

Financial Review

Operating income¹ in fiscal year 2005 was \$1.953 billion, above the \$982 million earned in FY04 and \$528 million in FY03. Including a \$62 million gain from derivatives and hedging activities, IFC's net income totaled \$2.015 billion in FY05, compared to \$993 million in FY04. Operating income in FY05 comprised income of \$1.759 billion on the Corporation's client services operations (compared to \$911 million in FY04) and income on treasury services of \$194 million, after administrative expenses (above the \$71 million treasury contribution in FY04). Overall, the Corporation's operating return on average net worth rose from 13.7 percent in FY04 to 22.6 percent in FY05.

The strong growth in profit on client services operations reflected significant realized gains on sales of investments, robust dividend income from the equity portfolio, stronger loan portfolio income, and the positive impact of a release of loss reserves in FY05. The loan portfolio generated operating income of \$323 million in FY05 (after charges for non-accruals, specific loss provisions, internal administrative expenses, borrowing costs, and loan hedging costs). This follows an operating profit of \$304 million in FY04.

The equity and quasi-equity portfolios—the portfolios funded from net worth—recorded operating income of \$1.4 billion in FY05, significantly above \$585 million in FY04. Capital gains realized on equity sales totaled a record \$723 million in FY05, up from \$381 million in FY04.

The liquid asset portfolios outperformed their investment benchmarks in FY05 and earned a positive return for the year. Reflecting a rise in U.S. Treasury yields, income from liquid assets rose to \$194 million including \$175 million of realized and unrealized trading losses (compared to \$71 million and \$104 million respectively in FY04).

New investment commitments for IFC's account amounted to \$5.4 billion (including \$220 million in signed guarantees), and an additional \$1.1 billion in loan syndications were signed. The disbursed outstanding investment portfolio stood at \$12.3 billion at June 30, 2005, about the same level as the year before. The Corporation's administrative expenses grew 12 percent to \$403 million in FY05. As a share of the average disbursed investment portfolio, total administrative expenses rose to 3.3 percent in FY05, up from 3.0 percent in FY04. Administrative expenses include the grossing-up effect of certain revenues and expenses attributable to the Corporation's reimbursable program (\$33 million in FY05, as compared

with \$34 million in FY04). IFC's borrowings continued to keep pace with its lending activities. New borrowings in the international markets totaled \$2.0 billion equivalent in FY05.

IFC'S FINANCIAL PERFORMANCE HIGHLIGHTS

(millions of U.S. dollars)

	FY05	FY04
Client services—operating income	1,759	911
Loan—operating income	323	304
Equity/quasi-equity—operating income	1,425	585
Technical assistance	(8)	(7)
Contributions to facilities	(38)	(29)
Corporate charges and other	57	58
IFC treasury services—operating income	194	71
IFC treasury services—liquid assets	194	71
IFC operating income	1,953	982

Financial Performance of Major Product Lines

Disbursed and outstanding loans (excluding loan-type quasi-equities), or straight loans, rose 3 percent to \$8.3 billion in FY05. IFC's loan portfolio recorded operating income of \$325 million in FY05, compared to \$304 million in FY04. Lower nonaccrual rates, higher recoveries of interest past due, stronger financial fee income, and a release of specific loss reserves all contributed to the improved performance of the straight loan portfolio. Operating income here was equivalent to a return of 22.7 percent of capital employed in FY05, unchanged from FY04.

The equity and quasi-equity portfolio (including loan-type quasi-equities), IFC's net worth funded portfolio, totaled \$4.0 billion outstanding in FY05. This portfolio recorded a record operating income of \$1.4 billion in FY05, compared to \$585 million in FY04, because of significant capital gains from sales of equities, strong dividend income, and changes in carrying value of equity investments. Capital gains realized on equity sales totaled \$723 million in FY05, compared with \$381 million in FY04. Due in part to continued demand in the global markets for energy and resources, dividend income also grew strongly, totaling \$258 million in FY05, up from \$207 million in FY04. Changes in the carrying value of investments contributed \$269 million to equity portfolio income in FY05, compared to \$74 million in FY04. In addition, in FY05, \$191 million of

1. Operating income is defined as income after expenditures for technical assistance and advisory service (TAAS) but before any gain/loss from accounting for derivatives and hedging activities (SFAS No. 133). Certain amounts in the prior years have been reclassified to conform to the current year's presentation.

unrealized gains were recognized on investments accounted for by the equity method. Operating income on this portfolio (net of custody fees and derivatives gains/losses) amounted to a return on capital employed of 44.5 percent in FY05, after 17.6 percent in FY04.

