

Management's Discussion and Analysis of Financial Condition and Results of Operations

I. OVERVIEW

International Finance Corporation (IFC or the Corporation) is an international organization, established in 1956, to further economic growth in its developing member countries by promoting private sector development. IFC is a member of the World Bank Group, which also includes the International Bank for Reconstruction and Development (the World Bank), the International Development Association (IDA), and the Multilateral Investment Guarantee Agency (MIGA). It is a legal entity separate and distinct from the World Bank, IDA, and MIGA, with its own Articles of Agreement, share capital, financial structure, management, and staff. Membership in IFC is open only to member countries of the World Bank. As of June 30, 2005, IFC's entire share capital was held by 178 member countries.

IFC's principal products are loans and equity investments, with a small guarantee portfolio. Unlike most multilateral development institutions, IFC does not accept host government guarantees of its loans. IFC raises virtually all of the funds for its lending activities through the issuance of debt obligations in the international capital markets, while maintaining a small borrowing window with the World Bank. Equity investments are funded from net worth. During the year ended June 30, 2005 (FY05), IFC had an authorized borrowing ceiling of \$3.0 billion (including \$0.5 billion to allow for possible prefunding of the funding program for the year to June 30, 2006 (FY06) during FY05).

IFC's capital base and its assets and liabilities are primarily denominated in US dollars. The Corporation seeks to minimize market risk (foreign exchange and interest rate risks) by closely matching the currency, rate bases, and maturity of its liabilities in various currencies with assets having the same characteristics. The Corporation controls residual market risk by utilizing currency and interest rate swaps and other derivative instruments.

II. FINANCIAL SUMMARY

Basis of preparation of the Corporation's financial statements

The accounting and reporting policies of the Corporation conform to accounting principles generally accepted in the United States (US GAAP).

The Corporation has traditionally prepared one set of financial statements and footnotes, complying with both US GAAP and International Financial Reporting Standards (IFRS). However, principally due to material differences between US Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivatives and Certain Hedging Relationships* (collectively SFAS No. 133), and its counterpart in IFRS, IAS No. 39, *Financial Instruments Recognition and Measurement*, it has not been possible for the Corporation to satisfy the requirements of both US GAAP and IFRS via one set of financial statements since the year ended June 30, 2000.

IFC is actively monitoring developments related to accounting standards and the primary basis for preparation of its financial statements, all with a view to the necessary systems and controls to manage its various lines of business. IFC plans to resume presentation of its financial statements using IFRS by the year ending June 30, 2007.

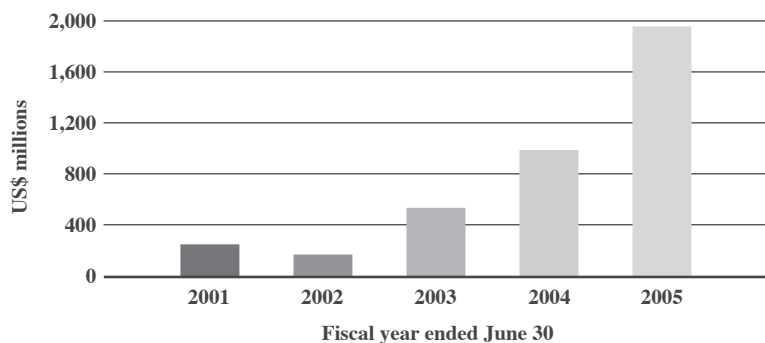
Unless stated otherwise, discussions of financial performance herein refer to income after expenditures for technical assistance and advisory service (TAAS) (operating income). Operating income excludes the effects of SFAS No. 133. The effects of SFAS No. 133 on net income are discussed in Section VII.

Financial performance summary

From year to year, IFC's operating income is affected by a number of factors, principally the magnitude of provisions for losses against its loans and guarantees; impairment of equity investments; loans in nonaccrual status and recoveries of interest on loans formerly in nonaccrual status; and income (dividends and capital gains) generated from its equity portfolio. A significant part of IFC's liquid assets portfolio is invested in fixed income securities, which are also subject to external market factors that affect the value of such securities, adding variability to operating income. Net income also includes net gains and losses on financial instruments other than from trading activities, pursuant to the implementation of SFAS No. 133.

IFC has been consistently profitable since its inception in 1956, and recorded operating income for FY05 of \$1,953 million, as compared with \$982 million for the year ended June 30, 2004 (FY04), and \$528 million for the year ended June 30, 2003 (FY03). The \$1,953 million of operating income in FY05 was a record high for the third consecutive year for the Corporation, reflecting strong contributions across each of IFC's main product lines: loans, equities and treasury operations. The Corporation reported record net income in FY05, including the effects of SFAS No. 133, of \$2,015 million, as compared with \$993 million for FY04 and \$487 million for FY03.

The Corporation's operating income for the past five fiscal years ended June 30 is presented below:



The table below presents selected financial data for the last five fiscal years (in millions of US dollars, except where otherwise stated):

	As of and for the years ended June 30				
	2005	2004	2003	2002	2001
Net income highlights:					
Interest income	1,193	796	795	1,040	1,505
Of which:					
Interest and financial fees from loans	660	518	477	547	732
Income from time deposits and securities	533	278	318	493	773
Charges on borrowings	(309)	(141)	(226)	(438)	(961)
Net (losses) gains on trading activities	(175)	(104)	157	31	87
Net income from equity investments	1,365	658	145	160	26
Of which:					
Realized capital gains on equity sales	723	381	52	288	91
Dividends and profit participations	258	207	147	141	131
Unrealized income from LLPs and certain LLCs	191	-	-	-	-
Changes in carrying value of equity investments	269	74	(50)	(268)	(196)
Equity investment impairment write-downs	(62)	-	-	-	-
Net losses on equity-related derivatives and custody & other fees	(14)	(4)	(4)	(1)	-
Release of (provision for) losses on loans & guarantees	261	103	(48)	(389)	(206)
Net noninterest expense	(344)	(330)	(295)	(243)	(210)
Income before expenditures for TAAS	1,991	982	528	161	241
Expenditures for TAAS	(38)	-	-	-	-
Income after expenditures for TAAS (operating income)	1,953	982	528	161	241
Net gains (losses) on other financial instruments	62	11	(41)	54	11
Effect of accounting change	-	-	-	-	93
Net income	2,015	993	487	215	345
Balance sheet highlights:					
Total assets	39,560	32,361	31,543	27,739	26,170
Liquid assets, net of associated derivatives	13,325	13,055	12,952	14,532	13,258
Loans and equity investments, net	11,489	10,279	9,377	7,963	8,696
Borrowings withdrawn and outstanding	15,359	16,254	17,315	16,581	15,457
Total capital	9,798	7,782	6,789	6,304	6,095
Key financial ratios: (1)					
Return on average assets (2)	5.4%	3.1%	1.8%	0.6%	0.6%
Return on average net worth (3)	22.6%	13.7%	8.2%	2.7%	4.1%
Cash and liquid investments as a percentage of next three years' estimated net cash requirements	142%	116%	107%	109%	101%
Debt to equity ratio (4)	1.8:1	2.3:1	2.6:1	2.8:1	2.6:1
Capital adequacy ratio (5)	50%	48%	45%	49%	48%
Total reserve against losses on loans to total disbursed loan portfolio (6)	9.9%	14.0%	18.2%	21.9%	16.0%

1. Key financial ratios are generally calculated excluding the effects of SFAS No. 133.

2. Return on average assets is defined as operating income for the fiscal year as a percentage of the average of total assets at the end of such fiscal year and the previous fiscal year.

3. Return on average net worth is defined as operating income for the fiscal year as a percentage of the average of total net worth (excluding payments on account of pending subscriptions) at the end of such fiscal year and the previous fiscal year.

4. Debt to equity ratio is defined as the ratio of outstanding borrowings plus outstanding guarantees to subscribed capital plus retained earnings at the end of the fiscal year.

5. Capital adequacy ratio is defined as the ratio of capital (including paid-in capital, retained earnings, and general loan loss reserve) to risk-weighted assets, both on- and off-balance sheet.

6. Total reserves against losses on loans to total disbursed loan portfolio is defined as reserve against losses on loans as a percentage of the total disbursed loan portfolio at the end of the fiscal year.

III. CLIENT SERVICES

Business overview

In partnership with private investors, IFC assists in financing the establishment, improvement, and expansion of private sector enterprises by making investments where sufficient private capital is not otherwise available on reasonable terms. IFC seeks to bring together domestic and foreign private capital and experienced management and thereby create conditions conducive to the flow of private capital (domestic and foreign) into productive investments in its developing member countries. In this way, IFC plays a catalytic role in mobilizing additional project funding from other investors and lenders, either through cofinancing or through loan syndications and guarantees. In addition to project finance (described below) and resource mobilization, IFC offers financial and technical advisory services to private businesses in developing member countries. It also advises member governments on private sector development matters.

IFC's investments are normally made in its developing member countries. The Articles of Agreement mandate that IFC shall invest in productive private enterprise. The requirement for private ownership does not disqualify enterprises that are partly owned by the public sector if such enterprises are organized under local commercial and corporate law, operate free of host government control in a market context and according to profitability criteria, and/or are in the process of being totally or partially privatized.

The Corporation's main investment activity is project financing. This encompasses "greenfield" projects, expansions, and modernizations. IFC also provides corporate credits to selected companies to finance ongoing programs of investment projects. In addition, the Corporation facilitates financing through financial intermediaries, covering project and general purpose lending and specialized lending products such as leasing, trade, and mortgage finance. These financial intermediaries function either as IFC's borrower, on-lending to private sector companies at their own risk, or as IFC's agent, identifying companies for direct loans from IFC.

