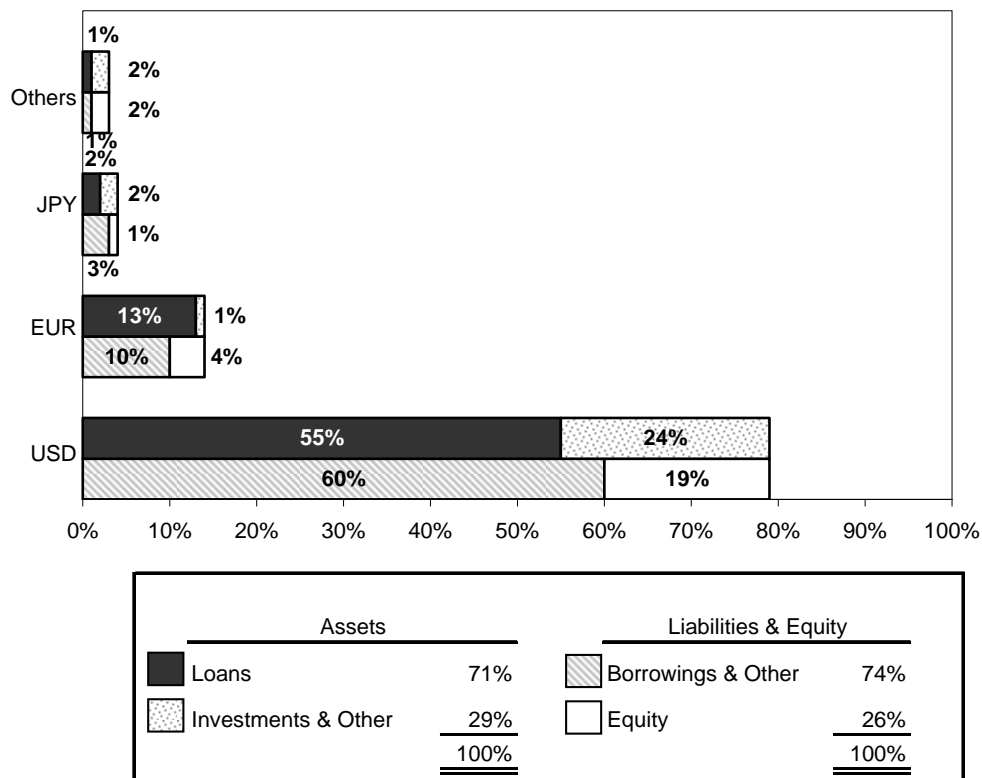
Liquidity risk arises from the general funding needs of IBRD's activities and in the management of its assets and liabilities. For a discussion on how liquidity is managed, refer to Section 4-Investment Activities.

Operational Risk

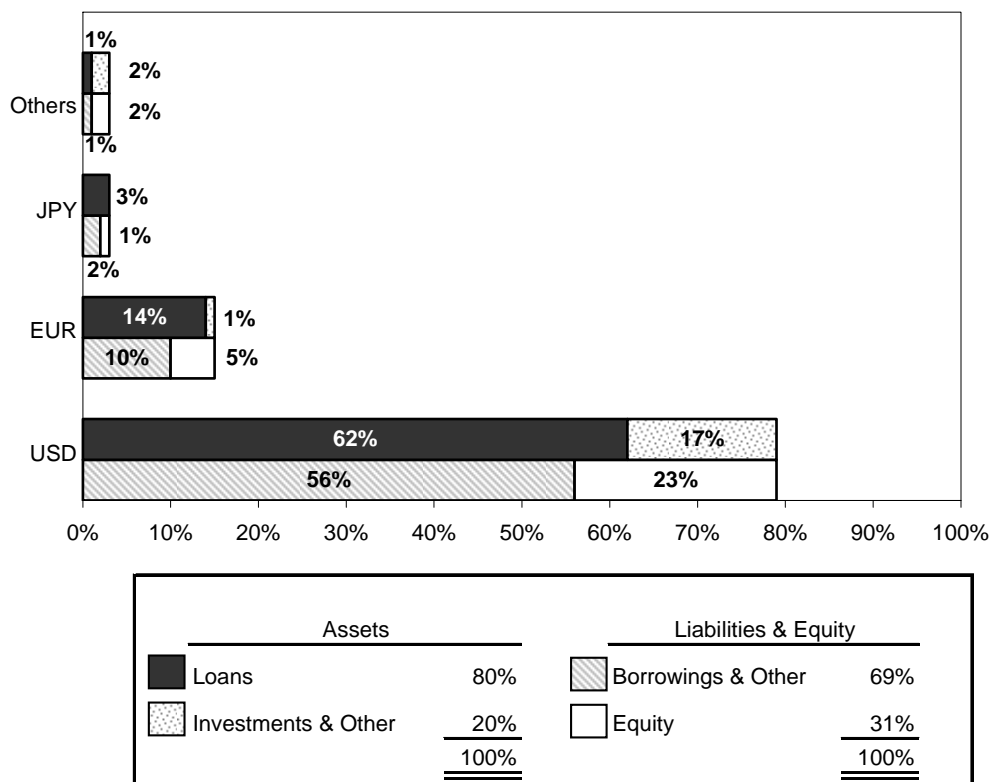
Operational risk is the potential for loss resulting from inadequate or failed internal processes or systems, human factors, or external events, and includes business disruption and system failure, transaction processing failures and failures in execution of legal, fiduciary and agency responsibilities.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

