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IFC

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May 22, 2001

Mr. William J. McDonough
Chairman of the Basel Committee
on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH - 4002 Basel
Switzerland

Dear Mr. ~~McDonough~~: Bill

Re: Comments on The New Basel Capital Accord in its January 2001 draft

In addition to the comments you will receive from the World Bank Group we would like to provide you with detailed comments specifically related to IFC's sale of participations in IFC loans, also referred to as the B-loan Program. Through this mechanism, participating financial institutions share fully in the credit risk of projects but also enjoy IFC's preferences as a multilateral development institution. The loan structure is described in Attachment 1.

The New Basel Capital Accord, like the existing Accord, does not contain any specific guidance for the treatment of country risks, although it is implicit that country risk should be considered.

In assessing the New Basel Capital Accord's implications for the financial products of multilateral institutions, in particular participations by commercial banks in the B-Loans of these institutions, we are concerned about the lack of guidance in regard to country risk mitigants. This is particularly important since clear guidance is, on the other hand, provided for certain financial structures, such as mortgages (§ 37) and guarantees (§ 117 et seq.), that reduce regulatory capital requirements.

IFC, as a multilateral development institution, enjoys a de facto preferred creditor status in its member countries. This means that member governments grant IFC's loans preferential access to foreign exchange in the event of a country foreign exchange crisis.

The preferred creditor status that participating financial institutions share through the B-loan program is an effective political risk mitigant as substantiated by the following:

- Since IFC's lending program began in 1956, no IFC loan has been included in any general country rescheduling.

- During times of foreign exchange rationing or debt moratoria, IFC borrowers have been able to obtain access to foreign exchange reserves necessary to effect payment in US dollars on IFC's loans and such payments have been able to be transferred out of the country.

- IFC's preferred creditor status is a key factor in IFC's AAA ratings (as noted in Attachment 2, "*Moody's Investor Service Global Research on IFC*" dated September 2000, and Attachment 3, Standard and Poor's February 2001 analysis of IFC).

- Standard and Poor's February 2001 analysis of IFC (Attachment 3) also states that "Because of IFC's preferred-creditor status, the implicit foreign currency ratings on many of its loans are actually higher than the foreign currency ratings of the borrowers' countries of domicile. This has been explicitly acknowledged by Standard & Poor's in the case of securitized IFC loans to private-sector borrowers in Argentina, Brazil and Mexico; each was assigned a foreign currency rating equal to the local currency rating and above the foreign currency rating of the sovereign."

- IFC's preferred creditor status serves as an enhancement to rated transactions targeted to the capital markets allowing these transactions to be rated above the sovereign ceiling due to the mitigation of transfer and convertibility risk. (See Attachment 4, *"How Preferred Creditor Status Enhances Ratings"* STANDARD & POOR'S CREDIT WEEK June 30, 1999).

- During the Asia crisis beginning in 1997, IFC did not experience delays in remittances on its loans, including B-loans, attributable to restrictions on foreign exchange transactions in those countries with limited foreign exchange at the time (including Russia, Thailand and Indonesia).

- In August, 1998 Pakistan imposed severe restrictions on remittances because of the lack of foreign exchange reserves. IFC's preferred access to foreign exchange was, nonetheless, respected.

- The value of the B-loan mechanism has been consistently recognized by G-10 bank regulatory agencies, which exempt banks participating in IFC's B-loans from specific mandatory country risk provisioning where such provisioning is otherwise required. See Attachment 5 for examples of these exemptions.

IFC's B-loan program allows banks to lend to private sector companies in countries where they would not be able or willing to do so without the benefit of the preferred creditor status of a multilateral institution. IFC has a portfolio of $7.4 billion in B-loans to emerging markets. Extensive experience has demonstrated that the B-loan product has worked as an effective mitigant of political risk comparable to political risk insurance. Attachment 6 contains Standard & Poor's research on the subject published on 09-April, 2001.

We recommend that:

- Multilateral institutions be included as eligible guarantors/protection providers under paragraph 129 of the New Basel Capital Accord, and 143 for guarantees issued by the multilateral institutions.

- Multilateral B-loans to emerging market borrowers be assigned under the New Basel Capital Accord (§ 133 and following, § 182) a capital weighting in financial institutions' ratings systems no greater or more costly than that assigned to "equivalent" mitigation products.

It must be realized that the preferred creditor status enjoyed by IFC and other multilateral development banks and shared with banks participating in its loans is not a guarantee and is not governed by legal contract. However, it has proven over time to be an effective country risk mitigant since it is based on the mutual self-interest of governments that agree to treat the multilaterals as preferred creditors to ensure that the multilateral development banks continue lending in bad times as well as good.

We would therefore highly appreciate your consideration of this issue when revising the current wording of the proposed New Basel Capital Accord. We believe that this issue is material not only for multilateral institutions, but is also of great importance generally for emerging market countries seeking access to long term capital investment.

Sincerely yours,

cc: Ms. Daniele Nouy, Secretary General of the Basel Committee on Banking Supervision, Bank for International Settlement
Mr. Jean Lemiere, President, European Bank for Reconstruction and Development
Mr. Hiroshi Toyoda, Manager Private Sector Department, Inter- American Development Bank
Mr. Tadao Chino, President, Asian Development Bank

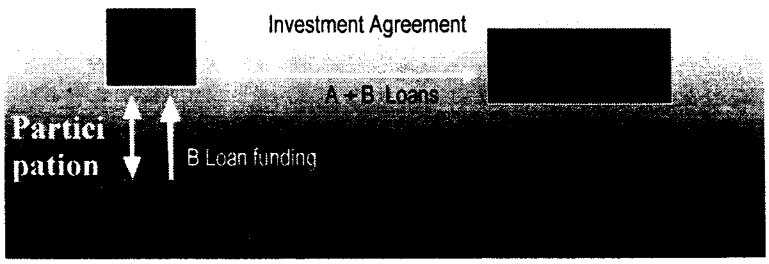
Attachments

1. Structure of IFC B-loans
2. Moody's Investor Services, Global Credit Research, September 2000
3. STANDARD & POOR'S SOVEREIGN RATING SERVICE analysis of International Finance Corp., February 2001
4. *"How Preferred Creditor Status Enhances Ratings"* STANDARD & POOR'S CREDITWEEK June 30, 1999
5. Treatment of IFC Loan participations by bank regulators in selected countries
6. *"B- Loans and Political Risk Insurance: Different Roads to the Same Destination"*, STANDARD & POOR'S RATINGS DIRECT, 09-April-2001

ATTACHMENT 1 - Structure of IFC B-loans

The B-loan is structured as participations in an IFC loan with IFC as the lender of record for the entire loan. IFC acts on behalf of both itself and B-loan participants in all dealings with the borrower. The borrower enters into one Investment Agreement with IFC covering both portions of the loan: the A portion (for IFC's own account) and the B portion (for commercial bank's account). The terms and conditions of these two portions are usually identical with the exception that often the IFC A-loan has a longer maturity than the B-loan and, as a result, a higher interest rate spread. IFC then enters into a Participation Agreement with each participant in the B-loan. This agreement spells out the respective roles and responsibilities of the participant and IFC in the loan. (The figure below provides an illustration of the B-loan structure.)

B Loan Structure



When participating in an IFC loan, financial institutions enter into a relationship different from that of a typical loan syndication. In a traditional loan syndication, each bank makes a direct loan to the borrower and decisions relating to the management of the loan are made by votes of the members of the syndicate. In addition, they have direct access to the borrower for information. However, IFC must maintain discretion in the administration of the B-loan. Participants are granted consent rights over decisions only in limited circumstances. IFC uses a consultation process to understand participants' views for many decisions while, at other times, information is simply provided, all as defined in the Participation Agreement. IFC is the sole source of information relating to the loan, i.e., the participants do not have direct access to the borrower.

IFC administers the entire loan, collects all payments from the Borrower and distributes them pro rata among itself and the participants. IFC cannot be repaid in full until and unless all the participants are paid in full. In addition any default to a participant by a Borrower is a default to IFC.

Moody's Investors Service
Global Credit Research

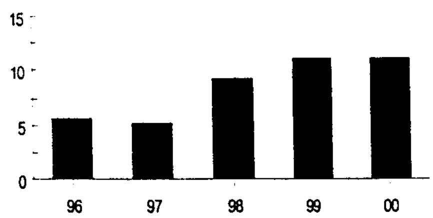
International Finance Corporation

September 2000

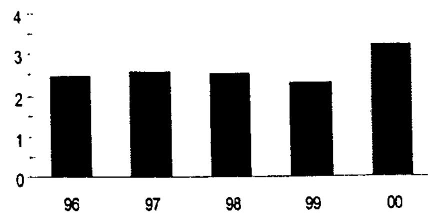
Ratings and Contacts

Category	Moody's Rating	Analyst	Phone
Issuer Rating	Aaa	Hanan Amin-Salem/New York	1.212.553.1653
Senior Unsecured	Aaa	Kristin Lindow/New York	
Other Short Term	P-1	David H. Levey/New York	

Asset Quality [1]



Return on Assets (%)



[1] Non-accruals as % of total loans.

Operating Statistics [1]

International Finance Corporation

	2000	1999	1998	1997	1996
Return on Average Assets (%)	3.21	2.31	2.51	2.60	2.49
Return on Average Equity (%)	5.11	3.61	3.96	7.96	7.35
Interest Coverage Ratio (X)	1.47	1.37	1.38	1.81	1.71
Net Write-Offs/Avg. Lns. + Eqty. Inv.(%)	0.51	0.26	0.30	0.54	0.62

[1] Data for fiscal years which end June 30.

Balance Sheet Statistics [1]

International Finance Corporation

	2000	1999	1998	1997	1996
Assets (US$ Mil.)	22,756	19,847	18,185	16,973	14,292
Equity (US$ Mil.)	5,733	5,344	5,084	4,737	4,158
Eqty + Loss Res/Lns + Eqty (%)	70.44	71.41	73.60	69.01	64.40
Brwgs+Gts./Subscr Cap+Acc Earn (X)	2.61	2.33	2.19	2.08	2.03
Eqty - Loss Res/Eqty (X)	0.66	0.66	0.70	0.77	0.79
Loss Res/Loans (%)	23.76	23.60	22.14	16.37	14.27

[1] Data for fiscal years which end June 30.

Opinion

Rating Rationale

Moody's Aaa rating on the International Finance Corporation (IFC), a part of the World Bank Group, is based on its prudent capital adequacy and liquidity policies, active member support, and preferred creditor status. These factors should continue to support the rating despite the financial and economic turmoil that has afflicted several of the countries to which the IFC is exposed, and which has led to a substantial increase in the non-performing loan ratio (to about 11% of total loans) since FY 1997. Notably, however, asset quality stabilized during FY 2000 with no new problem loans or equity investments emerging.

The IFC is a profitable supranational agency organized as a joint stock company with sovereign owners, primarily serving private sector companies but guided by a mission to mobilize private investment in support of economic development. The basic business – lending to and investing in private companies in developing country economies – is inherently high risk, but the risk is cushioned by strong capital and reserves as well as by the preferential treatment accorded from shareholder governments. Transfer risk, for example, is reduced by host government policies granting the IFC and its clients special access to foreign exchange.

The IFC is conservatively leveraged, with a 2.6:1 ratio of outstanding debt and commitments to capital at the end of FY2000. In 1993 the corporation decided to formally control its off-balance sheet risk, adopting a risk-weighted assets/capital approach similar to the BIS standard for banks. At fiscal year end 2000, this ratio stood at 47.6% against the minimum of 30% required by policy. Net income rebounded in FY2000, although it did not returned to the pre-crisis level.

Rating Outlook

The outlook is stable, given the IFC's credit strengths, which should continue to allow it to withstand financial and economic problems in the countries in which its borrowers are located.

Author	Associate Analyst	Production Associate
Hanan Amin-Salem	*Mary O'Donnell*	*William L. Thompson*

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Rating Rationale and Outlook

Moody's Aaa rating of the International Finance Corporation (IFC) is based on its strong capitalization and sound financial management, its membership within the World Bank Group and its strong shareholder support. Unlike other multilateral development banks (MDBs), the IFC lends to private sector companies in high-risk economies *without* the benefit of a sovereign guarantee. It also lacks the callable capital that is a critical rating factor supporting the Aaa ratings of the MDBs such as the International Bank for Reconstruction and Development (IBRD or World Bank) and the Asian Development Bank. Moody's therefore views the IFC's high level of capital and reserves as essential to its rating.

The very strong support that the IFC receives from its owners affords a large measure of comfort to investors. In Moody's view, the IFC faces very little transfer risk in its portfolio because of the preferred creditor status it has historically been accorded by its member countries. **IFC loans have never been included in a sovereign debt rescheduling, nor have payments to the IFC ever been permanently interrupted by a general debt-servicing moratorium.** Moreover, cumulative writeoffs of loans and equity investments as a percentage of cumulative disbursements since the inception of the institution stand at only 2.2%—a ratio that reflects the IFC's success in restructuring loans. In Moody's view, given the shareholder support that the IFC enjoys, along with its relatively modest size, it is likely that one or a few member governments would provide additional capital well before any disruption in the organization's operations would occur.

Moody's notes that the IFC's lending activities and profitability have begun to recover from the impact of the global financial crisis during 1997-98. Asset quality deteriorated, particularly in Asia where many borrowers unable to withstand the shock of sharp local currency devaluations could no longer meet their debt service obligations to the IFC, and the Corporation's profitability suffered as a consequence. Over the last fiscal year (ending June 30, 2000), however, the proportion of non-performing loans stabilized in relative terms and the IFC's income staged a robust recovery.

Nevertheless, asset quality and capital adequacy issues will continue to be concerns for the IFC going forward. Not only do important risks remain in the institution's loan and equity portfolios, but new risks may emerge as the IFC expands its lending activities into new countries and new spheres of investment. With the remarkable growth of the private sector in emerging market economies in recent years along with the increasing role of private capital flows to those countries, the IFC's role within the donor community in general and within the World Bank Group in particular has increased in prominence. At the same time, the volatility of those flows heightens the vulnerability of the IFC's borrowers and in turn of the IFC itself.

As a development institution, the Corporation will likely have an enhanced role in the areas of institution building in capital markets, in the development of small and medium-sized enterprises and in funds for infrastructure. In the future, should IFC's board wish for the Corporation to take on a larger role that would be synonymous with a significantly faster balance sheet expansion than the gradual pace that is currently anticipated by the IFC management, then a capital increase may become necessary.

Structure

The International Finance Corporation (IFC) is a multilateral institution that furthers the economic development of its member countries through the promotion of private investment. The IFC is a member of the World Bank Group, which also includes the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), and the Multilateral Investment Guarantee Agency (MIGA). The IFC makes loans and equity investments, organizes syndications, underwrites securities, and offers advisory services. In addition to deploying its own resources, the Corporation has sought to catalyze additional investment flows to private companies in developing countries.