The Corporation applies stringent tests of enterprise soundness, project viability, and developmental impact in determining the eligibility of projects for its investments.

Technical assistance and advisory services

IFC has historically delivered its mission primarily through investments. IFC has increased its efforts in frontier markets and sustainable development. As a result, the demands on the Corporation for associated advisory work and technical assistance have increased and continue to grow. In FY04, IFC established a funding mechanism for technical assistance and advisory services, funded by designations of IFC's retained earnings. This funding mechanism finances project development facilities, private enterprise partnerships, and similar facilities focused on small and medium-size enterprise development and similar initiatives.

Amounts designated for technical assistance and advisory services are determined based on the Corporation's annual operating income in excess of \$150 million, contemplating the financial capacity and priorities of the Corporation, and are approved by the Corporation's Board of Directors prior to the issuance of the annual financial statements. Expenditures for the various approved technical assistance and advisory projects are recorded as expenses in the Corporation's income statement in the year in which they occur, beginning in the year ended June 30, 2005 (FY05), and have the effect of reducing retained earnings designated for this specific purpose. On August 3, 2004, IFC's Board of Directors approved a designation of \$225 million of the Corporation's retained earnings. On July 28, 2005, IFC's Board of Directors approved a further designation of \$125 million of the Corporation's retained earnings. Additional information on the funding mechanism for technical assistance and advisory services can be found in Notes A and K to the Corporation's FY05 financial statements.

Performance-based grants initiative

In FY05, IFC began the analysis to create a program to fund performance-based grants, targeted at specific industries in developing countries. The performance-based grants initiative (PBGI) involves establishing a pool of resources for funding performance-based grants to individual private-sector projects in developing markets. The PBGI will further IFC's frontier strategy by opening new opportunities to generate developmental impact.

The initiative has been discussed by IFC's Board of Directors during the second half of FY05 but no decisions on the principles or modalities of the initiative have yet been made. As a result, IFC has designated \$250 million of retained earnings for the initiative, with further deliberations to occur in FY06 on the principles and specifics of the initiative.

Investment process and portfolio supervision

IFC's investment process can be divided into six main stages:

- Identification and appraisal
- Board approval
- Document negotiation
- Commitment
- Disbursement
- Supervision

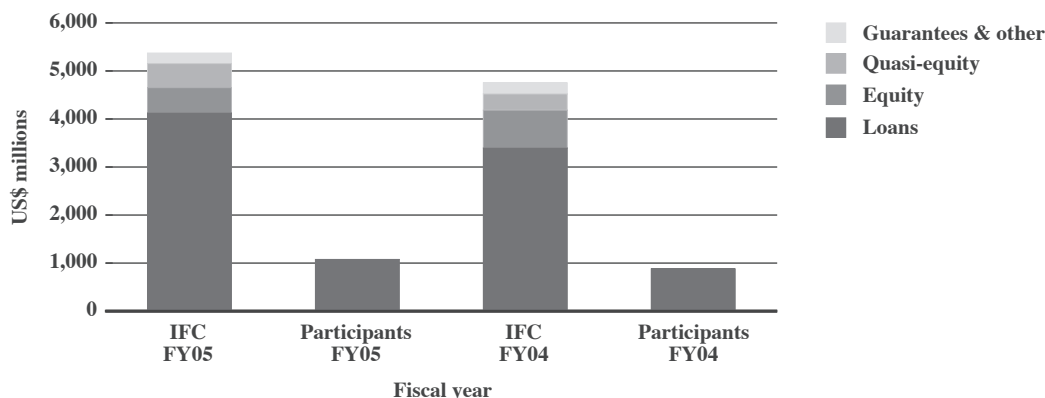
The initial four stages are carried out under the responsibility of the Vice President, Investment Operations, while the fifth and sixth stages are overseen by the Vice President, Portfolio and Risk Management.

The Corporation carefully supervises its projects to monitor project performance and compliance with contractual obligations and with IFC's internal policies and procedures. IFC's Board of Directors is informed of such matters and of recommended courses of action at regular intervals.

Investment program summary

Commitments

In FY05, the Corporation entered into new commitments totaling \$5.4 billion, compared with \$4.8 billion for FY04. Loan and equity investment commitments pending disbursement at June 30, 2005 were \$5.8 billion (\$4.6 billion at June 30, 2004). Guarantees and client risk management facilities committed but not utilized at June 30, 2005, were \$0.8 billion (\$0.7 billion at June 30, 2004). FY05 and FY04 commitments comprised the following:

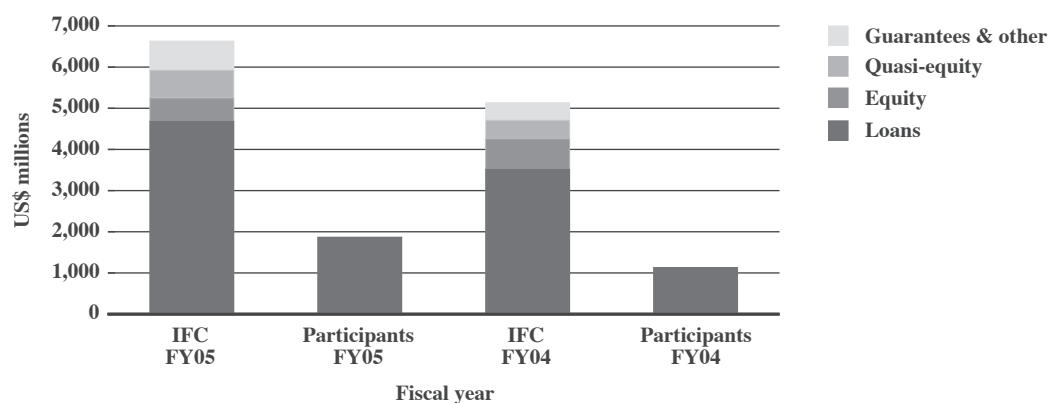


Disbursements

IFC disbursed \$3.5 billion for its own account in FY05 (\$3.2 billion in FY04). IFC's disbursed and outstanding loan portfolio for its own account, excluding fair value adjustments, (disbursed loan portfolio) grew 2% to \$10.0 billion at June 30, 2005 (\$9.7 billion at June 30, 2004). IFC's equity investment portfolio, net of impairment write-downs and including unrealized gains on investments in LLPs and certain LLCs, grew 32% to \$2.5 billion at June 30, 2005 (\$1.9 billion at June 30, 2004). The increase in the equity investment portfolio was principally attributable to the Corporation's changed process of estimating impairment as detailed in Note C to the Corporation's FY05 financial statements.

Approvals

In FY05, IFC approved new investments for its own account, including guarantees and client risk management facilities, totaling \$6.6 billion, representing 252 projects, compared with \$5.1 billion in FY04, representing 224 projects. In addition, IFC approved loan participations (B-loans) arranged to be placed with financial institutions (Participants) for loans approved by the Corporation's Board of Directors totaling \$1.9 billion in FY05, compared with \$1.1 billion in FY04. FY05 and FY04 approvals comprised the following:

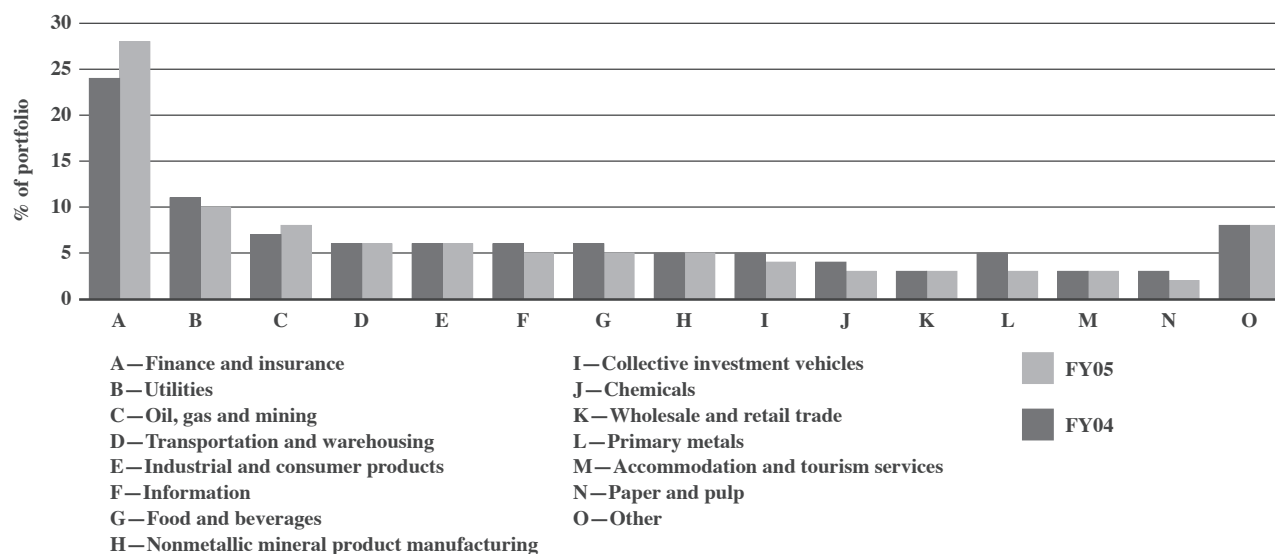


Approvals pending commitment for IFC's own account at June 30, 2005, including guarantees and client risk management facilities, were \$3.5 billion (\$2.4 billion at June 30, 2004).