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

For all currencies at June 30, 2009



For all currencies at June 30, 2008



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 a Board-approved Integrated Risk Management Framework and involves the following core steps:

- Key operational risks are identified annually and documented using a combination of tools including business process review and risk assessments.
- Operational risks are assessed based on likelihood of occurrence and the resulting financial impact using probability and severity parameters.
- Controls that mitigate operational risks are evaluated using a combination of processes including self assessments, independent walk through tests of processes, 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 risks and operational effectiveness of internal controls are reported to the Audit Committee.

Internal Control Over Financial Reporting

Management makes an annual assertion whether, 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, 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, 2009 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, 2009.

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. Loans in the non-accrual portfolio are individually assigned the highest 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 and Guarantees.

Fair Value of Financial Instruments

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. Some financial assets and liabilities use valuation techniques which require significant unobservable inputs. These inputs require management to make assumptions and judgments.

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 judgment. 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, accumulated benefit obligations and funded status associated with these plans are based

on financial market interest rates, past experience, and management's best estimate of future benefit changes and economic conditions. For further details, please refer to Notes to Financial Statements-Note K-Pension and Other Postretirement Benefits.

8. RESULTS OF OPERATIONS

In FY 2009, operating income decreased by \$1,699 million from \$2,271 million in FY 2008 to \$572 million, primarily due to an increase of \$284 million in provision for losses on loans and guarantees in FY 2009, compared to a release of \$684 million in FY 2008.

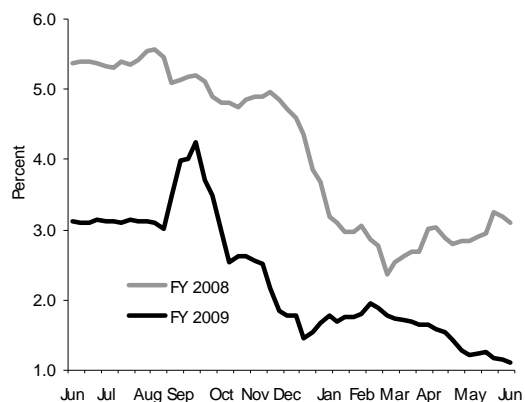
Net income on a reported basis was \$3,114 million in FY 2009, compared to a \$1,491 million in FY 2008, an increase of \$1,623 million. This was primarily due to higher net unrealized gains of \$3,280 million due to IBRD's fair value adjustments on non-trading portfolios, net in FY 2009 compared to net unrealized losses of \$40 million in FY 2008. For more details refer to Fair Value Adjustment on Non-Trading Portfolios, net, discussed later in this section.

Interest Rate Environment

During FY 2009, short-term interest rates for the U.S. dollar were lower than those in FY 2008.

Figure 10 illustrates these general trends for the six-month LIBOR U.S. dollar rates.

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



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 16** shows a breakdown of income, net of funding costs, on a reported basis.