By year-end FY2000 (June 30), the 174 member countries had contributed $2.36 billion of paid-in capital to the IFC. Paid-in capital in turn represents 99% of the $2.37 billion in subscribed capital. The largest single shareholder is the United States with 23.7% of voting power, followed by Japan with 5.9% (with the combined voting power of member countries rated Aaa/Aa by Moody's amounting to 68.1% of the total). Membership in the International Monetary Fund (IMF) and the IBRD are prerequisites for membership in the IFC. Provisions in the IFC's articles ensure that the IFC board of directors is identical to that of the World Bank, facilitating coordination of the two institutions' policies and operations.

However, the distribution of voting power in the IFC board differs from that of the World Bank board because of the different patterns of ownership.

Capital Adequacy

IFC's maximum leveraging ratio (defined as the ratio of drawn debt, including guarantees, over the sum of total subscribed capital plus accumulated earnings) is 4X. The IFC sets minimum capital adequacy at 30% of total risk-weighted assets, where capital is defined as paid-in capital, retained earnings and adjusted general loss reserves, and placed against the sum of on and off-balance sheet assets weighted for risk. At the end of FY2000, the IFC's actual leverage and capital adequacy ratios were, respectively, 2.6X and 47.6%—very comfortably within its policy limits. Theoretically, this suggests that the IFC could expand its operations significantly on its existing capital base. However, such an expansion—particularly if it became necessary in the midst of a new crisis—could be difficult given the degree of country concentration that already exists in the Corporations's loan and equity investment portfolio (please see the following section of the report for further details). The countries to which the IFC is already the most heavily exposed are those that would also likely to be the most vulnerable in the event that severe financial and economic stresses were to re-emerge—leaving the IFC with little headroom to respond by extending new loans to borrowers operating within their boundaries. In short, the IFC's room for manuever in crisis circumstances in certain countries would be curtailed unless it either revised its internal country concentration limits, managed to redistribute risks to the market, or obtained fresh capital from member countries.

By sector and individual obligor—if not by country—the IFC's outstanding loans and equity investments are well diversified. Reflecting in part the reverberations of the Asian financial crisis and the need to consolidate after a period of rapid growth, IFC's approval volumes remained at $3.5 billion in FY2000 (about the same level as FY1999). The IFC's management expects the loan and equity portfolio to expand on the order of about 10% over the next two years. While no significant changes in the composition of the portfolio are currently anticipated, the IFC expects that growth will increasingly come from projects located in new countries and sectors—that is, in relatively new member countries and sectors or those in which the IFC's activity has been limited to date. Given the difficult environment in which the IFC's mandate obliges it to operate, the need to maintain asset quality is paramount: a period of consolidation should facilitate this.

Net worth was $5.7 billion at the end of FY2000, up from $5.3 billion in FY1999. This was equal to 42.4% of disbursed assets and approved but undisbursed commitments—an unweighted measure of broad economic exposure. It was also equal to 63.9% of disbursed loans (net of loss provisions) and equity investments (net of specific reserves)—a narrower measure of cash exposure.

Asset Composition and Quality

ASSET COMPOSITION AND QUALITY

Liquidity on the IFC's balance sheet is high, equal to 59.4% of total assets net of swaps. Balance sheet liquidity has accumulated since the mid-1980s, reflecting the Corporation's profitable growth and its program of borrowing significant amounts in the capital markets in order to fund its loans. Loans are 34.6% of average assets, while equity participations represent 10.7% of average assets. The equity share of the investment portfolio has been rising in recent years, and is now equivalent to 24% of the portfolio. However, growth in equity investments is likely to be subdued going forward due to the constraint of an an internal rule that limits straight equity investments (net of reserves) to 50% of the IFC's net worth (at the end of fiscal year 2000, the IFC was at 33% of that limit).

The IFC grew its portfolio of risk assets rapidly in the years preceding the Asia crisis. Growth in outstanding loans and equity investments slowed down sharply in FY 1997 and particularly FY 1998, and then began to pick up again during FY 1999. At fiscal year-end 2000, those outstanding investments gross of reserves stood at $10.9 (representing an increase of approximately 9% over the previous fiscal year). At the end of the year the IFC's portfolio included loans and equity investments in 113 countries; 163 new borrowing companies were added to the client list.

Asset quality continued to reflect the fallout from the East Asian financial crisis, although it appears that the worst of the shock has already been absorbed and that the stock of non-performing loans has now stabilized. Non-performing loans (i.e. loans in non accrual status—defined broadly as arrears in excess of 60 days) have nearly tripled from $322 million in FY1997 to $922 million in FY2000 ($857 million in FY 1999). The bulk of these troubled loans are attributable to problems in Asia: the gross non-accrual rate for five of the main Asian borrowers—Indonesia, Korea, Malaysia, Thailand and the Philippines—was 26.7% in FY2000, up sharply from only only 0.3% in FY 1997. Moreover, while 40% of the loan exposure in one country is non-performing (this country accounts for about 4% of the IFC's total investment portfolio), some of this is expected to be restructured in the near future.

Nonetheless, while there was a slight increase in non accrual loans in nominal terms over the last fiscal year, the ratio of non accrual loans stayed constant at about 11.1% of total loans and no new loans fell into non-accrual status during the year. The IFC's interest collection rate also improved in Asia over during FY 2000—and has remained stable in Latin America even during the height of the crisis period. We discuss the impact of these developments over the last three years on the Corporation's profitability below (please see the discussion on "Earnings Trends and Profitability"), noting further that this has been offset to some extent by a continued strong performance in the IFC's investment portfolio.

Vulnerabilities nevertheless remain in the IFC's portfolio. While the global crisis has receded and economic recovery is underway in many countries, the underlying fundamentals of the recovery are still fragile. A downturn in global economic conditions remains a risk, and could adversely impact many of the countries in which the IFC's borrowers operate. Therefore, it is possible that non-accrual loans could increase. In addition to Asia, private sector borrowers in the Russian Federation and the large Latin American countries may be particularly susceptible in such a scenario.

As indicated above, there is a high degree of risk concentration by recipient country—similar to the situation at the IBRD and the other regional multilateral banks—although by sector the portfolio is well diversified and without undue concentration. The country concentration limit net of specific reserves is 12%: Argentina and Brazil accounted for 10.9% and 10.4% of the disbursed exposure, respectively, at fiscal year-end 2000. The IFC's next largest country exposures, in descending order, are: Mexico (6.0%); India (5.7%); and Turkey (5.7%). The largest ten country exposures (gross of reserves) account for 57.5% of the IFC's portfolio, down from 60.5% last year. Concentration by borrowing company is not great—there is only one company with a share of the disbursed portfolio equal to or in excess of 1%. The IFC is seeking ways to manage the concentration in Argentina and Brazil in order to give it room for manuever in the event that it may need to increase its exposure in those two countries in the midst of a crisis situation.

Reserves

Loss reserves consist of specific and general reserves, and additions to these reserves are charged to income. Specific reserves are determined after a case-by-case semiannual review of the entire portfolio. The level of specific reserves reflects a judgment by IFC management that the investment is suffering significant and relatively permanent value impairment. This judgment is based on the Corporation's experience with the investment, its expected future performance, its security, and the position of other project sponsors.

The general reserve is intended to provide for risk in the portfolio as a whole that cannot be specifically identified (excluding that portion already covered by specific reserves). The general reserve is estimated by management, subject to a minimum determined on the basis of fixed percentages of outstanding loans and equity investments. At the end of FY2000, total loss reserves rose in absolute terms by $148 million, but fell slightly to the equivalent of 18.0% of total loans and equity investments outstanding from 18.2% the previous year. The IFC also has material unrealized gains in its equity portfolio that are disclosed in the footnotes to the financial statements.

Asset/Liability Management and Liquidity

Over the last decade, the IFC has effectively weaned itself from the World Bank funding that accounted for 75.5% of total borrowed funds in FY1985. And for the last two fiscal years, the IFC has not contracted any new borrowing from the IBRD. This change in the IFC's funding approach has been driven by two main goals: (i) to diversify the IFC's sources of funds in support of a significantly expanded investment

program; and (ii) to reinforce the private sector character of the IFC by exposing the Corporation to the financial discipline that would be needed to raise funds in international debt markets at the lowest possible cost. The strategy was predicated on the IFC being able to achieve borrowing costs no worse than those it would pay on its loans from the World Bank—an objective that has been achieved. Total borrowings were $4.4 billion in FY2000.

Outstanding loans are denominated in a variety of currencies, but overwhelmingly concentrated in two of these: the US dollar (91.1%) and the Euro (7.0%). Borrowings are denominated in 16 currencies, with all borrowings denominated in US dollars on an after-swap basis.

The Corporation uses swaps, forwards and other derivatives to manage currency and interest rate risk pursuant to its internal policy of curtailing risks. The practice of match-funding and the Corporation's liquidity policy have driven most of the increase in cash and liquid assets from $2.4 billion in FY1991 to $12.2 billion (53.6% of total assets) by fiscal year-end 2000. The Corporation's liquidity policy stipulates that liquid assets on the balance sheet must equal at least 65% of the next three year's cash needs. At fiscal year end 2000, the IFC's liquidity was equivalent to 103% of the next three year's cash needs—well above the minimum policy limit for this ratio. To date the Corporation manages its liquidity with profitability as a secondary consideration to the preservation of its capital earnings.

Earnings Trends and Profitability

A conventional banking business usually features a mix of cyclically sensitive revenues and steadier, "evergreen" flows off the loan portfolio, processing activities and recurrent account services. Time series analysis of the IFC income statement shows, by contrast, that nearly all components of revenue are subject to considerable fluctuation, which probably reflects the higher risk nature of the fundamental business. The IFC's business mix actually resembles less that of a full service bank than that of a particularly large venture capital firm. Further, the Corporation's policy towards write-offs (taking as few as possible and preferring to work out problem situations) suggests that volatility is channeled through income statement revenue instead of the conventional asset quality indicators on the balance sheet. Finally, and appropriately, the Corporation appears less willing to use its equity portfolio to smooth results and more concerned with getting the market timing right and meeting development objectives.

Results for FY2000 reflected an improved economic and financial environment as the crisis in global financial markets receded: the institution's net income rose substantially to $380 million from $249 million in the previous fiscal year, equivalent to a return on average net worth of 5.1% by Moody's calculations. The improvement in net income was driven by the significant reduction in annual loss provisions as well as by an improvement in the interest collection rate (to 90.1% from 89.5% during FY 1999). However, profitability has not returned to the pre-crisis level.

Rating History

Date	Long-Term Issuer Rating
12/21/94	Aaa

International Finance Corporation

BALANCE SHEET SUMMARY [1]

	2000	1999	1998	1997	1996
(US$ Millions)					
Assets					
Total Assets	**22,756**	**19,847**	**18,185**	**16,973**	**14,292**
Loans and Equity Investments	8,967	8,214	7,454	7,347	6,941
Loans	8,304	7,733	6,874	6,574	6,139
Equity Investments	2,636	2,307	2,102	1,849	1,678
Less Reserve against Losses	-1,973	-1,825	-1,522	-1,076	-876
Net cash, deposits and securities	12,001	10,050	9,255	8,147	6,410
Other	1,788	1,583	1,476	1,480	941
Liabilities and Equity					
Total Liabilities	**17,023**	**14,503**	**13,101**	**12,236**	**10,134**
Borrowings Outstanding	14,919	12,429	11,162	10,123	8,956
From World Bank	273	350	454	599	791
From other Sources	14,646	12,080	10,708	9,525	8,165
Other Liabilities	2,104	2,074	1,939	2,113	1,178
Total Equity	**5,733**	**5,344**	**5,084**	**4,737**	**4,158**
Subscribed Capital	2,372	2,374	2,364	2,364	2,348
Less Portion not yet due	-14	-24	-28	-135	-272
Plus Pmt. on acct. of pending subscription	2	2	2	2	2
Equals Paid-in Capital (PIC)	2,360	2,352	2,338	2,231	2,078
Unrealized gain (loss) on securities	-5	-6	-3	3	8
Accumulated Earnings	3,378	2,998	2,749	2,503	2,071
Total Liabilities and Equity	**22,756**	**19,847**	**18,185**	**16,973**	**14,292**

BALANCE SHEET COMPOSITION

As % of Average Assets (Excluding Loss Reserve)

	2000	1999	1998	1997	1996
Gross Loans	34.6	35.3	35.6	38.3	42.8
Gross Equity Investments	10.7	10.7	10.5	10.6	11.4
Cash	0.2	0.4	0.5	0.3	0.2
Earning Liquid Assets	47.3	46.2	45.6	43.5	39.7
Other	7.3	7.4	7.8	7.3	5.8
Debt to World Bank	1.3	1.9	2.8	4.2	6.2
Debt to Market Sources	57.6	55.1	53.6	53.3	54.7
Other Liabilities	9.0	9.7	10.7	9.9	5.2
Total Liabilities	67.9	66.7	67.1	67.3	66.2
Total Equity (incl. Loss Reserve)	32.1	33.3	32.9	32.7	33.8

[1] All data pertains to fiscal years ending June 30.

INCOME STATEMENT SUMMARY [1]

	2000	1999	1998	1997	1996
(US$ Millions)					
Total Income	**1,682**	**1,517**	**1,572**	**1,417**	**1,175**
Income, Loans & Equity Investments	956	872	897	924	763
Interest and Financial Fees	694	607	583	580	521
Dividends & Profit Participations	130	99	96	148	87
Capital Gains on Equity Sales	132	166	218	[illegible]	155
Financial Service Fees	49	33	66	75	63
Income, Deposits and Securities	596	532	550	411	348
Income from Staff Requirement Plan	47	64	54	—	—
Other	34	16	5	7	1
Total Expenses	**1,302**	**1,268**	**1,361**	**985**	**830**
Charges on Borrowings	812	670	651	536	489
Administrative Expenses	267	258	218	178	185
Provision for Losses	215	333	481	266	151
Contribution to Special Programs	7	3	4	5	4
Other	1	4	7	—	—
Net Interest Income	525	401	316	532	471
Net Income [2]	**380**	**249**	**246**	**432**	**346**

[1] All data pertains to fiscal years ending June 30.
[2] For 1998, includes $34.1 million of accounting changes.