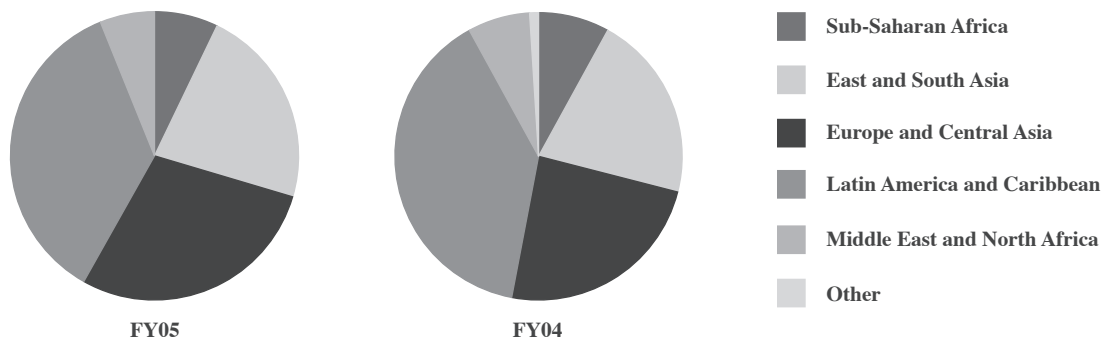
Disbursed investment portfolio

The Corporation's disbursed investment portfolio is widely diversified by sector and geographic region. The following charts show the distribution of the portfolio as of June 30, 2005 and June 30, 2004:

Distribution of disbursed investment portfolio by sector



Distribution of disbursed investment portfolio by geographic region



Disbursed B-loans

The portfolio of disbursed and outstanding B-loans at June 30, 2005 totaled \$4.4 billion in 204 transactions, compared with \$5.1 billion in 204 transactions at June 30, 2004.

Additional information on IFC’s loans and equity investments as of and for the years ended June 30, 2005 and June 30, 2004 can be found in Notes C, D , E, F and G to the Corporation’s FY05 financial statements.

Investment products

Loans

Loans account for the major part of the financing provided by IFC, representing 81% of the Corporation’s disbursed investment portfolio as of June 30, 2005, compared with 79% at June 30, 2004.

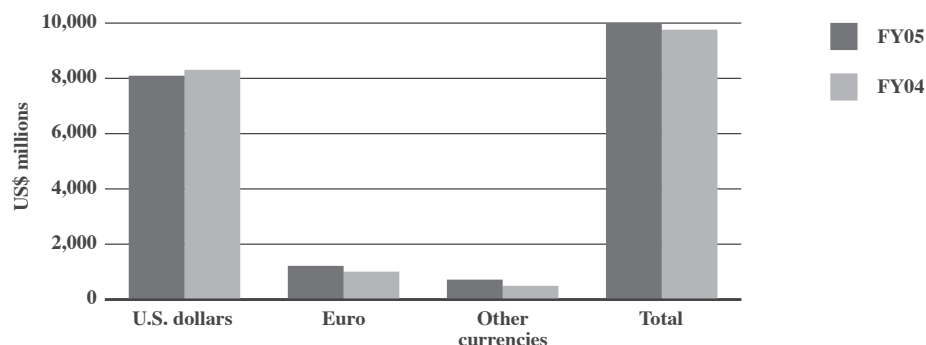
Loans will generally have the following characteristics:

- Term: typically amortizing with final maturities of up to 12 years
- Currency: primarily in major convertible currencies, principally US dollar, and to a lesser extent, Euro, Swiss franc and Japanese yen
- Interest rate: fixed or variable
- Pricing: reflects such factors as market conditions and country and project risks; variable rate loans are generally tied to the 6-month LIBOR index in the relevant currency.

Since the year ended June 30, 1999, IFC has offered local currency loan products to certain clients, provided that the Corporation is able to hedge its local currency exposure through mechanisms such as cross-currency swaps or forward contracts. Fixed-rate loans and loans in currencies other than US dollars are normally transformed, using currency and/or interest rate swaps, into US dollar variable rate loans.

On June 30, 2005, total loans disbursed and outstanding were \$10.0 billion (\$9.7 billion at June 30, 2004). At June 30, 2005, 81% (85% at June 30, 2004) of the Corporation’s loans were US dollar-denominated.

The currency composition of the loan portfolio at June 30, 2005 and June 30, 2004 is shown on the accompanying diagram:



Equity

Equity investments accounted for 19% of the Corporation's disbursed investment portfolio at June 30, 2005, compared with 21% at June 30, 2004. IFC's equity investments are typically in the form of common or preferred stock and are usually denominated in the currency of the country in which the investment is made.

Quasi-equity

In addition to traditional equity investments, the Corporation provides financing through a variety of quasi-equity instruments, which constitute a growing portion of its investment portfolio. Quasi-equities include subordinated or convertible loans, asset-backed securities, mortgage-backed securities, and certain common or preferred shares with put and/or call features. Depending upon their characteristics, quasi-equities may be classified as either loans or equity investments in the Corporation's balance sheet. At June 30, 2005, the Corporation's disbursed and outstanding quasi-equity portfolio totaled \$1,768 million (\$1,645 million at June 30, 2004), of which \$1,638 million was classified as loans (\$1,483 million at June 30, 2004) and \$130 million was classified as equity investments (\$162 million at June 30, 2004) in the Corporation's balance sheet.

Loan participations (B-loans)

IFC finances only a portion, usually not more than 25%, of the cost of any project. All IFC-financed projects, therefore, require other financial partners. The principal direct means by which the Corporation mobilizes such private sector finance is through the sale of participations in its loans, known as the B-loan program. Through the B-loan program, IFC has worked primarily with commercial banks but also with nonbank financial institutions in financing projects since the early 1960s. Over 150 commercial banks and nonbank financial institutions currently participate in IFC's B-loan program.

Whenever it syndicates a loan, IFC will always make a loan for its own account (an A-loan), thereby sharing the risk alongside its loan participants. IFC acts as the lender of record and is responsible for the administration of the entire loan, including the B-loan. IFC charges fees to the borrower at prevailing market rates to cover the cost of the syndication of the B-loan. Since it began its loan syndication program, IFC has placed participations totaling \$24 billion.

Client risk management products

IFC provides clients with access to asset and liability management tools such as currency swaps and interest rate swaps, caps and floors by acting as an intermediary between clients and market counterparties. IFC also provides risk-sharing structures and guarantees that allow its clients to transact directly with market counterparties.

Guarantees and partial credit guarantees

The Corporation offers partial credit guarantees to clients covering, on a risk-sharing basis, client obligations on bonds and/or loans. The Corporation's guarantee is available for debt instruments and trade obligations of clients and covers commercial as well as noncommercial risks. IFC will provide local currency guarantees, but when a guarantee is called, the client will generally be obligated to reimburse the Corporation in US dollar terms. Guarantee fees are consistent with IFC's loan pricing policies. During FY05, the Corporation signed \$0.2 billion of guarantees, substantially unchanged from FY04.

Advisory activities

The Corporation, on its own or through a department jointly managed with the World Bank, provides three general types of advisory services to member countries and individual enterprises:

- Special advisory services on project structuring and financial packaging.
- Financial advisory services provided to member governments or to private sector clients.
- Policy advice to governments on capital markets development and private sector development, including privatization and foreign investment.

The Corporation also assists governments with developing legal frameworks for privatizing their state-owned sectors and selling individual enterprises. Fees are charged for advisory services consistent with market rates charged for comparable services. IFC recorded such fees amounting to \$41 million for FY05 (\$41 million for FY04 and \$51 million for FY03).

Technical assistance and advisory services

The provision of technical assistance and advisory services (TAAS) is an essential part of IFC's business. TAAS programs help IFC to deliver its mandate to support sustainable private sector development, helping to enrich development impact and distinguish IFC from its competition. Beginning in FY05, the Corporation established a funding mechanism for TAAS, funded by designations of IFC's retained earnings, in order to address its increased efforts in TAAS. IFC delivers TAAS through mechanisms such as Project Development Facilities and Private Enterprise Partnerships. In IFC's FY05 financial statements, expenditures for TAAS are separately reported as Expenditures for technical assistance and advisory services. Prior to FY05, such expenditures were reported as Contributions to special programs in noninterest expense. In FY05, expenditures for TAAS totaled \$38 million. In FY04, Contributions to special programs was \$29 million, compared with \$28 million in FY03. In FY05, such vehicles included:

- The World Bank Group's Global SME Capacity Building Facility, which funds partnerships and programs that support the core pillars of the World Bank Group's Small and Medium-Size Enterprise (SME) strategy.
- The Private Enterprise Partnership, which provides focused technical assistance, with the goal of helping build successful private businesses in the former Soviet Union region.
- The Private Enterprise Partnership for Africa, which enhances support to SMEs through project development and engaging in improving the investment climate.
- The Private Enterprise Partnership for the Middle East and North Africa (MENA) , which provides technical assistance to support private sector development to all countries in the MENA region.
- The Corporation's own Technical Assistance Trust Fund, which provides resources through which IFC can cofinance technical assistance being supported by donors.

IV. TREASURY SERVICES

Liquid assets

IFC invests its liquidity in highly rated fixed and floating rate instruments issued by, or unconditionally guaranteed by, governments, government agencies and instrumentalities, multilateral organizations, and AAA-rated corporate issuers; these include mortgage- and asset-backed securities, time deposits and other unconditional obligations of banks and financial institutions.

The Corporation manages the market risk associated with these investments through a variety of hedging techniques including derivatives, principally currency and interest rate swaps and financial futures.

IFC's liquid assets are invested in five separate portfolios.