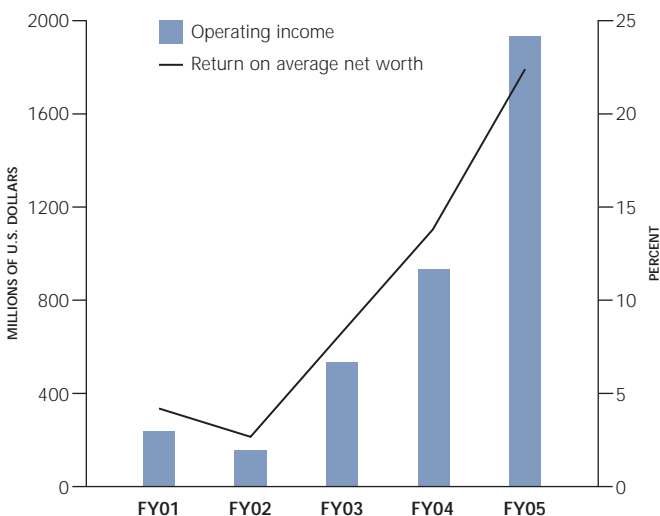
In FY05 there was another release of loss provisions totaling \$261 million, compared to \$103 million released in FY04. The total reserve against losses on loans declined to 9.9 percent of the year-end disbursed and outstanding loan portfolio, significantly below the level of 14.0 percent in FY04.

Capital and Retained Earnings

IFC's net worth consists of retained earnings and paid-in capital. IFC's paid-in capital was \$2.4 billion, unchanged from the end of FY04, while net income of \$2.0 billion increased retained earnings to \$7.4 billion. The Corporation's net worth at the end of FY05 was \$9.8 billion.

On June 30, 2005, IFC's capital adequacy ratio (paid-in capital, retained earnings, and adjusted general reserves compared with risk-weighted assets, both on- and off-balance sheet) stood at 50 percent. This is well above the policy minimum of 30 percent, defined under the capital adequacy framework adopted by the Board of Directors in May 1994. IFC's leverage ratio—outstanding borrowings and guarantees measured in relation to the sum of subscribed capital and retained earnings—was 1.8 to 1, well within the limit of 4.0 to 1 prescribed by the Articles of Agreement.

**OPERATING INCOME AND
RETURN ON AVERAGE NET WORTH**



Funding Management

In FY05, IFC borrowed \$2.0 billion equivalent in the international capital markets and repurchased \$133 million in outstanding debt. These repurchases were undertaken as part of IFC's strategy of enhancing the liquidity of its outstanding bond issues.

IFC issued securities in six currencies during FY05: U.S. dollars, Japanese yen, Peruvian soles, Malaysian ringgit, Moroccan dirham, and South African rand. The largest borrowing of the year was a \$1 billion global bond issue.

IFC raised 50 percent of total new borrowings in FY05 through a U.S. dollar global bond issue, 22 percent via structured issues primarily in Japan, 2 percent in Peruvian soles, 6 percent in Moroccan dirham, 7 percent in Malaysian ringgit, and 13 percent in South African rand. Notable among these was the Moroccan dirham issue, which was the first borrowing by a non-resident entity in that currency, and the Malaysian ringgit issue, which was the first domestic currency borrowing by a supranational under Islamic finance principles. All borrowings were swapped into floating-rate U.S. dollars. Most loans made by IFC are denominated in U.S. dollars on a floating-rate basis. The below-LIBOR cost achieved through the use of currency and interest rate swaps as well as the income generated through debt repurchases contributed to maintaining IFC's low funding cost in FY05.

Liquidity Management

Liquid assets on the balance sheet totaled \$13.3 billion on June 30, 2005, up from \$13.0 billion a year earlier. The majority of liquid assets are held in U.S. dollars, with small euro and yen balances held to support operational disbursements. Total liquid assets held are determined by constraints associated with IFC's AAA/Aaa credit ratings and, notably, by the pace of new market borrowings and new loan and equity disbursements to clients.