International Finance Corporation

FINANCIAL RATIOS

	2000	1999	1998	1997	1996
Asset Quality					
Total Loans on Non-Accrual (US$ Mil.)	922	857.0	633.3	322.0	345.0
Non-Accruals as % Gross Loans Out.	11.1	11.1	9.2	4.9	5.6
Non-Accruals as % Loan Loss Res.	82.8	82.4	76.8	59.2	77.4
Non-Accruals as % Loan Loss Res. + Accumulated Earnings	20.5	21.2	17.7	10.6	13.7
Gross Write-offs (Loan & Equity) as % Gross Loans and Equity Investments	0.5	0.3	0.3	0.5	0.7
Net Write-offs (Loan & Equity) as % Gross Loans & Equity Investments	0.5	0.3	0.3	0.5	0.6
Loss Reserve to Net Write-offs (Loan & Equity) (X)	35.2	70.2	57.2	23.6	18.1
Loss Reserve plus Accum. Earn. as % Gross Loan and Equity Investments	48.9	48.0	47.6	42.5	37.7
Liquidity (%)					
Liquid Assets as % Undisbursed Loans + Equity Investments	463.9	349.3	374.4	388.3	316.4
Liquid Assets as % Total Borrow. Out.	80.4	80.9	82.9	80.5	71.6
Liquid Assets as % Total Market Borrow.	81.9	83.2	86.4	85.5	78.5
Performance Statistics (%)					
Return on Avg Assets (Incl. Loss Res.)	3.2	2.3	2.5	2.6	2.5
Return on Avg Equity (Incl. Loss Res.)	5.1	3.6	4.0	8.0	7.3
Return on Earnings Assets	1.7	1.2	1.4	2.6	2.4
Equity Ratios					
PIC + Accum. Earn. + Loss Res. as % Gross Assets [1]	31.2	33.1	33.5	32.2	33.2
PIC + Accum. Earn. + Loss Res. as % Gross Loans + Equity Investments [1]	70.4	71.4	73.6	69.0	64.4
Borrowings Out. + Guarantees % Subscr. Cap. + Accum. Earn. (X) [1]	2.61	2.33	2.19	2.08	2.03
Equity Investments net of Loss Reserves as % PIC + Accum. Earnings [1]	30.7	27.5	29.7	31.3	33.6

[1] PIC equals Paid-in Capital

International Finance Corporation

COUNTRY EXPOSURE OF IFC [1][2]
(US$ Million for Fiscal Year 2000)

	Loan	Equity	Total	%
Argentina	1,043.4	152.9	1,196.3	10.94
Brazil	888.5	253.9	1,142.4	10.44
Mexico	538.7	116.4	655.1	5.99
India	372.5	249.9	622.4	5.69
Turkey	597.6	20.9	618.5	5.65
Thailand	440.3	58.1	498.4	4.56
Indonesia	352.7	127.8	480.5	4.39
Pakistan	377.0	78.1	455.1	4.16
Venezuela	251.5	63.3	314.8	2.88
Philippines	256.4	55.5	311.9	2.85
Ten Largest Borrowers	**5,118.6**	**1,176.8**	**6,295.4**	**57.5**
Total	**8,303.7**	**2,636.4**	**10,940.1**	**100.0**

[1] Ten largest country exposures in the disbursed portfolio.
[2] Figures shown as percentage of gross investment outstanding.

IFC OWNERSHIP DISTRIBUTION BY TEN LARGEST SHAREHOLDERS
(As of June 30, 2000)

	Capital Amount	% of Total	Voting Power % of Total
United States	569,379	24.15	23.72
Japan	141,174	5.99	5.89
Germany	128,908	5.47	5.38
United Kingdom	121,015	5.13	5.05
France	121,015	5.13	5.05
Canada	81,342	3.45	3.4
Italy	81,342	3.45	3.4
India	81,342	3.45	3.4
Russian Federation	81,342	3.45	3.4
Netherlands	56,131	2.38	2.35
Ten Largest Shareholders	**1,462,990**	**62.1**	**61.0**
Total	**2,357,552**		

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Report Number: 59591

How Preferred Creditor Support Enhances Ratings

The Latin American financial market turmoil in 1994-1995 and the more widespread turbulence since 1997 have prompted efforts to devise new structures to enable transactions originating in emerging market countries to achieve foreign currency ratings higher than those of their sovereigns. One approach, "future flow structured transactions," uses structural, administrative, and legal features to accomplish this goal. A second approach, preferred creditor transactions, uses the preferential treatment afforded some multilateral lending institutions to do the same.

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Standard & Poor's has rated six preferred creditor transactions, from four different countries: the United Mexican States (local currency rating BBB+/Stable/A-2, foreign currency rating BB/Stable/B); the Republic of Argentina (local currency rating BBB-/Stable/A-3, foreign currency rating BB/Stable/B); the Federative Republic of Brazil (local currency rating BB-/Negative/B, foreign currency rating B+/Negative/B); and the Kingdom of Thailand (local currency rating A-/Stable/A-2, foreign currency rating BBB-/Stable/A-3). These transactions have generally performed well since being rated, with only one having been downgraded, and that by a singe notch.

Nonetheless, there have been developments that dictate a more critical approach to these transactions. Moreover, careful consideration of the country of domicile of the issuer and the preferred creditor institution supporting the transaction is essential and requires that ratings be done on a case-by-case basis.

Preferred Creditor Institutions

Sovereign governments are unique in the latitude that they have to decide which obligations they will pay, or permit to be paid, and which they will not. During the postwar era, governments have generally taken the view that obligations to some multilateral lending institutions, including the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank (IADB), the Asian Development Bank, the African Development Bank, the International Finance Corp. (IFC), the European Bank for Reconstruction and Development (EBRD), and the Corporacion Andina de Fomento (CAF), warrant payment even when countries are defaulting on their sovereign obligations to other lenders. Moreover, the countries of the Paris Club have agreed with this view and exempted these institutions—"preferred creditor institutions"—from application of the comparability-of-treatment principle. While most of these institutions have experienced payment delays caused by government actions—some lasting several years—these delays have typically been fewer and shorter than those experienced by commercial and official bilateral lenders. Moreover, these institutions have not been required to participate in general reschedulings of countries' external debt.

Preferred creditor status is fundamentally a political expression and is de facto, as a matter of conduct, rather than de jure, as a matter of law. This conduct, in turn, reflects sovereigns' incentives to place priority on loan repayments to multilateral lending institutions. These incentives include committed loans that have yet to be disbursed, the willingness to initiate new loans when other lenders will not, the availability of generally lower-cost funds at longer-term maturities, technical assistance, and the threat of sanctions; they are reinforced by the almost universal policy among multilateral lenders of not participating in loan reschedulings. Buttressed by the long record of favorable treatment of loans from multilateral institutions by sovereigns under severe financial distress, these incentives have led Standard & Poor's to expect that in most cases obligations to these institutions will receive similarly preferential treatment in the future.

To date, Standard & Poor's has rated preferred creditor transactions of the IFC, the World Bank, and the IADB. Transactions involving other institutions claiming preferred creditor status are under discussion. However, the claims of preferred creditor status by these institutions, and the transactions themselves, will be considered on a case-by-case basis.

Preferred Creditor Transactions

Certain structures permit preferred creditor treatment to be passed on to other lenders, and their use may allow transactions to be rated higher than the applicable sovereign foreign currency rating. However, the fact that a preferred creditor institution is involved in a transaction does not by itself make it a preferred creditor transaction. Keeping in mind that a Standard & Poor's credit rating is an opinion on the likelihood of full and timely payment of a financial obligation, a preferred creditor transaction:

- Relies on the sovereign's preferred creditor treatment of an institution to enhance the probability that foreign exchange will be available for the full and timely payment of interest and principal by the emerging market borrower to third-party lenders. If the payment to third-party lenders does not rely on preferred creditor treatment, the transaction is strictly speaking not a preferred creditor transaction. For instance, the World Bank, the IFC, and the IADB are all rated 'AAA' by Standard & Poor's, and any transaction unconditionally guaranteed by these institutions would be assigned an 'AAA' rating. However, in providing a guarantee, they would be indistinguishable from the point of view of third-party lenders from any other 'AAA' rated financial institution—their status as preferred creditor institutions, while no doubt enhancing the performance of their loan portfolios and thereby contributing to their own 'AAA' ratings, would contribute nothing to the rating of the transaction which they are guaranteeing. As a consequence, a fully guaranteed transaction is not a preferred creditor transaction.
- Is structured so that a borrower satisfying all of its obligation to the preferred creditor will satisfy all of its obligations to third-party lenders. For instance, in 1990 the World Bank guaranteed the principal, but not the interest, on a 10-year bullet bond issued by the Republic of Hungary (local currency rating A/Stable/A-1, foreign currency rating BBB/Positive/A-3). While this guarantee had real economic value and thus provided comfort to investors and enhanced the marketability of the bond, it would not have enhanced the rating (Hungary was not rated by Standard & Poor's until 1992). This is because the interest payments remained the responsibility of the government of Hungary, and as long as the government could default on a payment of interest *or* principal without defaulting on its obligation to the World Bank, the bond would have received Hungary's sovereign foreign currency rating. By contrast, in 1998 the World Bank enhanced its partial credit guarantee program by including—in addition to a guarantee of US$300 million of principal—a "rolling" interest guarantee whereby the World Bank undertook to make one interest payment on behalf of the issuer, the Electricity Generating Authority of Thailand (EGAT), should

EGAT not make the payment itself. If the World Bank made such an interest payment and were reimbursed by EGAT or the government of Thailand (which provided an indemnity to the World Bank) within 60 days, the interest guarantee would be reinstated and again cover one interest payment; if it were not reimbursed, the interest guarantee would not be reinstated. This transaction was rated three notches above the sovereign foreign currency rating of Thailand. It was not the World Bank's guarantee of one additional interest payment itself that justified the upgrade—since subsequent interest payments were not similarly guaranteed—but rather the expectation that the government of Thailand would make that payment to the World Bank within the grace period even if it defaulted on other sovereign obligations. As a corollary, should the World Bank make an interest payment to EGAT's bondholders and not be reimbursed by EGAT or the government of Thailand within 60 days, the transaction would immediately be downgraded to the current rating of the Kingdom.

Criteria for Sovereign Guaranteed or Indemnified Preferred Creditor Transactions

While Standard & Poor's factors preferred creditor status into its ratings of both sovereign and private-sector issues, it does so using different criteria.

For preferred creditor transactions guaranteed or indemnified by a sovereign borrower, Standard & Poor's is prepared to assign a foreign currency rating as much as three notches above the sovereign foreign currency issuer credit rating if:

- The government has not defaulted on any obligations to any multilateral with preferred creditor status under the auspices of the current regime, or if so, not within the preceding 15 years. If recent or anticipated political changes suggest possible diminution of the priority accorded to preferred creditor debt, the rating enhancement may be fewer than three notches, even with an unblemished payment record.
- The political regime has good relations with multilateral institutions and is integrated into global trade and financial systems. If the political system is less than fully open, or if some local interest groups advocate a more isolationist path, the rating enhancement may be fewer than three notches.
- Preferred creditor debt and debt service are a fairly modest portion of total external obligations. The higher the proportion of preferred creditor status debt and debt service, the lower the ability of the sovereign to accord it priority. If the proportions of preferred creditor debt and debt service are low, but Standard & Poor's believes that there is a significant probability that they will rise appreciably over the term of the issue, the rating enhancement may be fewer than three notches.

The EGAT example cited above was Standard & Poor's first rating of a World Bank preferred creditor transaction. Since Thailand satisfied all of the three conditions outlined above, the transaction was rated 'A-', three notches above Standard & Poor's 'BBB-' sovereign foreign currency rating of the Kingdom.

It is important to note that since a sovereign guaranteed or indemnified preferred creditor transaction can be rated a maximum of three notches over the sovereign foreign currency rating, if Thailand's sovereign foreign currency rating were to be reduced, the rating of the EGAT transaction would be reduced pari passu. While this is not necessarily the case of a transaction enjoying a lower notch rating enhancement, it is likely unless there is some offsetting positive change.

Criteria for Unguaranteed and Private-Sector Preferred Creditor Transactions

All of the borrowers for IFC and IADB transactions rated by Standard & Poor's have been private-sector entities. In each case, one of these multilateral institutions has been the "lender of record"—the direct lender to the borrower. It in turn has maintained a portion of the loan on its balance sheet (the "A" loan) while participating a

portion of the loan out to commercial bank and/or institutional lenders (the "B" loan). These participations are either directly to the banks and institutional lenders or through securitizations of the loans through the use of special-purpose vehicles (SPVs). In either case, the participants bear the full commercial risk of the borrower—the credit enhancement of the transaction comes from the expectation that during a time of financial distress, the authorities will provide borrowers the opportunity to purchase foreign exchange to service loans to these institutions while denying or delaying that opportunity for loans by other creditors.

In these transactions, the rating analysis begins with the local currency rating of the borrower, which reflects the borrower's willingness and ability to service all of its obligations, regardless of currency, absent foreign exchange controls. If the borrower's obligation is to the IFC or the IADB, which have been determined by Standard & Poor's to be preferred creditor institutions in this context, Standard & Poor's expectation is that foreign exchange will be made available by the monetary authorities to the borrower against payment of the corresponding local currency to service its obligation. Accordingly, the constraint of the sovereign foreign currency rating is effectively removed, and the borrower's obligation can be assigned a foreign currency rating equal to its local currency rating. As in the case of the sovereign guaranteed preferred creditor transactions, however, this higher rating is subject to the past record of the borrower's country with respect to payment of multilateral obligations, the quality of its relations with multilateral institutions and its integration into the global trade and financial systems, and the relative size of the country's preferred creditor debt and debt service. It is thus possible for a transaction in a country not meeting these criteria to receive a foreign currency rating lower than its local currency rating, but still above the sovereign foreign currency rating.

The first preferred creditor transaction rated by Standard & Poor's employing these criteria was that done in 1995 for Apasco, a Mexican-domiciled cement company. The company's local currency rating was 'BBB+'; and Mexico's sovereign foreign currency rating was 'BB'. The IFC's US$85 million B loan to Apasco was placed in an SPV, the only asset of which was the IFC's B loan. The US$85 million notes issued in turn were rated 'BBB+' by Standard & Poor's, equal to the local currency rating of Apasco. Since that time, Standard & Poor's has rated similar IFC transactions originating in Mexico, Argentina, and Brazil. In each case, they have been assigned a foreign currency rating equal to the company's local currency rating. In a rating of a direct participation, earlier this year Standard & Poor's assigned its first rating to a B loan from the IADB to Transportadora de Gas del Sur S.A. (TGS), Argentina's largest natural gas transportation company. While Argentina's sovereign foreign currency rating was 'BB', the IADB's loan to TGS was rated 'BBB-', equal to the local currency rating of the company.