PORTFOLIO	MARKET VALUE *	COMPRISING	MANAGED BY	INVESTED IN	BENCHMARK
P0	\$1.0bn (\$0.2bn)	Funds awaiting disbursement or reinvestment	IFC's Treasury Department	Short-term deposits	US overnight Fed funds
P1	\$6.7bn (\$7.8bn)	Proceeds from market borrowings invested pending disbursement of operational loans	IFC's Treasury Department	Principally global government bonds, asset-backed securities, and other AAA-rated corporate bonds generally swapped into 6-month US dollar LIBOR	Since January 2001, adjusted 3-month US dollar LIBID **. Prior to January 2001, 6-month US dollar LIBOR
P2	\$4.1bn (\$3.7bn)	Primarily the Corporation's paid-in capital and accumulated earnings that have not been invested in equity and quasi-equity investments or fixed-rate loans	IFC's Treasury Department	US Treasuries and other sovereign and agency issues	3-year duration US Treasuries***
P3	\$1.1bn (\$1.1bn)	Proceeds from market borrowings	External managers appointed by IFC	Global government bonds and mortgage-backed securities	Same as for P1
P4	\$0.4bn (\$0.3bn)	An outsourced portion of the P2 portfolio	External managers appointed by IFC	US Treasuries and other sovereign and agency issues	Lehman Brothers Intermediate Treasury Index
Total	\$13.3bn (\$13.1bn)	* at June 30, 2005 (June 30, 2004) ** adjusted 3 month US dollar LIBID=US dollar LIBOR-12.5 basis points. The net duration of the P1 and P3 benchmarks is approximately 0.25 years. *** duration of P2 portfolio plus fixed-rate loans			

The P3 portfolio is not permitted to exceed 12% of the total value of liquid assets at any time.

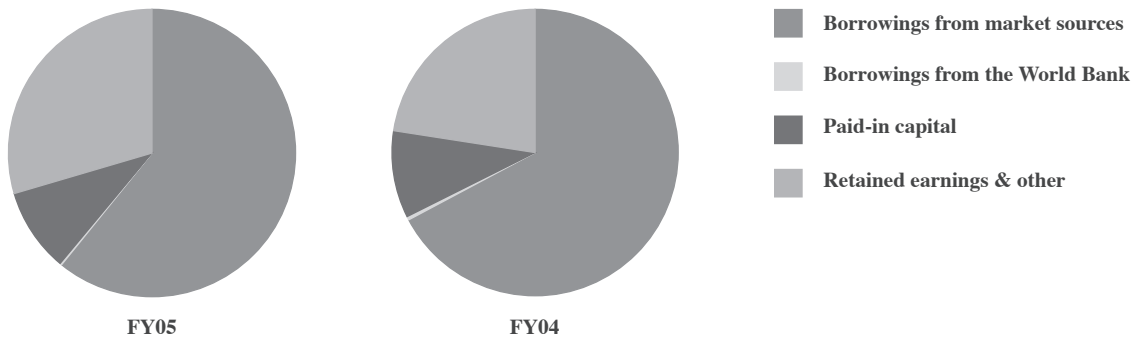
All portfolios are accounted for as trading portfolios.

The Corporation has a flexible approach to managing the liquid assets portfolios by making investments on an aggregate portfolio basis against its benchmark within specified risk parameters. In implementing these portfolio management strategies, the Corporation utilizes derivative instruments, including futures, and options, and takes long or short positions in securities.

All liquid assets are managed according to an investment authority approved by IFC's Board of Directors and investment guidelines approved by IFC's Finance and Risk Committee, a subcommittee of the Corporation's Management Group.

Capitalization

The Corporation's capitalization as of June 30, 2005 and June 30, 2004 is as follows:



Borrowings

The major source of IFC's borrowings is the international capital markets. Under the Articles of Agreement, the Corporation may borrow in the public markets of a member country only with approvals from that member and also the member in whose currency the borrowing is denominated. The Corporation borrowed \$2.0 billion during FY05 (\$3.0 billion in FY04 and \$3.5 billion in FY03). In addition, IFC's Board of Directors has authorized the repurchase and redemption of and tender for debt obligations issued by the Corporation. During FY05, the Corporation repurchased and retired \$133 million of outstanding debt (\$33 million in FY04).

IFC diversifies its borrowings by currency, country, source, and maturity to provide flexibility and cost-effectiveness. Outstanding market borrowings have remaining maturities ranging from less than one year to almost 30 years, with a weighted average remaining maturity of 11.6 years at June 30, 2005 (11.9 years at June 30, 2004).

Market borrowings are generally swapped into floating-rate obligations denominated in US dollars. As of June 30, 2005 the Corporation had gross payables from borrowing-related currency swaps of \$9.4 billion (\$9.1 billion at June 30, 2004) and from borrowing-related interest rate swaps in the notional principal amount of \$6.7 billion (\$7.3 billion at June 30, 2004). After the effect of these derivative instruments is taken into consideration, all of the Corporation's market borrowings at June 30, 2005, and June 30, 2004, were US dollar-denominated.

The weighted average cost of market borrowings after currency and interest rate swap transactions was 3.3% at June 30, 2005 (1.0% at June 30, 2004).

Capital and retained earnings

As of June 30, 2005, IFC's net worth (presented as Total Capital in the Corporation's balance sheet) amounted to \$9.8 billion, up from the June 30, 2004 level of \$7.8 billion.

As of June 30, 2005 and 2004, IFC's authorized capital was \$2.45 billion, of which \$2.36 billion was subscribed at June 30, 2005, unchanged from June 30, 2004. Over 99% of this was paid in (\$2.36 billion at June 30, 2005, and June 30, 2004). The Corporation has agreed to defer the payment dates for certain member countries. Pursuant to these arrangements, \$1 million of subscribed shares remained unpaid at June 30, 2005 (\$1 million at June 30, 2004).

V. ENTERPRISE RISK MANAGEMENT

In executing its sustainable private sector development business, IFC assumes various kinds of risks. The Corporation's management has defined a comprehensive enterprise risk management framework, within which it recognizes four main risk groupings: strategic risk, credit risk, financial risk, and operational risk.



Active management of these risks is a key determinant of the Corporation's success and its ability to maintain a stable capital and earnings base, and is an essential part of its operations. As part of its enterprise risk management framework, the Corporation has adopted several key financial and exposure policies and a number of prudential policies.

FY05 enterprise risk highlights

The Corporation established a regionally organized Project Risk Management function as part of its Financial Operations Department that will be responsible for centrally managing investment project administration and compliance monitoring.

A Business Risk Department was established to focus on the aspects of strategic and other risks the Corporation faces that are not explicitly monitored by established functions. It has also subsumed the operational risk framework development and Anti-Money Laundering and Combating of Financing of Terrorism functions.

The Corporation has initiated policy reviews in two areas: first, of its financial policies, to confirm that these are in line with new business imperatives and best practices in risk management; secondly, of its Safeguard Policies, Policy on Disclosure of Information, and Environmental, Health & Safety (EHS) Guidelines, involving a comprehensive update of its policies and guidelines, subsequent to stakeholder consultation and expert guidance. The reviews, including Board approval of revised policies, are expected to be completed during FY06.

Strategic risk

IFC defines strategic risk as the potential reputational, financial and other consequences of a failure to achieve its strategic mission and, in particular, its sustainable development mandate.

The overall management of strategic risk is effected through the definition and implementation of an annual strategy for meeting the Corporation's mission and guidelines for its investment operations and advisory services. The strategy is developed with Senior Management by the Operational Strategy Group, and is approved by the Board of Directors. The Operations Evaluation Group conducts ex post evaluations of the implementation of the Corporation's investment strategy on an ongoing basis.

Strategic risk includes the risk incurred by IFC in exercising its environmental and social development framework in member countries. Responsibility for managing this part of strategic risk rests with the Environmental and Social Development Department.

The key guiding principles and policies established as part of the framework for controlling strategic risk are as follows:

Guiding principles for IFC's operations

Catalytic role: IFC will seek above all to be a catalyst in facilitating productive investments in the private sector of its developing member countries. It does so by mobilizing financing from both foreign and domestic investors from the private and public sectors.

Business partnership: IFC functions like a business in partnership with the private sector. Thus, IFC takes the same commercial risks as do private institutions, investing its funds under the discipline of the marketplace.

Additionality: IFC participates in an investment only when it can make a special contribution not offered or brought to the deal by other investors.

Environmental and social policies

The Corporation has developed a comprehensive set of Guidelines and Safeguard Policies to promote environmentally and socially responsible private sector investments. Project sponsors are given the Safeguard Policies for environmental and social issues to review prior to conducting their assessments, as well as the environmental, health, and safety guidelines specific to the particular industry, sector, and type of project.

When making investments, IFC applies its standards to the project and project performance is monitored against those standards. Projects are expected to comply with the applicable policies and guidelines, as well as applicable local, national, and international laws.

FY05 strategic risk highlights

Two years ago, IFC's Environmental and Social Policies became widely recognized as best practice when twelve international commercial banks adopted them in the form of the Equator Principles. To date, a total of 31 leading international financial institutions have adopted these principles.

Credit risk

IFC defines credit risk as the potential reduction in value of on- and off-balance sheet assets due to a deteriorating credit profile of its clients, the countries in which it invests, or a financial counterparty. Credit risk is incurred in two areas of the Corporation's operations: (i) in its investment operations, where IFC provides loans, equity investments, guarantees and derivatives for clients in its developing member countries, and (ii) in its treasury operations, where credit risk is incurred with counterparties in IFC's liquid asset investment, borrowing and asset-liability management activities. As part of its mandate, IFC is prohibited from accepting host government guarantees of repayment on its investments and, therefore, incurs commercial and sovereign risk on its investments.