In FY05, IFC's liquid asset portfolios faced a challenging environment, and both the externally and internally managed portfolios had difficulty outperforming their benchmarks. The most important market events were the steady increase in interest rates by the U.S. Federal Reserve, coupled with unexpected strength at the long end of the yield curve. Even though overnight Fed Funds rose to 3.25 percent by the end of the fiscal year, the 10-year U.S. Treasury yield fell from around 4.5 percent to below 4 percent during the year, resulting in a dramatic flattening of the yield curve. The other key trends were the steep rise in oil prices, the decline of the U.S. dollar versus most other major currencies (though it had regained its losses by the end of FY05), and a relatively weak performance by the U.S. stock market. The

U.S. economy remained fairly strong, with unemployment falling and the housing sector showing no signs of moderating its growth. Inflation remained subdued. In Europe, growth was stagnant; unemployment remained high and consumer spending weak. Japan appears to have begun a modest recovery, and there have been some signs that the Bank of Japan might start tightening conditions, at least moderately.

In this environment, the liquid asset portfolios generated \$194 million in operating income, with \$124 million in spread income from funded liquidity and \$70 million from net worth liquidity, comprising interest income net of realized and unrealized losses. This compares with \$71 million during FY04, which included \$39 million in spread income from funded liquidity and \$32 million in interest and gains income from net worth liquidity.

IFC's liquid assets are invested in line with policies and standards set under the Investment Authority granted by the Board of Directors. The authority specifies the types of instruments and entities eligible for investment. IFC is authorized to invest its liquid assets in the obligations of highly rated governments, agencies, corporations, and commercial banks. Within the authority's framework, IFC's senior management has established prudent guidelines for managing the different dimensions of risk inherent in a large, diversified bond portfolio with particular regard to market (interest rate) risk and credit risk. For management and reporting purposes, IFC's liquid assets are separated into five distinct portfolios and invested globally in the highest-quality assets, including sovereign and triple-A-rated corporate bonds.

The P0 portfolio is a cash account that accommodates all of IFC's daily requirements, ranging from project cash movements (loans, equity, market borrowings) to administrative expenses of the Corporation. The portfolio also manages about \$450 million cash for the P2 portfolio, as part of that portfolio's new benchmark. The larger portfolio size, which is slightly longer in duration, has allowed P0 to take advantage of higher-yielding short-dated assets, including very short average life home equity lines and home equity lines of credit. At the beginning of FY05, P0's benchmark was changed from an overnight Effective Fed Funds target to overnight LIBID (LIBOR-12.5 basis points). While the change has not had a significant effect on portfolio performance, the new target is more in line with industry practice for an overnight book. P0 outperformed its LIBID benchmark by 18 basis points,

delivering a return of 2.37 percent compared to 2.09 percent on the benchmark.

The P1 portfolio consists of funded liquidity, specifically the proceeds of variable-rate borrowings, which are invested in high-quality investments pending disbursements of approved loans. IFC's objective is to outperform the total return of its benchmark—three-month U.S. dollar deposits—within the interest rate and credit risk limits allowed. The total return was 2.24 percent as compared to the benchmark return of 2.17 percent, with an excess return of 7 basis points.

The P2 portfolio corresponds primarily to the Corporation's paid-in capital and accumulated earnings. P2 is managed against the Lehman Brothers U.S. Intermediate Treasury benchmark. The portfolio is actively managed on a total return basis against this benchmark. The return for FY05 was 3.73 percent versus a benchmark return of 3.80 percent.

The P3 portfolio consists of funded liquidity, originally taken from the P1 portfolio. This portfolio is actively managed by six external managers against the P1 benchmark. At the end of FY05, assets in the P3 portfolio totaled \$1.128 billion—about 8 percent of the Corporation's total liquid assets. The portfolio consists of a global fixed income (GFI) program allocated to two asset managers with \$317 million under management and a mortgage-backed securities (MBS) program allocated to two asset managers with \$380 million under management. The remaining \$431 million is managed by two asset managers as a hybrid GFI/MBS mandate. The P3 portfolio delivered an absolute return of 2.35 percent for FY05, outperforming the benchmark by 0.10 percent.