It is important to note that under these criteria, and unlike the ratings of sovereign guaranteed transactions, the ratings of unguaranteed transactions are in principle independent of the sovereign foreign currency rating. Accordingly, there is no presumption that a reduction in the sovereign foreign currency rating will be accompanied by a reduction in the rating of the transaction. Of course, such a reduction could happen if there were a concomitant

Table 1

Loan Portfolio Characteristics of Select Multilateral Lenders

Institution	Disbursed loans (year-end 1998) (Mil. US$)	Growth in disbursed loans, 1993-1998* (Mil. US$)	% per annum
World Bank	103,336¶	2,035	0.4
Inter-American Development Bank	31,687	10,220	8.1
Asian Development Bank	24,698	10,993	12.5
African Development Bank	9,026	927	2.2
International Finance Corp.	5,898¶	1,764	7.4
European Bank for Reconstruction and Development	4,545	376	64.6
Corporacion Andina de Fomento	3,547	2,092	19.5

*Source: "Supranationals," September 1998, Standard & Poor's. *End-June 1993 to end-June 1998 for World Bank and IFC. ¶End-June 1998.*

reduction in the rating of the issuer, which can happen for reasons that also occasion the downgrade of a sovereign foreign currency rating, or if developments raised concern about future respect for the multilateral institution's preferred creditor status.

PREFERRED CREDITOR TRANSACTIONS GROW IN POPULARITY

Disbursed loans of multilateral institutions have increased at a relatively modest rate in recent years. For instance, between year-end 1993 and 1998, disbursed loans of seven rated multilateral lenders to emerging market countries increased at an average annual rate of 4.0%. In absolute terms, the Asian Development Bank and the IADB were leaders, with the EBRD a distant third. In percentage terms, the increase was paced by the EBRD, which started from a very low base, with CAF and the Asian Development Bank showing lower, but still double-digit, growth.

By contrast, the aggregate value of preferred creditor loan participations has increased sharply, albeit from a low base. This increase has been almost entirely the result of the IFC's loan participation program, which increased the value of participations (outstanding plus undisbursed) to US$9.2 billion at end-June 1998 from US$2.8 billion at end-June 1993, an average annual increase of 27.2%. The IADB has also become more active in this area, albeit from a very low base. At year-end 1996, the IADB had US$73 million in participated loans, which increased to US$231 million at year-end 1997 and US$256 million at year-end 1998. A substantial increase is expected during 1999, with a single B loan participation of US$176 million for TGS already having been rated and placed with investors. In addition, the World Bank's EGAT transaction added US$300 million in preferred creditor debt. Standard & Poor's has been shown transactions involving other multilateral institutions, and it seems likely there will be preferred creditor transactions emanating from additional multilaterals so long as there is market appetite and sovereigns continue to accord preferred creditor status.

New structures employing preferred creditor status have been developed. The IFC has again been the leader in this regard, with two notable transactions: the 1994 securitization of US$400 million of its A loan portfolio; and the "single-asset securitizations," such as that for Apasco noted above. These were important transactions because they were the first rated preferred creditor transactions; they brought the advantages of preferred creditor status to the attention of institutional investors; they were placed with institutional investors rather than the IFC's usual bank participants, which facilitated an expansion of the IFC's B loan program; they permitted longer maturities than were generally available from banks; and in the case of the single-asset securitizations, they allowed individual borrowers to be introduced to the capital markets. In addition, as described above, the World Bank's EGAT transaction was a potentially important innovation. Finally, Standard & Poor's has been shown other structures utilizing multilaterals' preferred creditor status, some of which may be viable should the sovereigns and the institutions agree to support them.

ISSUES REGARDING PREFERRED CREDITOR TRANSACTIONS

Preferred creditor transactions have become attractive to a growing number of market participants, both banks and increasingly, institutional investors. However, Standard & Poor's has concerns regarding these transactions of which investors and the originating institutions themselves should be aware. These concerns include the following:

- Will the preferred creditor status of multilateral institutions continue to be respected by sovereigns? As noted above, the ratings enhancement given preferred creditor institutions depends on sovereign governments continuing to accord preferred creditor status. Should that preference diminish even among a limited number of countries, higher ratings on transactions involving preferred creditors would be difficult to sustain. It was thus of some concern when the Islamic Republic of Pakistan ('SD'—selective default) failed to permit commercially viable IFC loans to be serviced in a timely manner during the second half of 1998.

However, eventually the foreign exchange was made available, reinforcing the IFC's preferred creditor status vis-à-vis Pakistan.

- Will the extension of preferred creditor status to private-sector lenders continue to be permitted by the major industrial countries? One result of the global financial turbulence of recent years has been the reconsideration of the existing "international financial architecture." One harbinger of change is the decision of official bilateral creditors, working through the Paris Club, to require the government of Pakistan to seek rescheduling of its bonds under the principle of "comparability of treatment." There have also been proposals that bond documentation be amended to facilitate the "bailing in" of private-sector lenders. Under these circumstances, it is at least plausible that at some point the major industrial countries—which are also the principal shareholders of the multilateral institutions—may become unwilling to allow private-sector lenders to fully enjoy the benefits of preferred creditor status and may decide to "bail in" those lenders as well. Depending on how this policy change would be applied, it could result in an immediate reduction in the ratings of all preferred creditor transactions. In this regard, it is important that preferred creditor institutions be seen as filling a special niche among lenders. This includes supporting transactions consistent with their role as development institutions, successfully mobilizing private-sector capital to support their transactions, and more generally, acting as a catalyst for other development-supporting transactions.
- Does concentration of preferred creditor risk make preferential treatment of preferred creditor transactions untenable? At the limit, if all of a country's external debt is accorded preferred creditor status, then effectively none of it is. Most emerging market countries have loans from at least three rated multilateral institutions, and some Latin American countries have loans from four (the World Bank, the IFC, the IADB, and CAF). In addition, there are other unrated multilateral institutions claiming preferred creditor status. Accordingly, while it is possible that no single institution would account for an unsettling portion of a country's medi-

Table 2

Select External Debt Ratios to Multilateral Lenders

Country	Multilateral/Total external debt, year-end 1997 (%)	Change in multilateral/Total external debt, 1992-1997 (% points)	Multilateral debt service/Total external debt service, 1997 (%)
El Salvador	68.2	25.5	69.2
Bolivia	58.7	10.7	60.3
Paraguay	57.5	7.4	52.9
Pakistan	46.0	0.9	29.5
Costa Rica	44.9	11.3	46.2
Papua New Guinea	38.7	13.3	22.0
Trinidad & Tobago	36.9	26.3	13.8
India	33.1	0.1	21.6
Romania	32.4	(22.1)	19.0
Morocco	31.7	6.4	34.9
Dominican Republic	27.9	5.0	30.8
Kazakhstan	24.1	24.1	9.5
Philippines	22.3	(3.6)	28.0
Jordan	20.8	7.8	33.8
Peru	18.6	5.4	20.6
Indonesia	16.3	(7.2)	14.8
Mexico	14.7	(4.3)	7.5
Panama	14.3	(4.1)	7.5
Bulgaria	13.1	10.1	32.6
Lebanon	11.4	(4.5)	5.0
Argentina	10.3	0.2	6.9
Slovak Republic	9.3	(4.4)	5.5
Turkey	9.8	(12.1)	16.1
Korea	8.8	(1.5)	5.4
Venezuela	8.4	(0.8)	5.9
Brazil	6.4	(3.3)	5.5
Russia	5.0	4.1	4.6
South Africa	0.0	0.0	0.0

Source: World Bank.

um- and long-term external debt—since that is what is generally rescheduled—it is possible that collectively multilateral institutions could. World Bank data on external debt provide some rough but nonetheless helpful figures in this regard. Table 2 shows for selected countries, as of year-end 1997, public and publicly guaranteed debt to multilateral institutions as a percentage of total medium- and long-term external debt, and debt service on multilateral debt as a percentage of total external debt. In addition, it shows the change in the ratio of multilateral to total external debt between year-end 1992 and 1997. Since no IFC loans are government guaranteed, and since the IADB and CAF are now doing a limited amount of lending to private-sector borrowers without government guarantees, these numbers underestimate the total share of preferred creditor debt. Nonetheless, they are helpful in identifying which countries are less likely to be given the full ratings enhancement for preferred creditor transactions because of the share of preferred creditor debt and its rapid growth. As shown in the table, for three countries—the Republic of El Salvador (local currency rating BBB+/Stable/A-2, foreign currency rating BB+/Stable/B), the Republic of Bolivia (local currency rating BB+/Stable/B, foreign currency rating BB-/Stable/B), and the Republic of Paraguay (local currency rating BB+/Negative/B, foreign currency B+/Negative/B)—preferred creditor debt accounts for more than half of total medium- and long-term external debt; and for two other countries, Pakistan and the Republic of Costa Rica (local currency rating BB+/Stable/B, foreign currency rating BB/Stable/B), multilateral debt is more than 40% of total external debt. Moreover, in four of these five cases, there has been a significant increase in the share of preferred creditor debt between 1993 and 1998. On the other hand, Brazil, Argentina, and Mexico have relatively low shares of multilateral debt, and thus far the amounts of unguaranteed preferred creditor debt are relatively modest.

- Is the transaction excessively "stretching the umbrella"? In addition to the transaction being structured so that by meeting its obligations to the preferred creditor institution the borrower fully services all of its obligations under the transaction, Standard & Poor's requires that the preferred creditor institution retain a meaningful stake in the transaction. Accordingly, Standard & Poor's would not grant—or continue to grant—full preferred creditor status to a transaction that was completely removed from the books of the preferred creditor institution, either by participating out all of a loan on an individual basis (a B loan participation or securitization) or by including all of an A loan in a pool of securitized loans of which it did not retain a meaningful share. This is important, since Standard & Poor's has been shown structures in which the preferred creditor institution was only involved as a booking agent to accord the transaction preferred creditor status.

Summary

In according preferred creditor status, sovereigns effectively allow for enhanced ratings of foreign currency transactions. Additional transactions of this type seem likely. However, each of these transactions must be rated on a case-by-case basis. Moreover, some ratings may be affected by changes in the sovereign rating (sovereign guaranteed or indemnified transactions), while others will be affected by changes in the underlying creditworthiness of the borrower (unguaranteed or private-sector transactions). Finally, all ratings of preferred creditor transactions are ultimately reliant on the multilateral lenders continuing to enjoy preferential treatment from the countries into which they are lending, which may be less certain today than seemed the case a few years ago because of the growth of preferred creditor debt to high levels in some countries and the possibility that Paris Club countries will decide to impose comparability of treatment on participants in preferred creditor loans.

STANDARD & POOR'S

SOVEREIGN RATINGS SERVICE

CREDIT RATINGS
AAA/Stable/A-1+

RATING HISTORY
'AAA' long-term foreign currency rating assigned 1989
'A-1+' short-term foreign currency rating 1997

BASIC DATA (2001)
(fiscal year ended June 30, 2000)
Total assets(incl. undisbursed loans and equity investments)........US$41.3 billion
Capital (paid-in).....US$2.4 billion
Number of shareholders........174

PURPOSE
To further economic development by supporting the growth and development of the private sector in member countries. IFC's primary activity is making loans and equity investments in individual private enterprises. IFC also mobilizes funds through cofinancings, loan syndications, securitizations, underwritings, and guarantees and provides financial and technical advisory services.

GENERAL CAPITAL
Total capital at June 30, 2000, was US$5.7 billion, consisting of US$2.4 billion of paid-in capital and US$3.4 billion of retained earnings and other items.

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ANALYSIS

INTERNATIONAL FINANCE CORP.

RATIONALE

The ratings on International Finance Corp. (IFC) reflect:

- Strong membership support, including treatment as a preferred creditor,
- Membership in the World Bank Group,
- Conservative statutory and management policies, and
- A stronger financial performance accompanying generally improving international financial conditions.

A member of the World Bank Group, IFC was established in 1956 to further economic development in its member countries by encouraging the growth and development of the private sector. While it complements the work of other World Bank Group members and is now working more closely with the World Bank than in the past, IFC is legally and financially independent, with its own Articles of Agreement, shareholders, financial structure, management, and staff.

IFC supports the development of private-sector enterprises in three principal ways:

- By making medium- and long-term loan and equity investments from its own resources;
- By mobilizing funding from other lenders and investors through cofinancings, syndications, securitizations, underwritings, and guarantees; and
- By providing a variety of financial and technical advisory services. Unlike other multilaterals, IFC cannot (under its Articles of Agreement) accept government guarantees for its loans.

IFC's membership in the World Bank Group, its commitment to emerging-market development and concomitant willingness to lend during periods of financial stress, its small share of the total external debt of borrowing countries, and the preferential treatment it has received from borrowing countries in the past all reinforce its status as a "preferred creditor." Accordingly, governments are expected to make foreign exchange available to private-sector borrowers to service their loans to IFC even when those governments are defaulting on their own sovereign obligations.

The number of member countries has grown to 174 (with two more in the process of joining) at fiscal-year-end 2000, from 147 at fiscal-year-end 1992, primarily through the admission of members from the former Soviet Union and the former Yugoslavia. IFC's membership has been supportive in the past, nearly doubling the institution's paid-in capital, to $2.4 billion at fiscal-year-end 2000, from $1.3 billion at fiscal-year-end 1992. Unlike that of most other multilateral lenders, all of IFC's capital is paid in. Moreover, all of IFC's net income is generally retained, and total equity increased to $5.7 billion at fiscal-year-end 2000, from $2.4 billion at fiscal-year-end 1992, an 11.6% average annual rate of growth.

Nonaccrual loans were 11.1% of disbursed loans at fiscal-year-end 2000,unchanged from one year earlier, but sharply higher than the 4.9% of fiscal-year 1997. While these figures are high relative to those of other 'AAA'-rated multilaterals, reflecting IFC's private-sector focus, nonaccrual loans are more than covered by loan-loss reserves. Reserves against equity investments were 28% of disbursed equity at fiscal-year-end 2000, even though sharply reduced provisions accounted for most of the increase in net income, to $380 million, from the $249 million of fiscal-year 1999. The return on average equity was 6.9%, up from the 4.8% of a year earlier, but

still well below the 9.7% return of fiscal-year-end 1997. IFC's liquidity is by far the strongest among rated multilateral lenders, and capitalization, with total net loans and equity investments of $9.0 billion against total equity of $5.7 billion, is consistent with IFC's 'AAA' rating.

Outlook

IFC's preferred-creditor status and conservative financial management will continue to underpin the ratings so long as IFC does not materially change its financial profile or business mix. Unless the institution's shareholders decide to expand its role, capital increases during the next few years will likely come entirely from retained earnings. However, improved profitability will support continued strong growth in disbursements. With the private sector expected to continue to play a larger role in economic development, IFC's franchise value is expected to increase.

Origin and Purpose

IFC was established in 1956 to further economic development in its member countries by encouraging the growth of private enterprise. It is a member of the World Bank Group, which also includes the International Bank for Reconstruction and Development ("World Bank," rated 'AAA/Stable/A-1+'), the International Development Association (IDA), and the Multilateral Investment Guarantee Agency (MIGA). Its activities are intended to complement the overall development objectives of the other group institutions. IFC, however, is legally and financially independent of other group entities, with its own Articles of Agreement, shareholders, financial structure, management, and staff. Moreover, unlike other group members, under its Articles of Agreement, IFC is not permitted to accept government guarantees, although involvement of a government in an enterprise does not necessarily preclude the corporation's lending or making an equity investment.