The Corporation's Risk Management and Financial Policy Department has oversight responsibility for overall credit risk management and, in addition, monitors and controls credit risk arising in IFC's treasury activities. With respect to IFC's credit risk exposures to clients in developing countries, the Credit Review Department plays a key role. At origination of new investments, the Credit Review Department analyzes information obtained from the investment departments and provides an independent review of the credit risk of the transaction. After commitment, the quality of IFC's loan and equity investment portfolio is monitored according to supervision principles and procedures defined in the Operational Policies and Procedures. Responsibility for the day-to-day monitoring and management of credit risk in the portfolio rests with the portfolio management units of individual investment departments. Their assessments are subject to quarterly review, on a sample basis, by the Loss Provisioning Division of the Controller's and Budgeting Department and by the Credit Review Department.

The Corporation's investment portfolio is subject to a number of operational and prudential limits, including limitations on single project/client exposure, single country exposure, and segment concentration. Similarly, credit policies and guidelines have been formulated covering treasury operations; these are subject to annual revision by the Risk Management and Financial Policy Department, and approval by the Finance and Risk Committee. Specifically, IFC has adopted the following key exposure policies:

Investment operations+

1. IFC does not normally finance for its own account more than 25% of a project's cost.
2. An equity investment in a company does not normally represent more than 35% of the company's total share capital, provided further that IFC is not the single largest shareholder. Until IFC resumes presentation of its financial statements in accordance with IFRS, IFC's equity investment in a company will not normally represent more than 20% of the company's total share capital.
3. Investment in a single obligor may not exceed 3% of IFC's total investment portfolio.
4. Equity plus quasi-equity investments in a single obligor may not exceed 3% of the Corporation's net worth plus general reserves, and straight equity investments may not exceed 1.5%.

Portfolio Management+

1. Total investments in a single country will not normally represent more than 12% of IFC's total investment portfolio or 25% of its net worth plus general reserves. Review trigger levels of between 1% and 6% of the portfolio are set for each country.
2. IFC lender of record disbursed exposure in a country may not exceed 10% for Heavily Indebted Poor Countries and 5% for all other countries. Exceptions for countries with low levels of external debt may be set by the Finance and Risk Committee. Lower trigger levels are set for certain countries.
3. The Corporation's total exposure to a single risk sector may not exceed 8% of the total investment portfolio. Lower review trigger levels are set for single sectors, and individually for the finance and insurance sector, based on IFC's total portfolio and the country exposure level.
4. IFC's held guarantees that are subrogated in local currency are limited to \$200 million.

+ All exposures are net of specific reserves

Treasury operations

1. Counterparties are subject to conservative eligibility criteria, currently restricted to banks and financial institutions with a minimum credit rating of A by leading international credit rating agencies.
2. Exposures to individual counterparties are subject to diversification caps. For derivatives, exposure is measured in terms of "worst case" potential exposure based on simulations of market variables. Institution-specific limits are updated monthly based on changes in counterparty size or credit status.
3. To limit exposure, IFC signs collateral agreements with counterparties that require the posting of collateral when net exposure exceeds certain predetermined thresholds, which decrease as a counterparty's credit rating deteriorates.
4. Because counterparties can be downgraded during the life of a transaction, the agreements provide an option for IFC to terminate all swaps if the counterparty is downgraded below investment grade or if other early termination events occur that are standard in the market.
5. Limits are also imposed on the volume of over-the-counter derivative transactions with individual counterparties.
6. For exchange-traded instruments, IFC limits credit risk by restricting transactions to a list of authorized exchanges, contracts and dealers, and by placing limits on the Corporation's open interest rate position in each contract.

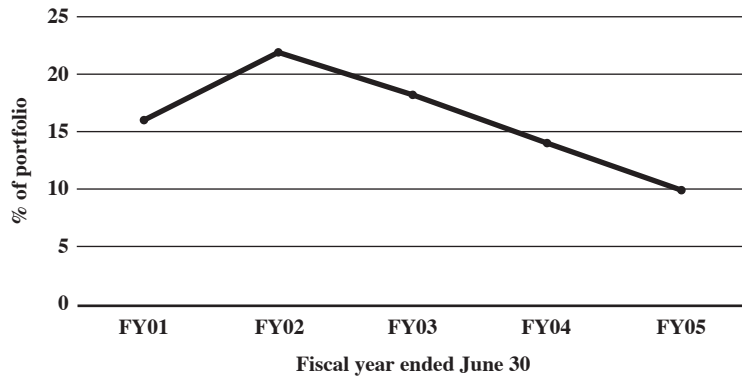
FY05 credit risk highlights

IFC does not recognize income on loans where collectibility is in doubt or payments of interest or principal are past due more than 60 days unless management anticipates that collection of interest is expected in the near future.

The amount of nonaccruing loans as a percentage of the disbursed loan portfolio, a key indicator of portfolio performance, decreased to 6.4% at June 30, 2005, compared with 11.5% at June 30, 2004. The principal amount outstanding on nonaccrual loans totaled \$634 million at June 30, 2005, a decrease of 43% from the June 30, 2004 level of \$1,121 million.

The quality of IFC's investment portfolio, as measured by the aggregate risk level, improved further during FY05, continuing the trend noted during the second half of FY03 and FY04. As a result, total reserves against losses on loans at June 30, 2005, decreased to \$989 million (\$1,367 million at June 30, 2004). This is equivalent to 9.9% of the disbursed loan portfolio, significantly below the level of 14.0% at June 30, 2004. As discussed in Note E to the Corporation's FY05 financial statements, the Corporation changed its process of estimating impairment on equity investments to adopt an impairment methodology based largely on fair value estimates. As a result, the Corporation recorded a change in carrying value of the equity investment portfolio. In this regard, the Corporation determined that impairments and changes in carrying value were deemed to be other than temporary. This change in carrying value of the equity portfolio has been reflected in net income from equity investments in the income statement and in equity investments in the balance sheet.

The five-year trend of reserves against losses on loans is presented below:



IFC operates under the assumption that the guarantee portfolio is exposed to the same idiosyncratic and systematic risks as IFC's loan portfolio and the inherent, probable losses in the guarantee portfolio need to be covered by an allowance for loss. The allowance at June 30, 2005, was \$13 million (\$16 million at June 30, 2004), based on the year-end portfolio, and is included in payables and other liabilities on the balance sheet. The reduction in allowance for the year, \$3 million for FY05 (\$14 million for FY04), is included in the release of (provision for) losses on loans and guarantees in the income statement.

The Corporation has not suffered credit losses on its exposures to derivatives counterparties in its treasury operations.

Financial risk

IFC defines financial risk in three components: (a) the potential inability to realize asset values in its portfolio sufficient to meet obligations to disburse funds as they arise (liquidity risk); (b) the potential inability to access funding at reasonable cost (funding risk); and (c) a deterioration in values of financial instruments or positions due to changes in market interest and exchange rates and the volatility thereof (market risk).

Key financial policies

IFC currently operates under a number of key financial policies as detailed below, which have been approved by its Board of Directors:

1. **Disbursed equity** plus quasi-equity investments (net of write-downs) may not exceed 100% of net worth and disbursed equity (net of write-downs) may not exceed 50% of net worth.
2. **Minimum liquidity** (liquid assets plus undrawn borrowing commitments from the World Bank) must be sufficient at all times to cover at least 65% of IFC's estimated net cash requirements for the next three years.
3. The currency, rate basis, and maturity of loan assets must be **closely matched** to borrowings; trigger levels at which foreign exchange and interest rate exposures are hedged are defined.
4. **Capital** (paid-in capital plus retained earnings plus general loan loss reserves) must equal at least 30% of risk-weighted assets.

In addition, under IFC's Articles of Agreement, as long as IFC has outstanding borrowings from the World Bank, IFC's **leverage**, as measured by the ratio of IFC's debt (borrowings plus outstanding guarantees) to IFC's equity (subscribed capital plus retained earnings), may not exceed 4.0 to 1.

Liquidity risk

Within the key financial policies described above, in practice the Corporation maintains, as a prudential measure, an operating liquidity target of not less than 70% of three years' net cash requirements, including projected disbursement and debt service requirements.

The primary instruments for maintaining sufficient liquidity are the Corporation's liquid asset portfolios. As noted above, IFC distinguishes five such portfolios:

- P0, which is generally invested in short-dated deposits, money market funds, and tri-party repos, reflecting its use for short-term funding requirements;
- P1, which is generally invested in: (a) foreign sovereign, sovereign-guaranteed and supra-national fixed income instruments (rated AA- or better); (b) US Treasury or agency instruments; (c) asset-backed securities rated AAA by at least two rating agencies and/or other AAA rated notes issued by Corporations; (d) interest rate futures and swaps to manage currency risk in the portfolio, as well as its duration relative to benchmark; and (e) cash deposits;
- P2, which is generally invested in US Treasuries and other sovereign and agency issues;
- P3, which comprises a global fixed income portfolio and a mortgage-backed securities portfolio (managed by external managers); and
- P4, which is an outsourced portion of the P2 portfolio (managed by external managers).

FY05 liquidity risk highlights

At June 30, 2005, the Corporation's liquidity level stood at \$13.3 billion, or 142% of its projected net cash requirements for three years (\$13.1 billion, and 116% at June 30, 2004).

Funding risk

The Corporation's primary objective with respect to managing funding risk is, through the adoption of the key financial policies described above, to maintain its AAA credit rating and, thereby, maintain access to funding as needed at the lowest possible cost. Access to funding is maximized, and cost is minimized, by issuing debt securities in various capital markets in a variety of currencies, sometimes using complex structures. These structures include borrowings payable in multiple currencies, or borrowings with principal and/or interest determined by reference to a specified index such as a stock market index, a reference interest rate, a commodity index, or one or more foreign exchange rates.

FY05 funding risk highlights

During FY05, the Corporation raised \$2.0 billion (\$3.0 billion in FY04) of funding at sub-LIBOR rates.

Market risk

The Corporation's exposure to market risk is minimized by adopting the matched funding policy noted above and by using a variety of derivative instruments to convert assets and liabilities into 6-month floating rate US dollar assets and liabilities.