The P4 portfolio is the outsourced portion of the P2 portfolio. P4 is actively managed by three managers against the Lehman Brothers U.S. Intermediate Treasury Index, like the P2 benchmark. At the end of FY05, assets in the P4 portfolio totaled \$415 million, about 3 percent of the Corporation's total liquid assets. For FY05, the P4 portfolio delivered 4.51 percent and beat its benchmark by 0.65 percent.

Risk Management and Financial Policies

In keeping with industry best practice, risk management and financial policies are administered by a separate department under the Vice Presidency of Portfolio and Risk Management. The department is independent from all transaction groups and is responsible for recommendations on financial policy

and risk management issues, risk measurement methodologies, risk limits, capital allocation and pricing, internal financial policy guidelines, monitoring compliance with these guidelines, and rating agency issues. It covers business operations, treasury activity, and active portfolio management with a view to ensuring coherence and consistency in policies and an integrated financial framework for all business activities.

IFC's overall activities are governed by a set of financial policies on exposure, capital adequacy, leverage, asset-liability management, liquidity, and derivatives. Specific activities in treasury and portfolio management are subject to detailed internal management guidelines for each area of activity.

IFC has policies that set guidelines on exposure to countries, sectors, products, and groups as well as single obligors. While these guidelines serve to limit and monitor business exposures, IFC also limits its financial risks through conservative financial policies. These include a minimum capital adequacy ratio of 30 percent of risk-weighted assets and a maximum ratio of debt plus outstanding guarantees to net worth of 4 to 1 as long as IFC has any outstanding borrowings from the IBRD. In addition, IFC has conservative approaches to asset-liability, liquidity, and derivatives exposure management as described below.

Funding, interest rate, and currency exposure is controlled through the matched funding policy, which requires loan assets to be funded by liabilities that have matching interest rate and currency characteristics. In order to accommodate client needs for loans in nondollar currencies in fixed or floating rates, and to allow for flexibility in borrowing and investment of liquid assets in various currencies and alternative interest rate bases, IFC makes use of derivatives, primarily over-the-counter swaps, to transform assets and liabilities into synthetic variable-rate dollar assets and liabilities. Equity and quasi-equity assets are funded from net worth and are limited by policies that require such investments not to exceed 100 percent of net worth.

Currency and interest rate mismatches that arise over the course of a loan's life (due to provisioning, prepayments, reschedulings, receipt of spread or fee income in nondollar currencies, and possible differences in LIBOR reset dates between assets and liabilities) are monitored and hedged on an ongoing basis subject to operational limits.

IFC's liquidity requirements are governed by the matched-funding policy and the liquidity policy. Under the matched-funding policy, IFC carries funded liquidity for approved but undisbursed loans. Under the liquidity policy, IFC is required to maintain at all times a level of liquid assets of not less than 65 percent of the next three years' projected net cash flow requirements.

IFC's liquid asset holdings are made up of market-funded portfolios and a net worth-funded portfolio. Interest rate risks are

managed against duration benchmarks for each of the portfolios, and currency risks are managed by using derivatives to hedge the currency exposure. Credit risks are managed through eligibility requirements for investments and issuer limits based on size and rating as well as concentration limits on asset classes.

IFC uses derivatives in the areas of funding, liquidity management, asset-liability management, client risk management products, and active portfolio management.

With the exception of the use of derivatives for active portfolio management, and some positions taken in liquid assets management, uses of derivatives do not entail market risk as they are used only for hedging purposes. Market risk arising from derivative use in liquid assets and portfolio management activities is subject to the respective guidelines for such activities. While the other derivatives used only for hedging do not entail open market risk, they create credit exposure that arises from the potential counterparty default when the derivative contract has positive value to IFC.

To manage these counterparty exposures, IFC has credit risk policies relating to eligibility criteria and credit limits that are coordinated with those of the IBRD. Limits are set in terms of the total potential exposure to the counterparty.

To protect against counterparty downgrades subsequent to undertaking contracts, IFC has entered into mark-to-market collateral agreements with most of its derivative counterparties.

The active portfolio management program enables IFC to hedge and manage the aggregate financial risks, returns, and exposures incurred in connection with its portfolio of loan, quasi-equity, and equity investments. The proactive use of risk management techniques, hedging instruments, and income enhancement strategies is tailored to IFC's financial risk tolerance and income objectives.

TREASURY CREDIT RISK ALLOCATION