IFC supports the private sector in three principal ways:

- By making long-term loan and/or equity investments from its own resources;
- By mobilizing funding from other lenders and investors through cofinancings, syndications, securitizations, underwritings, and guarantees; and
- By providing a variety of financial and technical advisory services.

Membership, Governance, and Organization

By year-end 1956, IFC had 56 developed and developing member countries. Membership increased gradually, to 147 member countries at fiscal-year-end 1992, then grew rapidly with the addition of new members from the former Soviet Union and the former Yugoslavia. At fiscal-year-end 2000, IFC had 174 members, unchanged from one year earlier, with membership in progress for two other countries (the former Republic of Yugoslavia; and Sao Tome and Principe.

IFC confers benefits on both its developing and developed country members. Developing country members benefit from:

- IFC's loans to, and equity investments in, private-sector companies in developing countries. For many years, IFC has been a leading investor in private-sector companies in developing countries. This is especially important now that the private sector is playing a much more significant role in most countries' development strategies, including investing in sectors that were formerly deemed the domain of the public sector.
- IFC's mobilization of other lenders. In recent years, participations in IFC loans by other financial institutions have become almost as large as loans maintained on IFC's own balance sheet.
- IFC's creation of incentives for private-sector clients to adopt and implement international accounting and financial management standards. By insisting on such standards, IFC has created important demonstration effects for other private-sector borrowers and, in some cases, contributed to the development of better regulatory standards.
- Financing at terms that, while market related and thus less favorable than those of multilateral lenders benefiting from sovereign guarantees, are typically better than a private-sector company could realize without IFC, especially in times of financial stress; for example, IFC often grants longer tenors than do private lenders.
- IFC's willingness and ability to act as a trusted financial and technical advisor, which is particularly important in the case of highly sensitive transactions.

Developed member countries also benefit from IFC's activities. In addition to broad-scale contributions to growth, trade, and development, the more direct benefits include:

- IFC's support for private-sector development, which is important ideologically and politically for some countries, especially the U.S.
- Some reduction in the pressure for official bilateral lending. IFC's own lending is to some degree a substitute for official lending. Moreover, each dollar of paid-in capital is leveraged through IFC's own leveraging and its ability to attract private-sector lenders to participate in its loans.

Control of IFC is firmly in the hands of industrial countries, with the G-7 shareholders collectively holding more than the 50% of voting shares required for most board decisions. At fiscal-year-end 2000, the lineup of voting shares was as follows:

- The U.S., 23.7%;
- Japan, 5.9%;
- Germany, 5.4%;
- France, 5.1%;
- The U.K., 5.1%;
- Canada, 3.4%; and
- Italy, 3.4%.

Increasing the IFC's authorized capital (aside from increases occasioned by new members) requires the agreement of members with four-fifths of the voting power, while amendments to the articles require the agreement of three-fifths of the governors, exercising 85% of the total voting power. The U.S. thus has a veto over the most important decisions affecting IFC.

Under IFC's Articles of Agreement, governors of the World Bank are ex officio governors of IFC and meet at least once annually in conjunction with the annual World Bank meetings. While the articles permit the governors to vote on specific questions without calling a meeting of the board, day-to-day decisions are delegated to the board of directors, with only the most important policy decisions reserved for the board of governors.

Under the Articles of Agreement, the president of the World Bank is chairman ex officio of IFC. While not so stipulated in the articles, the president of the World Bank is traditionally also the president of IFC. The day-to-day administration of the institution falls to the executive vice president. As a result of a reorganization during fiscal-year-end 2000, two vice presidents now manage the core business of IFC: The vice president for operations oversees new business from the origination through the commitment of funds, as well as treasury operations; and the vice president for Portfolio and Risk Management supervises projects on the balance sheet, as well as credit review, risk management, and trust-fund operations.

Other vice presidents oversee Human Resources and Administration, the Legal Department, and Private Sector Development Infrastructure, which has recently become a joint IFC-IBRD department. At fiscal-year-end 2000, IFC's staff—consisting of regular and fixed-term staff, long-term consultants, temporary staff, and overseas staff—numbered 1,933, up from 1,856 at fiscal-year-end 1999 and 1,224 at fiscal-year-end 1995.

Financial Policies

IFC operates on the basis of conservative financial and risk-management policies, which is appropriate for an institution 84% of whose loans and 71% of whose equity investments are to private-sector companies domiciled in non-investment-grade countries. Most of the corporation's current financial policies, which address the issues of capitalization, liquidity, and asset quality, were adopted following a board review during fiscal-year 1994.

Capitalization. IFC's capital constrains the size and composition of its balance sheet in several ways: Its articles require that as long as IFC is indebted to the World Bank (as it was at fiscal-year-end 2000), the ratio of outstanding debt plus guarantees to total capital should not exceed 4.0:1. The policies adopted by the board in fiscal-year 1994 include:

- Eligible capital (equal to paid-in capital, retained earnings, and general loss reserves) must be equal to at least 30% of total risk-weighted assets, which are calculated using a methodology based on the BIS guidelines for commercial banks.
- Exposure to a single country is limited to 25% of IFC's total capital.
- Total disbursed equity plus quasi-equity in a single obligor is limited to no more than 3% of total capital.
- Total disbursed equity and quasi-equity investments, net of specific reserves, are limited to no more than 100% of total capital.
- Total disbursed equity investments, net of specific reserves, are limited to no more than 50% of total capital.

Table 1 shows IFC's compliance with these guidelines. It is clear that IFC has consistently remained well within its financial-policy guidelines.

Liquidity. IFC's liquidity policy requires that it hold liquid assets equal to at least 65% of the next three years' expected cash requirements, that is, expected loan disbursements and debt-service payments. As shown in Table 2, during the past five years, IFC has maintained liquidity well in excess of that required by its policy. It sharply increased liquidity to 111% of expected cash requirements during fiscal-year 1999, reflecting management concern that IFC might be faced with a less-supportive borrowing environment in the face of international turmoil. However, with the return of more normal market conditions, IFC reduced its liquidity to 103% of expected requirements at fiscal-year-end 2000. This is by far the strongest liquidity position among rated multilateral lenders.

Asset Quality. IFC's mandate to lend and invest without government guarantees in the private sector in developing countries exposes the institution to greater credit risk than most other rated multilateral lenders. As a consequence, IFC has a variety of non-capital-based policies to manage these risks.

In addition to the policy that disbursed exposure (including loans, equity, quasi-equity, guarantees, and risk-management products) net of specific reserves to any single country not exceed 25% of capital, there is also a policy that neither the disbursed nor the held (including disbursed plus committed but as yet undisbursed exposure) portfolio's exposure in any single country exceed 12% of IFC's total portfolio. This policy reflects the fact that, even if IFC's preferred creditor status is respected, adverse economic conditions in a country could affect all of IFC's private sector clients in that country.

IFC had exposure to 111 different member countries at fiscal-year-end 2000, with disbursed loans in 101 and equity investments in 92. Table 3 shows the IFC's countries of greatest exposure, which in all cases were below the 12% limit at fiscal-year-end 2000. An exception to the 12% limit was made for Brazil during fiscal-year 1998 by IFC's Board of Directors, which noted that the exposure remained well below 25% of total capital policy.

Table 3 also shows that the country concentration of IFC's exposure, whether measured in terms of the five or 10 largest countries, has declined during the past few years. Countering this trend were significant increases in exposure in Mexico and Argentina, offset by decreases in Pakistan, Thailand, and India.

Table 1

Compliance with Capital-Based Management Guidelines

		—Year ended June 30—				
	Guidelines	2000	1999	1998	1997	1996
Debt + guarantees/total capital (x)	<4.0:1	2.5	2.4	2.3	2.2	2.2
Eligible capital/risk-weighted assets (%)	>30	47.6	47.5	48.6	48.1	44.7
Largest country exposure/total capital (%)	<25	17.6	16.6	18.6	18.0	18.2
Largest single equity + quasi-equity investment/total capital (%)	<3	1.6	1.7	1.2	1.4	1.1
Total equity + quasi-equity/total capital (%)	<100	52.6	47.9	46.7	45.8	46.8
Total disbursed equity/total capital (%)	<50	33.4	34.5	33.5	33.8	36.0

Table 2

IFC's Liquidity Position

	—Year ended June 30—				
	2000	1999	1998	1997	1996
Liquidity as percentage of next three years requirements (%)	103.1	[illegible]	77.8	82.8	86.0

Table 3

IFC's Countries of Largest Exposure: Disbursed Loans and Equity Investments*

(% of total)	Loans	Equity	Loans + Equity**		
	—Year ended June 30—				
Country	2000		2000	1999	1998
Argentina	12.6	5.8	10.9	10.2	9.8
Brazil	10.7	9.6	10.4	11.0	12.6
Mexico	6.5	4.4	6.0	5.3	4.6
India	4.5	9.5	5.7	6.3	7.1
Turkey	7.2	0.8	5.7	6.2	6.4
Thailand	5.3	2.2	4.6	5.6	6.2
Indonesia	4.3	4.9	4.4	5.1	5.4
Pakistan	4.5	3.0	4.2	5.0	6.0
Venezuela	3.0	2.4	2.9	2.4	2.2
Philippines	3.1	2.1	2.9	2.6	2.2
Five largest countries**	42.3	34.2	38.7	39.3	42.1
Ten largest countries**	61.7	44.6	57.6	59.9	62.5

*Before loss reserves. **Countries included vary from year to year.

Table 4

IFC's Disbursed Loan and Equity Investments by Region

	—Year ended June 30—							
	Disbursed loans				Disbursed equity			
(% of total)	2000	1999	1998	1997	2000	1999	1998	1997
Latin America	41.7	39.5	40.0	42.5	32.4	31.5	33.1	34.7
Asia	29.0	31.2	32.9	33.4	32.1	33.1	31.7	32.2
Europe & Central Asia	19.0	19.1	16.7	13.2	17.4	16.6	17.6	16.2
Sub-Saharan Africa	6.3	5.9	5.9	7.0	10.2	10.0	9.4	8.6
Middle East and North Africa	4.0	4.3	4.4	3.9	6.1	6.7	5.8	5.9
Multiregional facilities	N.A.	N.A.	N.A.	N.A.	1.7	2.2	2.4	2.3

*Before loss reserves. N.A.—not available.

Table 5

S&P Ratings of Countries to Which IFC Had Exposure at End-FY

	Disbursed loans (% portfolio)		Disbursed equity (% portfolio)	
	2000	1999	2000	1999
AA+	0.0	0.0		
AA-	0.0	0.0	0.4	0.4
A+	0.0	0.1	0.0	0.0
A			0.2	0.2
A-	2.4	3.4	6.2	8.5
BBB+	1.3	3.1	3.0	2.4
BBB	4.7	4.1	9.1	4.7
BBB-	7.7	11.0	9.7	11.0
BB+	11.5	4.1	7.9	5.9
BB	19.8	24.2	21.5	21.2
BB-	2.2	3.4	1.1	1.4
B+	19.8	14.9	12.4	15.0
B	3.3	7.9	2.8	1.3
B-	7.8	1.1	9.4	0.7
CCC+	0.0	4.6	0.0	6.9
SD	4.3	6.9	5.5	8.1

*<0.05%.

These changes reflect IFC's efforts to operate as both an aggressive yet prudent lender, meaning that both improving and deteriorating credit conditions—within bounds—create good business opportunities for IFC. Extremely adverse conditions, however, make the business environment for private-sector borrowers in some countries simply too risky.

While IFC does not have specific regional guidelines, the regional distribution of IFC's loan and equity exposure is shown in Table 4. Three aspects of this distribution warrant mention:

- The first is the substantial size of IFC's exposure in Latin America. This is consistent with the number of relatively strong companies in subinvestment and marginally investment-grade countries, which historically have provided attractive business opportunities for IFC.
- The second is the growth of lending to Europe and Central Asia, which reflects IFC's efforts to be supportive to the private sector in transition economies.
- The third is the increase in lending to Sub-Saharan Africa during fiscal-year 2000, which reflects IFC's renewed effort to find creditworthy private-sector borrowers in "frontier" economies, where poverty is particularly acute.

The use of disbursed figures understates the pickup in IFC's activities in Africa, where the dollar volume of approvals (including syndicated participations) tripled during fiscal-year 2000. This emphasis on Sub-Saharan African borrowers bears watching, since, during the past four years, Africa accounted for $57.7 million of IFC's total loan write-offs of $78.4 million, while accounting for less than 7% of the loan portfolio. By contrast, the experience with equity investments was more normal, with Sub-Saharan Africa accounting for $7.9 million out of $81.9 million in write-offs, while accounting for about 10% of the equity portfolio. The nonaccruals and write-offs on both the loan and equity portfolios were more consistent with exposures during fiscal-year 2000.

The distribution of IFC's loan and equity portfolios at fiscal-year-end 2000 and fiscal-year-end 1999 by Standard & Poor's ratings of their countries of domicile is shown in Table 5. While small amounts are in countries rated 'A' and above, representing equity investments made years ago in Taiwan ('AA+/Stable/A-1+') and Portugal ('AA/Stable/A-1+'), significant exposure begins with countries in the 'A-'

range, particularly the Czech Republic. However, IFC's loans and equity investments are concentrated in non-investment-grade or unrated countries, virtually all of which would be noninvestment grade if they were rated. The percentage of disbursed loans to non-investment-grade or unrated countries at fiscal-year-end 2000 was 83.9%, an increase from the 81.3% of fiscal-year-end 1999; the percentage of disbursed equity was 71.4% at fiscal-year-end 2000, down from the 77.8% of a year earlier. These changes in the country-credit-rating distribution of IFC's portfolios reflect, of course, both changes in country ratings and changes in the country composition of IFC's loan and equity portfolios.

IFC's policies limit exposure to a single "risk factor" to no more than 8% of IFC's total portfolio (net of specific reserves). However, these sectors do not in all cases correspond to specific industries, but rather represent exposures having a worldwide risk factor in common, such as the world market price in the case of a widely traded commodity. Table 8 shows the compliance with the "single-factor" guideline. There are no similar policy guidelines for more conventionally defined industries. However, management recently has determined that two industries warrant special attention in the future: the financial industry and the infrastructure industry, including power, water, sanitation, transportation, and telecommunications. Table 6 shows the industry distribution of loans, while Table 7 shows that of equity.

IFC's focus on the financial industry reflects several factors:

- A greater appreciation of the importance of healthy financial sectors, which was driven home by the international financial turmoil of the late 1990s;
- The potential contribution to the alleviation of poverty through, for instance, the development of mortgage markets;
- The opportunity to finance small and medium-sized companies efficiently through financing local financial firms; and, perhaps,
- The ability to engage in these activities with less risk by working through financial institutions that may be more creditworthy than the entities to which they are lending.