Investment operations

Implementation of the matched funding policy is a two-step process: funds are earmarked at Board approval stage and matched, with respect to interest rate and currency, at disbursement. Interest rate and currency exchange risk associated with fixed rate and/or non-US dollar lending is hedged via currency and interest rate swaps that convert cash flows into variable rate US dollar flows.

Exposures to market risk resulting from derivative transactions with clients, which are intended to facilitate clients' risk management, are minimized by entering into offsetting positions with highly rated market counterparties.

Liquid asset portfolios

Consistent with the matched funding policy, the P0, P1 and P3 portfolios are strictly managed to variable rate US dollar benchmarks, on a portfolio basis. To this end, a variety of derivative instruments are used, including short-term, over-the-counter foreign exchange forwards (covered forwards), interest rate and currency swaps, and exchange-traded interest rate futures and options. The Corporation also takes both long and short positions in securities in the management of these portfolios to their respective benchmarks.

The primary source of market risk in the liquid asset portfolios is the P2 and P4 portfolios, which, in contrast, are managed to a three-year duration US dollar benchmark, with additional flexibility to deviate from the benchmark. P2 represents the portion of IFC's capital not disbursed as equity investments, and the benchmark reflects the chosen risk profile for this uninvested capital. P4 represents an outsourced portion of the P2 portfolio.

Borrowing activities

Market risk associated with fixed rate obligations and structured instruments entered into as part of the Corporation's funding program is mitigated by using derivative instruments to convert them into variable rate US dollar obligations, consistent with the matched-funding policy.

Asset-liability management

While IFC's matched-funding policy provides a significant level of protection against currency and interest rate risk, the Corporation can be exposed to residual market risk in its overall asset and liability management. This residual market risk is monitored by the Asset-Liability Management group within the Treasury Department.

Residual currency risk arises from events such as changes in the level of non-US dollar loan loss reserves. This risk is managed by monitoring the aggregate position in each lending currency and hedging the exposure when the net asset or liability position exceeds \$5 million equivalent, through spot sales or purchases.

Residual interest rate risk may arise from two sources:

- Assets that are fully match-funded at inception, which can become mismatched over time due to write-downs, prepayments, or rescheduling; and
- Differing interest rate reset dates on assets and liabilities.

This residual risk is managed by: first, synchronizing interest rate reset dates on assets and liabilities at a portfolio level; and second, measuring the sensitivity of the present value of assets and liabilities in each currency to each basis point change in interest rates, with an action trigger of \$50,000 on this measure.

FY05 market risk highlights

Total liquid asset returns (comprising interest, realized and unrealized gains and losses, and translation adjustments) were \$358 million (\$177 million in FY04 and \$475 million in FY03), of which \$148 million was attributable to the P2 and, beginning in FY04, the P4 portfolio (\$21 million in FY04 and \$264 million in FY03). Currency translation losses for FY05 were \$7 million (\$7 million gain in FY04 and \$8 million gain in FY03).

Operational risk

IFC defines operational risk as the potential for loss resulting from events involving people, systems and processes. These include both internal and external events, whether caused by a lack of controls, documentation, or contingency planning, or by breakdowns in information systems, communications, physical safeguards, business continuity, supervision, transaction processing, or in the execution of legal, fiduciary, and agency responsibilities. As such, operational risk covers the risks emanating from the manner in which an entity is *operated* as opposed to the way it is *financed*.

Consistent with the Basel II Capital Adequacy guidelines, IFC is developing a matrix framework to analyze operational risk by identifying, for each area (people, systems and processes), which risks IFC will: (i) manage internally, as part of its ongoing business; (ii) alleviate through contingency planning; or (iii) insure externally, whether by subcontracting, outsourcing or hedging, including insurance.

Responsibility for the development of the framework for managing and monitoring operational risk, and for contingency planning for recovery from emergencies, now rests with the Business Risk Department. In respect of insurable operational risk, IFC's Insurance Services Group performs insurance reviews to identify the risks and assess the adequacy of existing insurance policies and limits.

IFC seeks to mitigate the risks it manages internally by maintaining a comprehensive system of internal controls that is designed not only to identify the parameters of various risks but also to monitor and control those areas of particular concern. Key components of this effort are:

Key components of operational risk management

- The Corporation has adopted the COSO¹ control framework and a control self-assessment methodology to evaluate the effectiveness of its internal controls in people, systems and processes, and it has an ongoing program in place to cover all significant business operations. In addition, the COBIT² methodology is used to supplement the COSO review of the information technology function. The program includes compliance testing of key internal controls assuring the reliability of external financial reporting and has been applied to Donor Funded Operations as well.
- The Internal Audit Department of the World Bank Group performs ongoing independent review of the effectiveness of IFC's internal controls in selected key areas and functions.
- To promote data integrity, the Corporation has formulated a Data Management Policy. The policy is enforced by the Information Quality Group within the Controller's Department and through a network of Departmental Data Stewards.
- The Corporation has a New Products/Initiatives Assessment Group, with representation from key business and support functions, to ensure that processes and controls are in place to manage the risks in new products and initiatives before they are executed.

1. COSO refers to the Internal Control - Integrated Framework formulated by the Committee of Sponsoring Organizations of the Treadway Commission, which was convened by the US Congress in response to the well-publicized irregularities that occurred in the financial sector in the United States during the late 1980s.

2. COBIT refers to Control Objectives for Information and Related Technology, first released in 1996, updated to the 3rd edition released in July 2000, sponsored by the Information Systems Audit and Control Association (ISACA).

FY05 operational risk highlights

IFC continues to focus on its preparedness to react to an emergency situation that disrupts its normal operations. During FY05, the Corporation has:

- Extended the scope of the back-up facilities available for its key systems and the testing thereof;
- Maintained computing facilities with wide-band communications linkages at the homes of staff considered essential to maintaining key business activities in the event that the headquarters building becomes unavailable for use in an emergency situation; and
- Undertaken periodic emergency response simulation exercises, to test the adequacy of its contingency planning and enhance the preparedness of its emergency management team.

The Corporation is continuing a multiyear effort to analyze and develop enhanced methodologies for measuring, monitoring and managing operational risk in its key activities. During FY05, IFC has:

- Continued a process-mapping exercise to identify potential areas of exposure to operational risk in investment processes and provide a basis for quantifying potential risks, with particular emphasis on its regional operations; and
- Started the development of a framework for IFC's strategic and operational risk functions within the newly established Business Risk Department.

Management has carried out an evaluation of internal controls over external financial reporting for the purposes of determining if there were any changes made in internal controls during the year ended June 30, 2005, that had materially affected, or would be reasonably likely to materially affect, IFC's internal control over external financial reporting. As of June 30, 2005, no such significant changes occurred.

Internal 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 IFC. Management believes that these controls and procedures were effective as of June 30, 2005.

VI. CRITICAL ACCOUNTING POLICIES

The Notes to the Corporation's FY05 financial statements contain a summary of the Corporation's significant accounting policies, including a discussion of recently issued accounting pronouncements. Certain of these policies are considered to be "critical" to the portrayal of the Corporation's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. These policies include: (i) determining the level of the allowance for losses in the loan portfolio; (ii) determining the level of impairment of equity investments; and (iii) determining the valuation of certain financial instruments with no quoted market prices. Additional information about these policies can be found in Notes A, C, O and P to the FY05 financial statements.

Reserve against losses on loans

The Corporation considers a loan as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the loan's contractual terms. The reserve against losses for impaired loans reflects management's judgment of the present value of expected future cash flows discounted at the loan's effective interest rate. The reserve against losses for loans includes an estimate of probable losses on loans inherent in the portfolio but not specifically identifiable. The reserve is established through periodic charges to income in the form of a provision for losses on loans. Loans written off, as well as any subsequent recoveries, are recorded through the reserve.

The assessment of the adequacy of total reserves against losses for loans is highly dependent on management's judgment about factors such as geographical concentration, industry, regional and macroeconomic conditions, and historical trends. Due to the inherent limitation of any particular estimation technique, management utilizes three different and independent methods to provide estimates for the total loan loss reserve balance: (1) a simulation model, (2) country risk ratings and probability of crisis associated with those risks, and (3) a model of the Corporation's long-term historical loan portfolio experience. Changes in these estimates could have a direct impact on the provision and could result in a change in the reserve balance.

The reserve against losses on loans is separately reported in the balance sheet as a reduction of the Corporation's total loans. Increases or decreases in the reserve level are reported in the income statement as provision for losses or release of provision for losses on loans, and guarantees. The reserve against losses on loans relates only to the Client Services segment of the Corporation (see Note R to the FY05 financial statements for further discussion of the Corporation's business segments).

Equity impairment

The Corporation assesses all equity investments for impairment each quarter. When an impairment is identified and is deemed to be other than temporary, the equity investment is written down to its impaired value, which becomes the new cost basis in the equity investment. The Corporation has elected to assume that all impairments shall be deemed to be other than temporary. Impairment losses are not reversed for subsequent recoveries in value of the equity investment until it is sold.

Prior to March 31, 2005, the Corporation had carried reserves against losses on the equity investment portfolio. During the year ended June 30, 2005, the Corporation changed its process of estimating impairment on equity investments to adopt an impairment methodology based largely on fair value estimates. As a result, the Corporation recorded a change in carrying value of the equity investment portfolio. In this regard, the Corporation determined that all impairments and changes in carrying value were deemed to be other than temporary. This change in carrying value of the equity portfolio has been reflected in net income from equity investments in the income statement and in equity investments in the balance sheet.