Table 16: Net Income (Loss)*In millions of U.S. dollars*

	<i>FY 2009</i>	<i>FY 2008</i>	<i>FY 2007</i>
Loan interest income, net of funding costs			
Debt funded	\$501	\$ 549	\$ 415
Equity funded	1,137	1,642	1,717
Net interest income	1,638	2,191	2,132
Other loan income	12	306	20
Provision for losses on loans and guarantees – (increase) decrease	(284)	684	405
Investment income, net of funding costs	(14)	49	77
LTIP Income	61	-	-
Other Interest Income (Loss)	246	10	(4)
Net Non-interest expense	(1,087)	(969)	(971)
Operating Income	572	2,271	1,659
Board of Governors-Approved Transfers	(738)	(740)	(957)
Fair Value Adjustment on Non-Trading Portfolios, net	3,280	(40)	(842)
Net Income (Loss) - Reported Basis	\$3,114	\$1,491	\$(140)

FY 2009 versus FY 2008

The decrease of \$1,699 million in Operating Income is explained by the following factors.

- A \$968 million reduction in income relating to the provision for losses on loans and guarantees. During FY 2009, there was a \$284 million increase in the provision for losses on loans and guarantees due primarily to the impact of changes in the credit quality of the accrual portfolio. During FY 2008, there was a \$684 million release of provision for losses on loans, primarily due to the positive impact of developments in the nonaccrual portfolio.
- A \$553 million reduction in loan interest income, net of funding costs, was primarily due to a decrease of \$505 million from equity funded loans, due to the lower short-term interest rates, particularly U.S. dollar six month **LIBOR**, between the two years (see **Figure 10**). This was partially offset by a \$236 million increase in other interest income from the equity duration extension swaps.
- A \$294 million decrease in other loan income, of which \$269 million is associated with Liberia's and Côte d'Ivoire's clearance of all overdue interest and charges to IBRD in FY 2008.
- A \$63 million decrease in investment income, net of funding costs, mainly due to the widening of the credit spreads in global bond markets.

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 Côte 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.

Table 17: Net Noninterest Expense*In millions of U.S. dollars*

	<i>FY 2009</i>	<i>FY 2008</i>	<i>FY 2007</i>
Gross Administrative Expenses			
Staff Costs	\$ 589	\$ 538	\$ 492
Operational Travel	108	110	101
Consultant Fees	131	116	98
Pension and other postretirement benefits	65	(12)	50
Contributions to Special Programs	197	176	171
Communications and IT	82	80	77
Contractual Services	94	83	68
Equipment and Buildings	149	138	143
Other Expenses	26	29	36
Total Gross Administrative Expenses	1,441	1,258	1,236
Less: Contribution to Special Programs	197	176	171
Total Net Administrative Expenses	1,244	1,082	1,065
Contribution to Special Programs	197	176	171
Service Fee Revenues	(295)	(272)	(261)
Externally Funded Outputs Income	(28)	(11)	-
Net Other Income	(31)	(6)	(4)
Total Net Noninterest Expense	\$1,087	\$ 969	\$ 971

Net Noninterest Expense

The main components of net noninterest expense are presented in **Table 17**.

FY 2009 versus FY 2008

Net noninterest expense increased by \$118 million primarily due to a \$77 million increase in pension and other post retirement benefits and a \$51 million increase in staff costs.

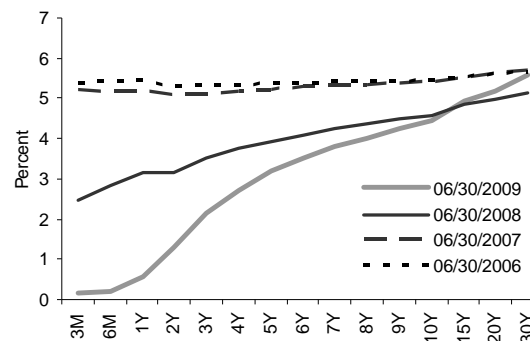
FY 2008 versus FY 2007

Net noninterest expense decreased by \$2 million primarily due to a \$62 million decrease in pension and other postretirement benefits expenses and an increase of \$22 million of service fee revenue and EFO income, partially offset by a \$79 million increase in staff costs, consultants fees and contractual services.