Thus more than 45% of approvals during fiscal-year 2000 were for financial-industry projects. And, as is clear from Table 7, the financial-services industry is by far the largest beneficiary of IFC's equity investments.

IFC's focus on the infrastructure industry is consistent with the focus of the World Bank Group on alleviating poverty and improving the quality of life in poorer countries. Infrastructure projects accounted for 21% of approvals during fiscal-year 2000.

In addition to geographic- and sector-concentration policies and guidelines noted above, IFC's policies limit its investments in a single project to:

- 25% of projects with a total cost of more than $30 million;
- 35% of projects costing less than $30 million; and
- 50% of the cost of expansion projects, as long as (a) is not violated.

Likewise, the institution's investments in a single obligor are limited to no more than 3% of the total investment portfolio (net of specific reserves). Limits on investments in a single project are monitored for compliance on a transaction-by-transaction basis. Adherence to limits on exposure to a single borrower and to a single risk factor are as summarized in Table 8.

These policy constraints on IFC's loan portfolio are complemented by conservative asset-valuation policies. Loans are carried at their principal amounts outstanding, despite the fact that their fair market value has been higher in each of the past five years, sometimes by significant amounts. IFC stops accruing interest on its loans either when the collectibility of a loan becomes doubtful or when interest or principal is 60 days past due, whichever is the earlier, in contrast to the six months past

Table 6

IFC's Disbursed Loan Portfolio by Industry

	—Year ended June 30—				
	2000		1999	1998	1997
	($ mil.)	(% of total)	(% of total)	(% of total)	(% of total)
Infrastructure	1657	20.0	19.0	19.8	18.3
Financial services	1656	19.9	18.6	17.4	15.2
Food and agribusiness	937	11.3	11.7	13.3	13.7
Mining and extraction	825	9.9	11.3	11.3	12.2
Manufacturing	619	7.5	7.7	7.0	6.1
Other	2610	31.4	31.7	31.3	34.4
Total	8304	100.0	100.0	100.0	100.0

Table 7

IFC's Disbursed Equity Portfolio by Industry

	—Year ended June 30—				
	2000		1999	1998	1997
	($ mil.)	(% of total)	(% of total)	(% of total)	(% of total)
Financial services	1039	39.4	34.4	35.4	32.2
Infrastructure	386	14.6	14.1	14.3	14.2
Mining and extraction	291	11.0	13.2	11.0	11.5
Food and agribusiness	192	7.3	8.0	8.4	9.1
Manufacturing	154	5.8	5.4	6.4	3.8
Other	19.8	21.8	24.9	25.5	29.1
Total	2306	100.0	100.0	100.0	100.0

Table 8

Compliance with Asset Quality Guidelines

		—Year ended June 30—				
	Guideline	2000	1999	1998	1997	1996
Largest percentage of held portfolio to single obligor	3.0	1.5	1.6	1.1	1.0	1.1
Largest percentage of held portfolio to single risk factor	8.0	3.8	4.1	3.7	4.9	7.5

due employed by some other rated multilaterals. After 60 days, accrued interest is reversed, and from that point on is recognized only when received. Past-due interest capitalized as part of a loan restructuring is recorded as deferred income and recognized only when the related principal is received. Specific reserves are established against impaired loans and are equal to the difference between the current disbursed and outstanding balance less the present value of expected future cash flows discounted at the loans' effective interest rates.

Equity investments are carried on IFC's balance sheet at cost; however, when the value of an equity investment decreases and is not expected to recover, a reserve is established and charged against income as a provision against losses on equity holdings. Gains on the sale of equities are measured against the average cost of the investments sold and are recorded as income when payment is received in freely convertible currencies.

In addition to there being specific reserves, a general reserve is charged against income to cover losses on IFC's loan and equity portfolios that are not presently identifiable. This reserve is established on the basis of several different parameters, including the country and industry of the borrower and whether or not adequate information is available to assess the investment risk.

As noted above, more than three-fourths of IFC's disbursed loans and equity are to clients in non-investment-grade countries. However, in addition to the reserves that have been set aside, as discussed below, the quality of IFC's existing loan and equity portfolios is higher than it might appear from the countries of domicile of its clients for two reasons:

- First, because IFC has traditionally been afforded preferred-creditor status by its member countries; and
- Second, because many of the companies to which IFC lends and in which it invests are among the stronger private-sector entities in these countries.

That the quality of IFC's investment portfolio is higher than might be expected is supported by the fact that IFC's investment portfolio through fiscal-year-end 2000 had total write-offs equal to 2.2% of cumulative disbursements; moreover, this percentage has declined modestly from the 2.4% of fiscal-year-end 1997. As a lender to the private sector, IFC does not have the luxury of deferring indefinitely losses on its loan portfolio.

It is important to understand properly the basis for IFC's preferred-creditor status, which is de facto and not based on treaty or law. Indeed, Section 5 of Article III of IFC's Articles of Agreement states that " . . .funds received by or payable to the Corporation in respect of an investment of the Corporation made in any member's territories pursuant to Section 1 of this Article shall not be free, solely by reason of any provision of this Agreement, from generally applicable foreign exchange restrictions, regulations and controls in force in the territories of that member."

In times of financial stress, however, governments have recognized the desirability of providing borrowers and recipients of equity investments from IFC with preferential access to foreign exchange in order to service their loans and have consistently done so, albeit with occasional delays. However, the exchange rate used in the conversion from local to foreign currency does not ordinarily come within the purview of IFC.

IFC's policy of making loans to creditworthy companies has been reinforced in recent years by its growing efforts to syndicate a portion of its loans to banks and institutional lenders. As a result, many of the companies to which IFC lends are among the strongest credits in their countries of domicile, with creditworthiness in local currency terms higher than the creditworthiness of their governments in foreign currency terms. Because of IFC's preferred-creditor status, the implicit foreign currency ratings on many of its loans are actually higher than the foreign currency ratings of the borrowers' countries of domicile. This has been explicitly acknowledged by Standard & Poor's in the case of securitized IFC loans to private-sector borrowers in Argentina, Brazil, and Mexico; each was assigned a foreign currency rating equal to the local currency rating and above the foreign currency rating of the sovereign.

Treasury Risk Management and Control. IFC follows a policy of funding loans with liabilities having the same currency and interest-rate basis and, for fixed-rate loans, the same duration. Because it must be able to offer its clients loan products in a number of currencies at both fixed and variable rates while funding itself opportunistically in a wide range of currency markets, IFC hedges its currency and interest-rate exposures, usually through swaps. It generally transforms borrowings into synthetic variable-rate U.S. dollar liabilities and loans, and liquid assets into variable-rate U.S.-dollar assets, tied to a six-month Libor index. This reflects the currency and interest-rate preferences of most of its borrowers. IFC uses derivatives only for hedging purposes; it does not actively trade its positions, nor does it run open positions.

The credit risk associated with swap transactions is addressed in two ways:

- First, IFC deals only with banks rated 'A' or above and nonbanks rated 'AAA', with exposures limited by the rating and size of the counterparty, as well as its country of domicile; and
- Second, by establishing mark-to-market collateral agreements with its counterparties.

At fiscal-year-end 2000, IFC had signed mark-to-market agreements with 41 counterparties, which covered 96% of total (potential) exposure and 86% of mark-to-market exposure on IFC's derivatives portfolio.

Finances. IFC's total adjusted balance-sheet assets increased by $4.8 billion, to $37.0 billion at fiscal-year-end 2000, a 15.1% increase over a year earlier. Of this amount, $12.0 billion was accounted for by liquid assets, and another $14.2 billion by derivative instruments. Disbursed loans and equity investments net of loss reserves increased by $0.8 billion, to $9.0 billion, a 9.2% increase, accounting for 24.2% of the total balance sheet. Total liabilities increased by $4.5 billion, to $31.2 billion, while total capital increased by $389 million, to $5.7 billion.

IFC is a more active user of derivatives than most other multilaterals; it also adheres to FASB Interpretation 39, which requires that both legs of currency swaps be shown on its balance sheet. Given the very high quality of these derivatives exposures, their prominence on IFC's balance sheet distorts comparisons with most other multilaterals. Accordingly, Table 9 also shows the size of balance-sheet assets net of derivatives-related transactions.

Capital and Capital Adequacy . As shown in Table 10, IFC's total capital of $5.7 billion at fiscal-year-end 2000 consisted of subscribed and paid-in capital of $2.36 billion, and retained earnings and other items of $3.38 billion. The last two increases in authorized capital, from $1.30 billion, were approved in 1992 and 1993. In fiscal-year 1992, when regularly scheduled payments

under the 1985 capital increase were completed, the board approved a general capital increase to $2.30 billion, to be paid in by Aug. 1, 1998, later extended to Aug. 1, 1999, and, for hardship cases, to Aug. 1, 2001. In fiscal-year 1993, the board approved a special capital increase of $150 million, most of which was to accommodate the subscriptions of the 15 new members from the former Soviet Union and four new members from the former Yugoslavia. As of fiscal-year-end 2000, 97% of authorized capital was subscribed, and of this amount, more than 99% was paid in. Unlike most other rated multilateral lending institutions, IFC has no callable capital.

IFC does not pay dividends to its shareholders, nor does it contribute to soft-loan windows from its net income. It also is under no obligation to contribute to the HIPC Initiative, unlike the World Bank and some other multilaterals. These policies support the growth of retained earnings, which have been the source of more than two-thirds of the growth in total capital since fiscal-year-end 1992. Between fiscal-year-end 2000 and fiscal-year-end 1992, subscribed and paid-in capital increased at an 8.2% average annual rate, while the other items included in total capital grew at a 14.6% average annual rate, for a combined average annual rate of 11.6%.

IFC's ratio of balance-sheet assets to capital, which has increased steadily and substantially since 1992, is of little analytical relevance given the growth and large size of IFC's derivatives exposure. Adjusting for the implementation of FASB Interpretation 39 by netting out the derivatives position shows a more moderate increase in gearing, to 3.97 times capital at fiscal-year-end 2000, from 3.25 times at fiscal-year-end 1992. Given the quality of the other balance-sheet items, it is more useful still to consider the ratio of IFC's net loans and equity investments to its capital. This shows a distinctly different pattern, with that ratio decreasing to a nine-year low of 1.47 times capital at fiscal-year-end 1998 before gradually increasing to 1.56 times at fiscal-year-end 2000; however, this ratio is well below that which prevailed from fiscal-year 1992 through fiscal-year 1996. Finally, as noted, for management purposes, since fiscal-year-end 1993, IFC has calculated a capital-adequacy ratio based on BIS guidelines. These numbers show a marginal decline in capital adequacy from the peak level of fiscal-year-end 1998; however, they are above those of the early 1990s. In sum, these latter two ratios suggest that, from a capital perspective, IFC's balance sheet is stronger now, even after the international turmoil of the late 1990s, than it was in the early 1990s.

Existing capital, supplemented by expected retained earnings, is believed to be sufficient to support growth in IFC's portfolio of about 11% annually for the next several years, and at present there are no firm plans for a new capital increase. However, if IFC's role in the context of the World Bank Group's overall strategy for the private sector were to be sharply expanded, capital in addition to that generated by the institution's retained earnings would be needed.

Loans and Equity Investments. The sum of disbursed loans and equity investments before loss reserves grew $0.90 billion during fiscal-year 2000, to $10.94 billion, a 9.0% increase. With loans and equity investments increasing by 7.4% and 14.3%, respectively, compared with 12.5% and 9.7% the previous year, 75.9% of the total was accounted for by loans, and 24.1% by equities, resuming a gradual shift in IFC's asset mix toward a higher share of equities.

The international financial turmoil of the late 1990s took its toll on IFC's loan portfolio. As shown in Table 10, interest-collection rates fell and nonaccrual loans increased sharply, necessitating a sharp increase in IFC's loan-loss provisions. However, the problems in the loan portfolio may have bottomed out during fiscal-year 2000, since collection rates increased slightly, and

Table 9

Summary IFC Balance Sheet ($ mil.)

	—Year ended June 30—								
	2000	1999	1998	1997	1996	1995	1994	1993	1992
Assets									
Liquidity	12.00	10.05	9.25	8.15	6.41	4.71	4.03	3.36	2.80
Net loan and equity investments	8.97	8.21	7.45	7.35	6.94	6.48	5.54	4.88	4.52
Derivative instruments	14.22	12.29	11.94	11.40	8.14	6.25	4.60	N.A.	N.A.
Other assets	1.79	1.58	1.48	1.48	0.94	0.68	0.51	0.52	0.45
Total assets	36.98	32.14	30.13	28.37	22.49	18.13	14.68	8.73	7.77
Liabilities and Capital									
Borrowings	14.92	12.45	11.16	10.12	8.96	7.99	6.53	5.57	5.11
Derivative instruments	14.99	13.01	12.68	12.18	8.28	5.91	4.51	N.A.	N.A.
Other liabilities	1.34	1.35	1.20	1.33	1.03	0.68	0.44	0.46	0.26
Total liabilities	31.25	26.79	25.04	23.64	18.27	14.53	11.49	6.03	5.38
Total capital	5.73	5.34	5.08	4.74	4.16	3.60	3.20	2.70	2.39
Total liabilities plus capital	36.98	32.14	30.13	28.37	22.43	18.13	14.68	8.73	7.77
Total assets net of derivatives related assets and liabilities	22.76	19.85	18.19	16.97	14.29	12.22	10.17	8.57	7.76

N.A.—Not available.

Table 10

IFC's Capital Adequacy

	—Year ended June 30—								
	2000	1999	1998	1997	1996	1995	1994	1993	1992
Capital stock ($ mil.)	2.36	2.35	2.34	2.23	2.08	1.87	1.66	1.42	1.25
Retained earnings and other ($ mil.)	3.37	3.00	2.75	2.51	2.08	1.73	1.54	1.28	1.14
Total capital ($ mil.)	5.73	5.34	5.08	4.74	4.16	3.60	3.20	2.70	2.39
Total assets/total capital (x)	6.46	6.01	5.93	5.99	5.39	5.03	4.59	3.23	3.25
Total assets, net/total capital (x)	3.97	3.71	3.58	3.58	3.44	3.39	3.18	3.17	3.25
Net loans and equity investments*/total capital (x)	1.56	1.54	1.47	1.55	1.67	1.80	1.73	1.81	1.89
Capital adequacy (%)**	47.6	47.5	48.6	48.1	44.7	42.0	43.7	45.0	N.A.

*Loans and equity investments net of reserves against losses. **Total capital + general loss reserves/risk-weighted assets.
N.A.—Not available.

nonaccrual loans, while increasing in absolute terms, remained unchanged as a percentage of disbursed loans. Accordingly, loan-loss provisions were reduced during fiscal-year 2000, for the second consecutive year. What is particularly interesting is that, despite the large provisions taken, loan write-offs during this period have been modest, even below levels of fiscal-years 1996 and 1997. Since it is a development institution, one might expect that IFC, being more supportive of borrowers' efforts to avoid liquidation, might thus be slower than some private-sector lenders to take write-offs, perhaps implying that larger write-offs will occur after a lag. However, even should write-offs be necessary, with total loan-loss reserves, at fiscal-year-end 2000, of $1,228 million as compared with nonaccrual loans of $922 million—a ratio of 1.33:1—IFC appears to be well provisioned.