Valuation of financial instruments with no quoted market prices

As part of its compliance with SFAS No. 133, the Corporation reports at fair value all of its derivative instruments and certain borrowings that the Corporation has designated as components of fair value hedges. In addition, certain features in various loan agreements, equity investment agreements, and borrowing contracts contain embedded derivatives that, for accounting purposes, are separately accounted as either derivative assets or liabilities, including puts, caps, floors, and forwards. Few of these instruments have a ready market valuation. Therefore, the fair values of the financial instruments with no quoted market prices are estimated using sophisticated pricing models of the net present value of estimated future cash flows. Management makes numerous assumptions in developing the pricing models, including the appropriate discount rates, interest rates, and related volatility and expected movement in foreign currency exchange rates. Changes in assumptions could have a significant impact on the amounts reported as assets and liabilities and the related gains and losses reported in the income statement. The fair value computations affect both the Client Services and Treasury segments of the Corporation (see Note R to the FY05 financial statements for further discussion of the Corporation's business segments).

Additional information can be found in Notes A, O and P to the FY05 financial statements.

VII. RESULTS OF OPERATIONS

Overview

The main elements of IFC's net income, and influences on the level and variability of operating and net income from year to year, are:

ELEMENTS	SIGNIFICANT INFLUENCES
Operating income:	
Spread on interest earning assets	Nonaccruals and recoveries of interest on loans formerly in nonaccrual status and income from participation notes
Liquid asset income	Realized and unrealized gains and losses on the liquid asset portfolios
Income from the equity investment portfolio	Performance of the equity portfolio (principally dividends, capital gains)
Provisions for losses on loans and guarantees	Level of provisions for losses on loans and guarantees
Equity impairment write-downs	Amount of impairment write-downs
Noninterest income and expense	Level of technical assistance and advisory services provided by the Corporation to its clients, the level of expense from the staff retirement and other benefits plans, and the approved administrative and other budgets
Net income:	
Net gains (losses) on other financial instruments	Principally, differences between changes in fair values of derivative instruments and changes in fair value of hedged items in fair value hedging relationships

The following paragraphs detail significant variances between FY05 and FY04, and FY04 and FY03, covering the periods included in the Corporation's FY05 financial statements. As disclosed in Note A to the Corporation's FY05 financial statements, certain amounts in FY04 and FY03 have been reclassified to conform to the current year's presentation. Such reclassifications had no effect on operating income, net income or total assets.

FY05 versus FY04

Operating income

The Corporation's income before expenditures for TAAS and net gains (losses) on other financial instruments for FY05 was \$1,991 million. Expenditures for TAAS for FY05 were \$38 million, resulting in income after expenditures for TAAS (operating income) for FY05 of \$1,953 million, a third consecutive record year. The improvement was mainly attributable to significant equity income (principally capital gains) and a continued overall improvement in the quality of the loan and equity investment portfolio, as measured by portfolio impairment and portfolio risk levels. The aggregate risk level within the portfolio has reduced principally due to: (i) the successful restructuring or rescheduling of problem projects; (ii) the growth in the outstanding portfolio in disbursements with better risk ratings; (iii) the write-off of investments with worse risk ratings than the average risk rating of the portfolio; and (iv) an overall improvement in country risk ratings. This improvement began during the latter stages of FY03 and continued through FY04 and FY05. The Corporation's liquid asset portfolios yielded strong positive contributions to the Corporation's operating income.

A more detailed analysis of the components of IFC's operating income follows.

Net interest income

IFC's primary interest earning assets are its loan portfolio and its liquid assets portfolios. Net interest income, after charges on borrowings are taken into account, increased by \$229 million from \$655 million in FY04 to \$884 million in FY05.

Interest and financial fees from loans (including guarantee fees) for FY05 totaled \$660 million, compared with \$518 million in FY04, an increase of \$142 million, or 27%. Interest income increased from \$449 million in FY04 to \$574 million in FY05. The growth in the loan portfolio and the overall increase in average interest rates during FY05, when compared with FY04, contributed \$118 million, net of interest expense on lending-related swaps, of the increase in interest income. Recoveries of interest on loans being removed from non-accrual status, net of reversals of income on loans being placed in nonaccrual status, were \$8 million lower in FY05, compared to FY04, at \$31 million in FY05 (\$39 million – FY04). Income from the Corporation's participation notes, over and above minimum contractual interest, totaled \$55 million in FY05 (\$40 million – FY04). Commitment and financial fees also grew to \$86 million in FY05 from \$69 million in FY04, reflecting strong commitments and disbursements.

Interest income from time deposits and securities are discussed below, as a component of liquid asset income.

The Corporation's **charges on borrowings** increased by \$168 million, from \$141 million in FY04 to \$309 million in FY05, largely reflecting the increased US dollar interest rate environment, when comparing FY05 and FY04. As the Corporation's borrowings generally reprice every six months, the effect of the significant rise in the interest rate environment in the fourth quarter of FY04 adversely impacted FY05 charges on borrowings. The weighted average cost of the Corporation's borrowings outstanding from market sources, after the effects of borrowing-related derivatives, rose during the year from 1.0% at June 30, 2004 to 3.3% at June 30, 2005. The borrowings portfolio, net of borrowing-related derivatives and before the effects of SFAS No. 133, decreased by \$0.4 billion in FY05 from \$16.4 billion at June 30, 2004, to \$16.0 billion at June 30, 2005.

Liquid asset income

Liquid asset income comprises interest from time deposits and securities, net gains and losses on trading activities, and a small currency translation effect. The liquid assets portfolio, net of derivatives and securities lending activities, increased from \$13.1 billion at June 30, 2004, to \$13.3 billion at June 30, 2005.

Liquid asset returns totaled \$358 million in FY05, reported as **interest income from time deposits and securities** (\$533 million), and **net losses on trading activities** (\$175 million) in the Corporation's FY05 income statement. Liquid asset returns totaled \$177 million in FY04, reported as interest income from time deposits and securities (\$278 million), net losses on trading activities (\$104 million), and currency translation gains (\$3 million).

Net income from equity investments

Net income from the equity investment portfolio increased by \$707 million from \$658 million in FY04 to \$1,365 million in FY05.

The Corporation generated realized capital gains on equity sales for FY05 of \$723 million, as compared with \$381 million for FY04, an increase of \$342 million. Realized capital gains on equity sales from 19 investments comprised 71% of the FY05 gains, compared to seven investments comprising 64% of the FY04 gains. IFC continued to take advantage of buoyant markets to sell equities and take some limited gains in investments where IFC's developmental role was complete, and where pre-determined sales trigger levels had been met.

Dividend income was also significantly higher in FY05 at \$258 million, as compared with \$207 million in FY04. Consistent with FY04, a significant amount of IFC's dividend income in FY05 was due to returns on the Corporation's joint ventures in the oil, gas and mining sectors, which totaled \$106 million in FY05, as compared with \$65 million in FY04.

Beginning in FY05, the Corporation's investments in its LLPs and certain LLCs are accounted for under the equity method. As a result, IFC's FY05 operating income includes unrealized income from its investments in LLPs and certain LLCs in the amount of \$191 million.

Release of provisions for losses on loans and guarantees

As noted above, the quality of the Corporation's investment portfolio improved during FY05, continuing the trend noted in FY03 and FY04. As a result, IFC recorded a release of provisions for losses on loans and guarantees of \$261 million in FY05, including a release of \$3 million in respect of guarantees, a significant improvement over FY04 when the Corporation recorded a release of \$103 million (\$14 million in respect of guarantees). On June 30, 2005, the Corporation's total reserves against losses on loans were 9.9% of the disbursed and outstanding loan portfolio (14.0% at June 30, 2004).

Noninterest income

Noninterest income of \$86 million for FY05 was \$11 million higher than in FY04 (\$75 million).

Noninterest expense

Administrative expenses (the principal component of noninterest expense) increased by 12% from \$360 million in FY04 to \$403 million in FY05 principally reflecting the Corporation's higher budget authority in FY05 when compared to FY04. Administrative expenses include the grossing-up effect of certain revenues and expenses attributable to the Corporation's reimbursable program and jeopardy projects (\$33 million in FY05, as compared with \$34 million in FY04). The Corporation recorded expense from pension and other postretirement benefit plans in FY05 of \$14 million, as compared with \$19 million in FY04.

Net income

As more fully disclosed in Notes A, O and P to the Corporation's FY05 financial statements, the Corporation has designated certain hedging relationships in its borrowing activities and its lending activities as fair value hedges. The Corporation generally matches the terms of its derivatives with the terms of the specific underlying financial instruments hedged, in terms of currencies, maturity dates, reset dates, interest rates, and other features. However, differing valuation methodologies are applied to the derivative and the hedged financial instrument, as prescribed by SFAS No. 133. The resulting ineffectiveness calculated for such relationships is recorded in net gains (losses) on other financial instruments, in net income.

The effects of SFAS No. 133 on net income in FY05 and FY04 can be summarized as follows (US\$ millions):

	FY05	FY04
Operating income	1,953	982
SFAS No. 133 adjustments:		
Net gains (losses) on other financial instruments	62	11
Net income	2,015	993

Net gains (losses) on other financial instruments largely comprises the difference between the change in fair value of derivative instruments and the change in fair value of the hedged item under designated hedging relationships.

FY04 versus FY03

Operating income

The Corporation's operating income for FY04 was \$982 million, a second consecutive record year, following FY03's then record operating income of \$528 million. The improvement was mainly attributable to significant equity income and an overall improvement in the quality of the loan and equity investment portfolio, as measured by portfolio impairment and portfolio risk levels, principally due to a reduction in the aggregate risk level within the portfolio resulting from the factors outlined above. This improvement began during the latter stages of FY03 and continued through FY04 and resulted in a release of provisions for losses on loans, equity investments and guarantees.