Fair Value Adjustment on Non-Trading Portfolios, net

During FY 2009, IBRD experienced net unrealized gains of \$3,280 million, primarily due to gains from the asset/liability management portfolio and from the borrowings portfolio (see **Figure 11**, IBRD's U.S. Dollar Funding Curve). For a detailed analysis, refer to *Fair Value Adjustment on Non-Trading Portfolios, net*, included in Section 2. 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.

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

9. GOVERNANCE

General Governance

Management Changes

Ms. Anne-Marie Leroy was appointed as Senior Vice President and Group General Counsel of the World Bank effective March 9, 2009.

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 and a balanced representation between borrowing and non-borrowing member countries. 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 updated its terms of reference in July 2009.

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 Conduct and Business Conduct Infrastructure

Staff members ethical obligations to the institution are embodied in its Core Values and Principles of Staff Employment. In support of this commitment, the institution has in place a Code of Professional Ethics, entitled Living our Values (the Code). The Code applies to all staff worldwide and is available on IBRD's website, www.worldbank.org.

Orientation training for new staff and other ethics training, attended by approximately 3,000 staff annually, promote awareness and familiarize staff with the Code.

The World Bank Group is currently finalizing an updated Code, which is expected to be rolled out in the first quarter of FY 2010 as the "Code of Conduct." An e-learning module on the updated Code is also in the final design phases, with rollout planned for the second quarter of FY 2010. This training will be for certification, and staff, including consultants, will be required to complete an acknowledgment that they will abide by the tenets of the Code.

In addition to the Code, the business conduct obligations of staff are articulated in the Staff Manual (Principles of Staff Employment, Staff Rules), Administrative Manual and other guidelines. The Principles and Staff Rules require that all staff avoid or properly manage conflicts of interest.

Further the Code, rules and policies, 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 the World Bank Group's business conduct framework. In accordance with the Staff Rules, senior managers must complete a confidential financial disclosure instrument with the Office of Ethics and Business Conduct.

The following World Bank Group units assist in communicating business conduct expectations to staff :

- The Office of Ethics and Business Conduct (EBC) works to ensure that staff are aware of their business conduct-related obligations. It provides insight on ethics trends to senior

management and oversees related outreach, training and communication initiatives. EBC also handles allegations of staff misconduct not involving significant fraud and corruption.

- The Integrity Vice Presidency (INT) is charged with investigating allegations of significant fraud and corruption both within the World Bank Group and in Bank-funded projects worldwide. It also trains and educates staff and clients in detecting and reporting fraud and corruption.
- Both EBC and INT report directly to the President of the World Bank Group. Staff from these units include professionals from a broad range of disciplines including trainers, financial analysts, researchers, investigators, lawyers, prosecutors, forensic accountants, and staff with World Bank Group operational experience. These units maintain comprehensive websites to provide guidance on how to handle concerns.

The World Bank Group has both an Ethics HelpLine and a Fraud and Corruption hotline, overseen by EBC and INT respectively. These resources are referenced in the Code, and are run by an outside firm staffed by trained specialists. This third-party service offers numerous methods of communication in addition to a toll free service in countries where access to telecommunications may be limited. These phone services can accept calls in multiple languages. Other reporting channels include: phone, mail, email (EBC maintains a Lotus Notes service account called Ethics_HelpLine), anonymously, or through confidential submission through the units' respective websites. Callers may also visit the offices in person.

IBRD has in place procedures for the receipt, retention and handling of recommendations and concerns identified during accounting, internal control and auditing processes.

The World Bank Group's Staff Rules clarify and codify the obligations of staff in reporting suspected fraud, corruption or other misconduct that may threaten the operations or governance of the World Bank Group. Additionally, these rules offer protection from retaliation. In FY 2008, the institution implemented strengthened whistleblower protections.

Auditor Independence

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. In FY 2009 in connection with the mandatory rebidding process, KPMG began a five-year term as IBRD's external auditor.

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 FAIR VALUE FINANCIAL STATEMENTS TO REPORTED BASIS

IBRD's Condensed Fair Value Balance Sheet at June 30, 2008 is presented, with a reconciliation to the reported basis, in **Table 18** below. Similarly, IBRD's Condensed Fair Value Statement of Income for the year ended June 30, 2008 is presented, with a reconciliation to the reported basis, in **Table 19**.