Equity Portfolio. As noted, IFC makes provisions when the reduction in the value of an equity investment decreases and is not expected to recover. As Table 11 indicates, international financial turmoil and associated problems with its equity portfolio prompted IFC to make provisions substantially higher during fiscal-years 1998 and 1999 than in previous years. Improved international financial conditions prompted sharply lower provisions during fiscal-year 2000; however, write-offs increased to 1.6% of disbursed equity investments, consistent with the larger provisions taken earlier. Even after this write-off, reserves were 28% of balance-sheet equity. Given that net write-offs on the equity portfolio have been modest, averaging less than 1% of the portfolio over the past six years, and given that IFC has historically enjoyed significant capital gains from its equity portfolio, most of which are not realized in any one year, the reserve appears to be adequate.

Funding. IFC borrowed $4.4 billion during fiscal-year 2000, $1 billion in the form of its first dollar-denominated global bond. Borrowings were conducted in nine different currencies, including:

- U.S. dollars (28%),
- Yen (26%),
- Pounds sterling (25%),
- New Zealand dollars (4%), and
- Euros, Hong Kong dollars, Singapore dollars, South African rand, and Slovak koruna together comprising the remaining 17%.

The weighted average maturity of IFC's market borrowings increased to 6.7 years at fiscal-year-end 2000, from 5.4 years one year earlier. For the second consecutive year, IFC did not draw under its committed facility from the IBRD, and outstandings decreased to $273 million, from $350 million. This is in line with IFC's having established its own market access, thus reducing its reliance on funding from the IBRD, which, in fiscal-year 1985, accounted for more than 75% of much smaller borrowings.

Profitability. As a multilateral development institution, IFC does not seek to maximize its net income. However, as noted, retained earnings have accounted for more than two-thirds of the growth in IFC's capital over the past eight years and are likely to account for virtually all the growth during the next few years. Accordingly, net income must be a matter of concern to IFC's management, consistent with the institution's development objectives.

IFC's net income for fiscal-year 2000 was $380 million, up sharply from the $249 million of fiscal-year 1999. This was equal to a return on average year-end equity and assets of 6.9% and 1.05%, respectively, also up sharply from the 4.8% and 0.77% of fiscal-year 1999. These returns, however, remain markedly lower than those of 1997 and 1996, before the start of the most recent round of international financial turmoil.

The $131 million improvement in net income corresponded to a $118 million reduction in provisions for losses on IFC's loan and equity portfolios, reflecting a drop, from the high levels in fiscal-years 1998 and 1999, to more historical levels. Administrative expenses increased by $9 million (3.5%), net interest income plus income from equity investments by $7 million, and service fees plus other noninterest income net of expenses by $15 million. This $15 million included a one-time gain from the sale of an information-providing business.

IFC is differentiated from most other rated multilaterals not only by its lending

Table 11

Indicators of Loan Portfolio Quality and Provisioning

	—Year ended June 30—				
	2000	1999	1998	1997	1996
Interest collection rate (%)	[illegible]	89.5	91.9	95.7	94.8
Nonaccrual loans ($ mil.)	922	857	683	322	345
As a % of disbursed loans	[illegible]	[illegible]	9.2	4.9	5.6
Specific provisions ($ mil.)	80	194	241	162	21
Total provisions ($ mil.)	149	157	282	172	N.A.
Write-offs ($ mil.)	20	13	7	28	27
Specific loan-loss reserves ($ mil.)	751	669	525	329	248
Total loan-loss reserves ($ mil.)	1228	1168	977	720	N.A.
Times nonaccrual loans*	1.33	1.36	1.54	2.24	N.A.
As a % of disbursed loans*	14.0	14.5	14.2	[illegible]	N.A.

*Before loss reserves. N.A.—Not available.

Table 12

Indicators of Equity Portfolio Quality and Provisioning

	—Year ended June 30—				
	2000	1999	1998	1997	1996
Equity investments on balance sheet before reserves ($ mil.)	2636	2606	2182	1849	1678
Specific provisions ($ mil.)	61	176	172	8	73
Write-offs of ($ mil.)	15	5	[illegible]	19	25
Specific loss reserves ($ mil.)	563	571	407	247	184
As a % of equity investments	21	25	19	13	11
Total reserves ($ mil.)	745	707	545	357	N.A.
As a % of balance-sheet equity	28	31	26	19	N.A.

N.A.—Not available.

to the private sector and without government guarantees, but also by its equity investments' representing a significant portion of its investments. Table 14 makes a rough comparison of alternative measures of the profitability of IFC's loans (which include quasi-equity) and equity investments, taking into account:

- Funding costs (assumed to be the same for both);
- Both realized and unrealized capital gains; and
- Alternative measures of losses—either provisions or write-offs.

The numbers for equity profitability in each year are multiplied by the ratio of average loans to average equity investments outstanding, to reflect the fact that IFC's average loan portfolio each year during this period was more than three times the size of its equity portfolio.

Realized income from lending is equal to total interest income less funding costs (assumed equal to the average cost of IFC's year-end borrowings from market sources after swaps) less write-offs or loss provisions. Realized equity income is equal to dividend and profit participations plus capital gains on equity sales less funding costs (assumed equal to those used for loans) less write-offs or loss provisions. Incomes incorporating changes in the difference between carrying values and fair market values of the loan portfolio and the carrying and market value of equity investments are also calculated.

By all measures of profitability, IFC's equity portfolio has outperformed its loan portfolio by a wide margin. This is especially true if IFC is believed to be overprovisioning for losses on its equity portfolio. What offsets the greater profitability of the equity portfolio is its greater volatility; for instance, over the four years for which we have data, the sum of the year-to-year changes in the profitability of the equity portfolio is by each measure at least three times as large as the sum of the changes in the profitability of the loan portfolio.

Profitability outlook. IFC anticipates its disbursed portfolio will increase by nearly 11% per year over the next two years, while the growth in administrative expenses is slated to be about 5% during fiscal-year 2001. While this suggests an improvement in underlying earnings, the performance of IFC's loan and equity portfolios, and the corresponding provisions required to be taken, will again be an important determinant of net income.

Syndications Program

Article I of the IFC's Articles of Agreement directs the organization to "seek to stimulate, and to help create conditions conducive to, the flow of private capital, domestic and foreign, into productive investment in member countries." Pursuant to this directive, IFC has, since the early 1960s, cooperated with financial institutions, primarily commercial banks but more recently institutional investors as well, in financing private-sector borrowers. By far the most important means for doing so has been the syndication of participations in IFC's loans, which is known as the "B-loan program."

Under the B-loan program, IFC retains a portion of a loan (the "A loan") on its own balance sheet and participates the remainder (the "B loan") to other financial institutions. In doing so, IFC remains the lender of record; that is, on the books of the borrower the entire loan appears as a loan from IFC, which acts on behalf of both itself and B-loan participants in all dealings with borrowers. In addition, IFC, as lender of record, receives all payments, including interest, principal, and fees; handles disbursements; distributes financial statements and other information on borrowers; and monitors compliance with the loan documentation. For some larger or more complex financings, a commercial bank is sometimes appointed as agent for B-loan participants, generally to

Table 13

Summary Income Statement Items

	—Year ended June 30—				
($ mil.)	2000	1999	1998	1997	1996
Interest income	1,290	1,138	[illegible]	991	869
Charges on borrowings	[illegible]	(670)	[illegible]	(536)	(489)
Net interest income	478	468	482	455	380
Service fees	49	39	66	75	63
Income from equity investments	262	265	[illegible]	344	242
Provision for losses on investments	[illegible]	[illegible]	[illegible]	(366)	[illegible]
Administrative expenses	(267)	(258)	[illegible]	(175)*	(188)*
Other noninterest income and expenses	73	74	83		
Net income	380	249	246	432	346
As a % of end-year average total capital	[illegible]	[illegible]	[illegible]	[illegible]	8.9
As a % of end-year average total assets	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

*Includes other noninterest income and expenses.

Table [illegible]

Comparison of Performance of IFC's Loan and Equity Portfolio ($ mil.)

		—Year ended June 30—			
	Total 1997-2000	2000	1999	1998	1997
Average loan investments/equity investments (x)		[illegible]	[illegible]	[illegible]	3.60
Realized income					
Loan income using provisions	[illegible]	47	76	[illegible]	[illegible]
Equity income using provisions	[illegible]	151	(85)	28	561
Loan income using write-offs	[illegible]	[illegible]	[illegible]	105	202
Equity income using write-offs	1228	[illegible]	452	[illegible]	[illegible]
Including unrealized gains/losses					
Loan income using provisions, changes in fair value of the portfolio	[illegible]	(49)	[illegible]	(6)	[illegible]
Equity income using provisions, changes in unrealized capital gains	[illegible]	286	[illegible]	[illegible]	[illegible]
Loan income using write-offs, changes in fair value of the portfolio	[illegible]	79	[illegible]	[illegible]	[illegible]
Equity income using write-offs, changes in unrealized capital gains	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

handle payments and disbursements. The B-loan program offers benefits to both participants and IFC. The principal benefit to participants is that the preferred-creditor status traditionally afforded IFC is passed on to participant institutions. IFC's preferred-creditor status is de facto and not one of treaty or law. Indeed, Section 5 of Article III of IFC's Articles of Agreement states that "funds received by or payable to the Corporation in respect of an investment of the Corporation made in any member's territories pursuant to Section 1 of this Article shall not be free, solely by reason of any provision of this Agreement, from generally applicable foreign exchange restrictions, regulations and controls in force in the territories of that member." In times of financial stress, however, governments have recognized the value of providing borrowers from IFC with preferential access to foreign exchange to service their IFC loans and have consistently done so, although the exchange rate used in the conversion from local to foreign currency is not ordinarily a matter for IFC involvement. As a consequence, no borrower has been precluded from servicing its loan from IFC because of the unavailability of foreign exchange, although there have been occasional delays of limited duration, most recently in Pakistan in 1998. In addition, no IFC loan has to date been included in a general rescheduling or restructuring of a country's foreign debt made necessary by a shortage of foreign exchange. Under the terms of the participation agreement, IFC must distribute all loan payments, including interest, principal, and fees, whether received directly from the borrower or from the realization of security, pro rata among the participants and itself; it is therefore impossible for a borrower to repay IFC fully without also repaying participants fully. Finally, the de facto preferred-creditor status of participations in IFC loans has been recognized by bank regulatory authorities in many countries, who have in turn exempted these loans from mandatory provisioning requirements.

It is important to recognize that, while participation in an IFC loan has traditionally provided protection against transfer and convertibility risk, it is not a guarantee from IFC, nor does it protect the participant from other sorts of risks. Both IFC and participants are fully exposed to a borrower's commercial risk, particularly since Article I of IFC's Articles of Agreement requires that investments be made "without guarantee of repayment by the member government concerned." Through December 1999, cumulative losses as a percentage of closed out loan participations to private sector investors were 1.41%,a remarkably low percentage given the concentration of IFC's loan portfolio in sub-investment-grade countries. In cases of commercial problems, IFC seeks to act as a normal commercial lender, often taking a leading role on its own behalf and on behalf of its participants in restructuring loans, when it appears advantageous to do so, and seeking value through liquidation, when circumstances warrant. In doing so, IFC is bound by the terms of the participation agreement to obtain the consent of its participants. Restructuring situations can result in differences of opinion between IFC and at least some of its participants, typically driven by IFC's perspective as a development institution. However, the growth of the B-loan portfolio's importance in leveraging IFC's investments has created strong incentives for IFC to pay close attention to its participants' views.

Table 15

IFC's and Participants' Loans: Outstanding Plus Committed but Undisbursed Loans

	—Year ended June 30—							
(Bil. $)	2000	1999	1998	1997	1996	1995	1994	1993
IFC's loans for its own account	10.05	9.80	9.90	8.29	7.71	7.45	6.40	5.62
Participants' loans	8.16	8.21	9.15	8.47	6.15	4.90	3.62	2.76
IFC's + participants' loans	18.21	18.01	18.05	16.76	13.86	12.36	10.02	8.38
Participants as a % of total loans	44.8	45.6	50.7	50.5	44.4	39.7	36.1	32.9

Table 16

Signings of Loan Participations ($ mil.)

—Year ended June 30—					
2000	1999	1998	1997	1996	1995
1,511.8	888.5	2,169.1	3,014.9	2,497.0	1,558.0

Table 17

Geographic Distribution of Participants in IFC's B Loans

	—Year ended June 30—					
(% of total)	2000	1999	1998	1997	1996	1995
Germany	15	17	20	18	14	19
France	7	19	19	15	19	19
U.S.	13	7	16	15	15	5
Netherlands	9	14	15	12	15	19
Japan	9	1	10	12	12	14
Other Europe	26	15	18	17	13	20
Other Asia	2	0	3	7	8	2
Other	[illegible]	[illegible]	[illegible]	2	3	1
Other America	6	5	[illegible]	4	2	[illegible]

The B-loan program also confers important benefits on IFC. First, and most important, it allows IFC to comply with its Article-I directive to mobilize capital on behalf of private-sector borrowers in developing countries. It also helps IFC meet its internal targets of limiting its own participation in a project to 25% of total project costs and its credit exposure in any single country to 12% of its disbursed portfolio. Less obvious advantages are the increased leverage IFC enjoys with borrowers as a result of being able to offer much larger financings than it could using only its own resources and the ability to undertake multiple transactions with the same borrower without taking on excessive credit exposure. Larger transactions also permit IFC to charge larger fees for its efforts, enhancing at least marginally the institution's profitability. Finally, since IFC lends on market-related terms, syndicating these loans provides a reality check on the structure and pricing of transactions.

IFC's loan-participation program for many years was limited almost entirely to commercial banks. However, with the 1995 securitization of a pool of $400 million of

loans from its own portfolio (the Latin America and Asia Trust) and the first securitization of an individual B loan (for the Mexican cement company Apasco), IFC began to place its loans with institutional investors. At fiscal-year-end 2000, institutional investors held $631 million of IFC's total of $8.2 billion of outstanding plus committed but undisbursed B loans, and two institutional investors were among IFC's largest 30 participants.

Given the importance of ratings to institutional investors, the Latin America and Asia Trust and each of the securitized individual loans have received foreign currency ratings from one or more rating agencies. For those rated by Standard & Poor's, the foreign currency rating in each case was equivalent to the local currency rating of the issuer, which in all cases was higher than the sovereign foreign currency rating on the borrower's country of domicile. This is an explicit recognition of the strength of the preferred-creditor status enjoyed by IFC. (For more detail, see "How Preferred Creditor Support Enhances Ratings," CreditWeek, June 30, 1999.)