The Corporation's liquid asset portfolios yielded a positive contribution to the Corporation's operating income although at a lower level than in FY03 mainly due to the overall higher interest rate environment during FY04, with a significant rising interest rate environment during the fourth quarter of FY04. The Corporation has a significant holding of fixed income securities, principally in its P2 portfolio, that decline in value in a rising interest rate environment.

A more detailed analysis of the components of IFC's operating income follows.

Net interest income

IFC's primary interest earning assets are its loan portfolio and its liquid assets portfolios. After charges on borrowings are taken into account, net interest income increased by \$86 million or 15% from \$569 million in FY03 to \$655 million in FY04.

Interest and financial fees from loans (including guarantee fees) for FY04 were \$518 million, compared with \$477 million in FY03, an increase of \$41 million, or 9%. Interest income increased from \$414 million in FY03 to \$444 million in FY04, principally reflecting the overall increase in average interest rates during FY04, when compared with FY03. The growth in the loan portfolio and the overall increase in average interest rates during FY04, when compared with FY03, contributed \$12 million, net of interest expense on lending-related swaps, of the increase in interest income. Recoveries of interest on loans being removed from non-accrual status, net of reversals of income on loans being placed in nonaccrual status, were \$39 million in FY04 (\$23 million – FY03). Income from the Corporation's participation notes, over and above minimum contractual interest, totaled \$40 million in FY04 (\$33 million – FY03). Commitment and financial fees also grew from \$63 million in FY03 to \$69 million in FY04, reflecting strong commitments and disbursements.

Interest income from time deposits and securities are discussed below, as a component of liquid asset income.

The Corporation's **charges on borrowings** decreased by \$85 million, from \$226 million in FY03 to \$141 million in FY04, largely reflecting the declining US dollar interest rate environment in late FY03 and early FY04. As the Corporation's borrowings generally reprice every six months, the effect of the significant rise in the interest rate environment in the fourth quarter of FY04 did not have a significant impact on charges on borrowings until early FY05. The weighted average cost of the Corporation's borrowings outstanding from market sources, after the effects of borrowing-related derivatives, rose slightly during the year from 0.9% at June 30, 2003 to 1.0% at June 30, 2004. The borrowings portfolio, net of borrowing-related derivatives and before the effects of SFAS No. 133, increased by \$0.5 billion in FY04 from \$15.9 billion at June 30, 2003, to \$16.4 billion at June 30, 2004.

Liquid asset income

Liquid asset income comprises interest from time deposits and securities, net gains and losses on trading activities, and a small currency translation effect. The liquid assets portfolio, net of derivatives and securities lending activities, increased marginally from \$13.0 billion at June 30, 2003, to \$13.1 billion at June 30, 2004.

The overall rising interest rate environment experienced during FY04, concentrated in the fourth quarter, resulted in a negative impact on the carrying value of the Corporation's fixed income liquid asset investments and, accordingly, lower total returns. Liquid asset returns totaled \$177 million in FY04, reported as **interest income from time deposits and securities** (\$278 million), **net losses on trading activities** (\$104 million) and **currency translation gains** (\$3 million) in the Corporation's FY04 income statement. Liquid asset returns totaled \$475 million in FY03, reported as interest income from time deposits and securities (\$318 million), and net gains on trading activities (\$157 million).

Net income from equity investments

Net income from the equity investment portfolio increased by \$513 million from \$145 million in FY03 to \$658 million in FY04.

The Corporation generated realized capital gains on equity sales for FY04 of \$381 million, as compared with \$52 million for FY03, an increase of \$329 million. Realized capital gains on equity sales in FY04 were highly concentrated, with \$193 million of the total capital gains resulting from sales or partial sales of single equity investments in each of the Czech Republic, the Republic of Korea, and Mexico. IFC took advantage of buoyant markets to take some limited gains in investments where IFC's developmental role was complete, where pre-determined sales trigger levels had been met, and where markets had valued them adequately. Such opportunities did not occur in FY03 with only one sale of an equity investment generating a capital gain in excess of \$5 million.

Dividend income was also significantly higher in FY04 at \$207 million, as compared with \$147 million in FY03. Consistent with FY03, a significant amount of IFC's dividend income in FY04 was due in part to returns on the Corporation's joint ventures in the oil, gas and mining sectors, which totaled \$65 million in FY04, as compared with \$61 million in FY03.

Release of provisions for losses on loans and guarantees

As noted above, the quality of the Corporation's investment portfolio improved during FY04, continuing the trend noted in the last nine months of FY03. As a result, IFC recorded a release of provisions for losses on loans and guarantees of \$103 million in FY04, including a release of \$14 million in respect of guarantees, a significant improvement over FY03 when the Corporation recorded a charge of \$48 million (which included a charge of \$1 million in respect of guarantees). On June 30, 2004, the Corporation's total reserves against losses on loans were 14.0% of the disbursed and outstanding loan portfolio (19.0% at June 30, 2003).

Noninterest income

Noninterest income of \$75 million for FY04 was \$10 million lower than in FY03 (\$85 million), principally due to lower service fees - \$41 million in FY04, as compared with \$51 million in FY03. FY03 service fees included the recovery of \$11 million of overdue interest and penalties received from one of the Corporation's client risk management derivatives to a client in the power sector which did not recur in FY04.

Noninterest expense

Administrative expenses (the principal component of noninterest expense) increased by 8% from \$332 million in FY03 to \$360 million in FY04 principally reflecting the Corporation's higher budget authority in FY04 when compared to FY03. Administrative expenses include the grossing-up effect of certain revenues and expenses attributable to the Corporation's reimbursable program and jeopardy projects (\$34 million in FY04, as compared with \$30 million in FY03). The Corporation recorded expense from pension and other postretirement benefit plans in FY04 of \$19 million, as compared with \$24 million in FY03.

Net income

As more fully disclosed in Notes A, N and O to the Corporation's FY04 financial statements, the Corporation has designated certain hedging relationships in its borrowing activities and its lending activities as fair value hedges. The Corporation generally matches the terms of its derivatives with the terms of the specific underlying financial instruments hedged, in terms of currencies, maturity dates, reset dates, interest rates, and other features. However, differing valuation methodologies are applied to the derivative and the hedged financial instrument, as prescribed by SFAS No. 133. The resulting ineffectiveness calculated for such relationships is recorded in net gains (losses) on other financial instruments, in net income.

The effects of SFAS No. 133 on net income FY04 and FY03 can be summarized as follows (US\$ millions):

	FY04	FY03
Operating income	982	528
SFAS No. 133 adjustments:		
Net gains (losses) on other financial instruments	11	(41)
Net income	993	487

Net gains (losses) on other financial instruments largely comprises the difference between the change in fair value of derivative instruments and the change in fair value of the hedged item under designated hedging relationships.

VIII. GOVERNANCE

Management Changes

The Board of Directors (the Board) is charged, under the Articles of Agreement, with the selection of IFC's President. Following the decision by Mr. James D. Wolfensohn to retire on May 31, 2005, the Directors unanimously selected on March 31, 2005, Mr. Paul Wolfowitz to be the next president. Mr. Wolfowitz's appointment became effective June 1, 2005.

Following the retirement of the Corporation's Executive Vice President (EVP), Mr. Peter Woicke, effective January 31, 2005, Mr. Assaad Jabre has been appointed Acting EVP, effective January 31, 2005.

Board of Directors

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

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

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

Audit Committee

Membership

The Audit Committee consists of eight members of the Board. Membership on the Committee is determined by the Board, based upon nominations by the Chairman of the Board, following informal consultation with the Directors. In addition, membership of the Committee is expected to reflect the economic and geographic diversity of IFC's member countries. Other relevant selection criteria include seniority, continuity and relevant experience. Some or all of the responsibilities of individual committee members are performed by their alternates or advisors. Generally, Committee members are appointed for a two year term; reappointment to a second term, when possible, is desirable for continuity. Audit Committee meetings are generally open to any members 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 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 IFC'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 Corporation's financial position and risk-bearing capacity. The Audit Committee monitors the evolution of developments in corporate governance and the role of audit committees on an ongoing basis and revised its terms of reference in FY04.

Communications

The Audit Committee communicates regularly with the 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 Directors, Alternates, World Bank Group Senior Management and Vice Presidents of IFC.
- "Statement(s) of the Chairman" and statements issued by other members of the Committee.
- The Annual Report to the Board, which provides an overview of the main issues addressed by the Audit Committee over the year.

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

Executive sessions

Members of the Audit 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 outside 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. Directors have complete access to the management of the Corporation. 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 Directors.

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

Code of Ethics

The World Bank Group strives to foster and maintain a positive work environment that supports the ethical behavior of its staff. To facilitate this effort, the World Bank Group has a Code of Professional Ethics in place. The Code (Code of Professional Ethics – Living our Values) applies to all staff (including managers, consultants, and temporary employees) worldwide.

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

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

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

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

The World Bank Group has in place procedures for the receipt, retention and treatment of complaints received regarding accounting, internal controls and auditing matters.

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

Auditor Independence

In FY03, the Board adopted a set of principles applicable to the appointment of the external auditor for IFC. 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, upon recommendation of the Audit Committee;
- Mandatory rebidding of the external audit contract every five years;
- Prohibition of any firm serving as external auditor for more than two consecutive five-year terms;
- Mandatory rotation of the senior partner after five years; and
- An evaluation of the performance of the external auditor at the mid-point of the five year term.

In FY04, IFC's external auditor, Deloitte and Touche LLP, began a new five-year term and will have served eleven years as external auditor upon completion of that term, pursuant to a one-time grandfathered exemption from the above-referenced ten-year limit. Even within a five-year term the service of the external auditors is subject to recommendation by the Audit Committee for annual reappointment and approval of a resolution by the Board.

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. IFC's external 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; and
- Presentation of a statement regarding independence.

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