Table 18: Condensed Fair Value Balance Sheet at June 30, 2008*In millions of U.S. dollars*

	June 30, 2008		
	Reported Basis	Additional Fair Value Adjustments	Fair Value Basis
Due from Banks	\$ 890		\$ 890
Investments	26,598		26,598
Net Loans Outstanding	97,268	\$1,124	98,392 ^a
Receivable from Derivatives			
Investments	5,857		5,857
Client Operations	20,269		20,269
Borrowings	76,098		76,098
Others	609		609
Other Assets	5,722		5,722
Total Assets	<u>\$233,311</u>	<u>\$1,124</u>	<u>\$234,435</u>
Borrowings	\$87,402	\$2,544	\$ 89,946
Payable for Derivatives			
Investments	6,309		6,309
Client Operations	20,263		20,263
Borrowings	69,152		69,152
Others	1,007		1,007
Other Liabilities	7,630		7,630
Total Liabilities	191,763	\$2,544	194,307
Paid in Capital Stock	11,486		11,486
Retained Earnings and Other Equity	30,062	(1,420)	28,642
Total Equity	41,548	(1,420)	40,128
Total Liabilities and Equity	<u>\$233,311</u>	<u>\$1,124</u>	<u>\$234,435</u>

^a Effective July 1, 2009, IBRD modified its loans valuation approach for consistency with FAS 157. Had the model been in place as of June 30, 2008, the fair value of loans would have been \$96,941 million, instead of \$98,392.

Table 19: Condensed Fair Value Statement of Income for the year ended June 30, 2008^a*In millions of U.S. dollars*

	FY 2008		
	Reported Comprehensive Basis	Adjustments to Fair Value	Fair Value Comprehensive Basis ^b
Income from Loans	\$5,497		\$5,497
Income from Investments, <i>net</i> ^c	1,066		1,066
Other Income	300		300
Total Income	<u>6,863</u>		<u>6,863</u>
Borrowing Expenses	4,017		4,017
Administrative Expenses including contributions to Special Programs	1,258		1,258
Release of Provision for Losses on Loans and Guarantees	(684)	\$684	-
Other Expenses	1		1
Total Expenses	<u>4,592</u>	<u>684</u>	<u>5,276</u>
Operating Income	2,271	(684)	1,587
Board of Governors-Approved Transfers	(740)		(740)
Fair Value Adjustment on Non-Trading Portfolios, <i>net</i>	(40)	(403) ^d	(443)
Fair Value Adjustment on Loans		983	983
Currency Translation Adjustment and Other Adjustments		(252)	(252)
Net (Loss) Income	<u>\$1,491</u>	<u>\$(356)</u>	<u>\$1,135</u>

^a Amounts have been reclassified to conform with the current year's presentation.

^b Comprehensive basis comprises net income on a reported basis as well as the components of other comprehensive income as reported in the financial statements.

^c Unrealized gains on derivatives in the investment trading portfolio are included in Income from Investments, *net*.

^d As of June 30, 2008, a fair value adjustment was necessary because non-hybrid debt instruments were carried at amortized cost.

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. COSO was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative which studied the causal factors that can lead to fraudulent financial reporting. In 1992, COSO issued its Internal Control-Integrated Framework, which provided a common definition of internal control and guidance on judging its effectiveness.

Credit Default Swaps (CDS): A derivatives contract that provides protection against deteriorating credit quality and would allow one party to receive payment in the event of a default or specified credit event by a third party.

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 fair value adjustment on non-trading portfolios, net) 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, effective and undisbursed DDOs and guarantees, deferred loan income and Long-Term Income Portfolio assets.

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

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 instrument or economic condition.

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.

Strategic Capital Adequacy Framework: Evaluates IBRD's capital adequacy as measured by stress test and appropriate long term equity-to-loan target range. This target equity-to-loans range provides a background framework in the context of annual net income allocation decisions, as well as in the assessment of the initiatives for the use of capital. The capital adequacy framework has been approved by the Executive Directors.

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 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.