As shown below, IFC's B-loan program has taken on increasing importance since the early 1990s, with participants' holdings of IFC loans actually exceeding IFC's own holdings at fiscal-year-end 1998 and 1997. The decline in the size of the B-loan portfolio over the past two years reflects the maturing of the Asian loan portfolio and the lack of recovery in the growth of new business in this region.

Reflecting the cautious attitude of banks and institutional investors toward emerging-market risk during fiscal-year 1999 and the increased complexity of closing deals in this more difficult environment, signings of loan participations dropped sharply, to the lowest level in at least the past five years. However, signings during fiscal-year 2000 increased by 70%, although they remain well below levels of fiscal-years 1997 and 1998.

European banks continued to dominate the mix of participants during fiscal-year 2000, accounting for 78% of participations, although down from the 83% of a year earlier. Increases in participations by German, U.K., and Spanish banks following their clients into Latin America offset most of the decline by Dutch banks. Participations by U.S. investors, particularly institutional investors, also increased. ■

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Treatment of IFC Loan Participations by Bank Regulators in Industrialized Countries

In the late 1980s, bank regulators in the leading capital-exporting countries began imposing country-risk provisioning requirements on the banks under their supervision. The requirements varied, but typically banks became obliged to report in detail their exposure to highly-indebted developing and transition countries, and to maintain minimum levels of loss provisioning in respect of such countries as specified by the regulators.

These rules naturally limited the appetite of commercial banks for developing and transition-country lending risk. Beginning in 1990, IFC therefore approached the bank regulators to request that, given the degree of protection afforded by the lender-of-record mechanism, IFC B-loans should be exempt from the normal country provisioning rules.

These approaches were successful. In subsequent years, favorable treatment of IFC B-loans was granted by the bank regulators in all those industrialized countries where (a) mandatory country-risk provisioning requirements were imposed, and (b) specific exemption requests by IFC were needed.

More recently, however, bank regulators in some countries have moved away from prescriptive and specific country-risk provisioning regimes. The most common regulatory approach is to allow individual banks to formulate their own policies on provisioning, based on the bank's assessment of country risk and taking into account internal credit policies and external auditors' opinions. These policies are discussed with the regulators, and, if necessary, justified to them. IFC understands that in such discussions its umbrella is recognized by regulators as an important factor in mitigating country risk.

The detailed practices of bank regulators still vary. In a number of European countries (including Italy, Portugal, and Spain) specific provisioning rules continue to apply, and therefore the exemptions granted to IFC B-loans in the 1990s remain valid. In other countries, such as Germany and the United States, the bank regulators never imposed across-the-board country provisioning. IFC knows currently of no industrialized country where its B-loans are subject to country-risk provisioning as a matter of course.

COMMISSION BANCAIRE
Secrétariat général
Service des Affaires Internationales

Le 06 janvier 2000

PRECISIONS METHODOLOGIQUES RELATIVES A LA DECLARATION DES ENGAGEMENTS INTERNATIONAUX[1]

ARRETE 1999

1. DEFINITION DES RISQUES A RECENSER

1.1. Définition des termes

Au sens de la présente enquête, *les engagements internationaux qui doivent être déclarés sont constitués du montant total des engagements non compromis, de bilan ou de hors-bilan, portés par un établissement directement ou au travers de structures dites de défaisance, sur des débiteurs privés ou publics résidant dans les pays recensés sur la liste jointe en annexe 1.b (critère de résidence) ou dont la bonne fin dépend de la situation de débiteurs privés ou publics résidant dans de tels pays (critère de nationalité).*

Les engagements sur des débiteurs publics en monnaie locale font également partie du périmètre concerné. Un tableau synoptique en annexe 1.a recense ces différentes catégories de risques.

[1] Pour tout renseignement complémentaire vous pouvez joindre le Service des Affaires Internationales par téléphone au 01.42.92.57.88 ou 60.39 ou par fax au 01.42.92.20.15.

LISTE DES GARANTIES ADMISES EN DEDUCTION DE LA BASE DE RECENSEMENT DES COUVERTURES

Peuvent être prises en compte en déduction de la base de recensement des couvertures :

- les garanties accordées par des Etats de l'EEE et du G10, par la Coface pour sa partie publique, par ses homologues étrangers des pays de l'EEE et du G10

(.........)

- les garanties accordées par des institutions financières internationales,

- En ce qui concerne les *garanties offertes* par les institutions financières internationales, sont notamment prises en compte le groupe de la Banque Mondiale (BIRD, Société Financière Internationale (SFI), Miga, l'IDA et l'ICSID), la Banque Européenne de Reconstruction et de Développement (BERD), la Banque Européenne d'Investissement, la Banque Interaméricaine de Développement, la Banque Asiatique de Développement et la Banque Africaine de Développement.

- En ce qui concerne les ***sous-participations***, la SFI, la BERD, la Banque Asiatique de Développement, la Banque Africaine de Développement et la Banque Interaméricaine de Développement, et bien que le risque de signature porte sur l'emprunteur final, l'inclusion de ces encours dans la base de couverture n'est pas nécessaire au titre du risque sur le pays considéré en raison des caractéristiques particulières de ces opérations, mais seulement en créances douteuses si la situation financière du débiteur le justifie. Il en est de même pour les sous-participations de l'Inter-American Investment Corp (IIC).

(.........)

Banco de Portugal

INSTRUÇÃO Nº 10/99 - (BNBP Nº 5, 17.05.99)

TEMAS | SUPERVISÃO
NORMAS PRUDENCIAIS

ASSUNTO: **Provisões para risco-país. Empréstimos sindicados IFC.**

Considerando que na contratação dos chamados empréstimos "B", organizados pela IFC- International Finance Corporation, esta assume a posição de mutuante numa determinada porção do financiamento (o empréstimo "A"), vendendo a porção remanescente a um conjunto de instituições bancárias, e que estas, não obstante suportarem todos os riscos inerentes aos empréstimos ("B"), nomeadamente o risco-país, não estabelecem relações contratuais directas com os mutuários, os quais são responsáveis, perante a referida IFC, pelo serviço da dívida;

Considerando que a experiência demonstra que os referidos empréstimos não têm sido objecto de incumprimento relacionado com a situação das reservas cambiais dos países de residência ou de estabelecimento dos mutuários;

Considerando o disposto na alínea f) do nº1 do número 12º do Aviso nº 3/95, publicado no Diário da República, II Série, de 30 de Junho de 1995, o Banco de Portugal determina o seguinte:

São isentos da constituição de provisões para risco-país os activos correspondentes aos financiamentos concedidos no âmbito de empréstimos (sindicados) "B" organizados pela IFC - International Finance Corporation.

Outros dados:

Unofficial Translation of Banco de Portugal (Supervisory Department) Instruction to Banks No. 10/99, dated May 17, 1999

Subject: Country-risk provisions. IFC syndicated loans

Considering that in the contracting of the so-called "B" loans organized by the IFC (International Finance Corporation) the latter assumes the role of lender for a certain proportion of the financing (the "A" loan), selling the remaining portion to a group of banking institutions, and that these institutions, although bearing all the risks inherent in the "B" loans, namely the country risk, have no direct contractual relationship with the borrowers, who are responsible to the IFC for debt service;

Considering that experience demonstrates that the loans referred to have not been the subject of default related to the foreign reserves situation of the borrowers' countries of residence or establishment;

Considering what is provided for in line f), n.1, no. 12 of Advice no. 3/95, published in the Diario da Republica, Series II, of June 30, 1996, the Banco de Portugal has determined as follows:

Assets corresponding to financings granted through (syndicated) "B" loans organized by the IFC (International Finance Corporation) are exempt from the constitution of country-risk provisions.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

October 12, 1995

Mr. Richard Parry
Head, IFC Syndications
International Finance Corporation
1850 I Street, N. W.
Washington, D.C. 20433

Dear Mr. Parry:

I am responding to your letter dated September 28, 1995, to Mr. Leon S.Tarrant, concerning an exemption from country risk reporting and provisioning requirements for United States bank participations in International Finance Corporation (IFC) "B" loans. In terms of existing U.S. regulation and bank supervisory practice, I interpret your question to ask: whether U.S. banks taking new IFC "B" loan participations, where the borrower is located in a country that has been classified "Value Impaired" by the Federal banking agencies, would necessarily be required to establish Allocated Transfer Risk Reserves (ATRR) against such loans. We understand that these participations would not be formally guaranteed by the IFC. Please note that the ATRR is the only mandatory country risk provisioning requirement we have for borrowers, and that it applies only where the particular country has been classified "Value Impaired".

The preambles to Federal banking regulations (12 CFR Parts 20, 211 and 351) issued February 13, 1984, pursuant to the International Lending Supervision Act of 1983, state than "an ATRR normally would not be required initially for net new lending when the additional loans are made in countries implementing economic adjustment programs, such as programs approved by the International Monetary Fund, designed to correct the countries' economic difficulties in an orderly manner. Whether an ATRR subsequently is required for those new loans would be determined by the agencies [Federal bank regulators] on the basis of performance and continued inapplicability generally of the criteria for establishment of an ATRR".

Therefore, I can confirm that although we do not grant exemptions from ATRRs for existing exposures, U.S. banks taking new IFC "B" loan participations where country risk has led to a "Value Impaired" classification would not necessarily have to make an ATRR against such loans, assuming some appropriate adjustment program as described above is being implemented.

You also ask whether such IFC "B" loan participations may be exempted from country exposure reporting by U. S. banks on the Country Exposure Report (form FFIEC 009) and the Country

Exposure Information Report (form FFIEC 009a). Such "B" loan participations must continue to be reported on forms FFIEC 009 and FFIEC 009a. However on form FFIEC 009a, which is publicly available, the reporting bank may include a footnote in the section for "Statements by management of the reporting institution" showing the amount of International Finance Corporation B loan participations.

I trust that this is responsive to your request.

Sincerely,

Timothy M. Sullivan
Director
International Banking and Finance

cc: Michael Martinson, FRB
Charles Collier, FDIC

Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

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Reference: Guideline for Banks

Our File: P2070-4

February 19, 1996

Subject: Guideline C-4, Exposures to Designated Countries

Attached is a revised version of guideline C-4, Exposures to Designated Countries

The revised guideline removes the conditions for adding new countries to the list and exempts all new exposures to countries on the list entered into on or after November 1, 1995. Exposures incurred on or after this date will be dealt with under normal procedures for recognizing and measuring impairment both for accounting and income tax rules.

These changes were announced on December 7, 1995 and a draft of the revised guideline was sent for review to the Canadian Bankers Association on December 19, 1995. The CBA agreed to the draft guideline on January 22, 1996.

Please retain the annexes to the guideline that are in your guideline manual. These annexes have not been amended.

Questions on the document should be directed to Brad Shinn, Policy and Research Division, at (613) 998-9793 (fax: (613) 998-8466).

The guideline is available in English and French. Copies may be obtained by contacting Carol Ossa at (613) 990-7655 (fax: (613) 952-8219)

Nicholas Le Pan
Assistant Superintendent
Policy Sector

Attachment

Canada

Criteria for Determining the Minimum Level of Country Risk Provisions

Banks are required to maintain a 35 per cent minimum level of provisions for losses against their exposures to the designated countries.

The formula for calculating the level of provisions against the designated country list is: .

(. . . . .)

Provisionable assets reduced by specific provisions against private sector commercial risk loans is the base against which qualifying provisions are measured.

For this purpose, provisionable assets is total exposures adjusted upward by any write-down on loans exchanged for the debt acquired in a restructuring that are carried on the books of the bank at the reporting date. Total exposures represents total claims on the basis of ultimate risk that were extended prior to November 1, 1995, including such claims that are subsequently rescheduled as part of a formal rescheduling, less:

- local claims funded by local deposits where such local claims and deposits are denominated in local currency;
- short-term trade credits that are extensions of credit with maturities of one year and under that are directly related to imports or exports, and that will be liquidated through the proceeds of international trade. Provided these two conditions are met, extension of credit may include acceptances discounted, as well as other loans and advances whenever extensions relate directly to international trade;
- co-financing arrangements with specified multilateral development banks (MDB) (Annex H). Exposures must be co-financed with a MDB and not parallel to a loan made by a MDB; and
- exposures that are either guaranteed or insured against political risk (i.e., risks other than commercial risks, including payment delay caused by a blockage of funds or transfer difficulties, war or hostilities, cancellation or non-renewal of export or import permits) by a government owned export credit agency that is located in a country that is not designated for country risk provisioning purposes or a specified MDB (Annex H).

(. . . . .)

Annex H

Specified Multilateral Development Banks (MDBs)

International Bank for Reconstruction and Development (IBRD)
International Development Agency (IDA)
International Finance Corporation (IFC)
Inter-American Development Bank (IDB)
Asian Development Bank (AsDB)
African Development Bank (AfDB)
European Bank for Reconstruction and Development (EBRD)
European Investment Bank (EIB)
Caribbean Development Bank (CDB)
Nordic Investment Bank (NIB)
Multilateral Investment Guarantee Agency (MIGA)
Social Development Fund (SDF)

Research:

"B" Loans and Political Risk Insurance: Different Roads to the Same Destination

Publication Date: 09-Apr-2001
Analyst: Larry Hays, Ph.D., New York (1) 212-438-7347; Diane Audino, New York (1) 212-438-2388; Marie Cavanaugh, New York (1) 212-438-7343

Lenders taking foreign-currency credit exposure to private-sector issuers in emerging market countries have long been concerned that foreign exchange controls might prevent these issuers from servicing their obligations. Two means of mitigating this risk-participations in loans made by select multilateral institutions (so-called "B" loans) and "political risk insurance"(or, more specifically, transfer and convertibility [T&C] insurance)-have become more prominent since both were tailored to meet the requirements of the capital markets (see "How Preferred Creditor Support Enhances Ratings," RatingsDirect, June 15, 1999, also at www.standardandpoors.com under ResourceCenter-RatingsCriteria-Sovereigns; and "Political Risk Insurance May Enhance Emerging Market Structured Transactions," RatingsDirect, Nov. 2, 1999, also at www.standardandpoors.com under ResourceCenter-RatingsCriteria-StructuredFinance in Securitization in Latin America 2000).

Neither the "B" loan structure nor T&C insurance enhances the underlying creditworthiness of an issuer; consequently, neither elevates the local currency rating of the obligor. However, both can mitigate transfer and convertibility risk, allowing an obligation to receive a foreign currency rating as high as the issuer's local currency rating.

"B" Loans and T&C Insurance

Both means of mitigating sovereign risk are well established. The International Finance Corporation (IFC), the pioneer in developing the "B" loan structure, was making "B" loans in the 1970s, and the Inter-American Development Bank, the European Bank for Reconstruction and Development, and the Asian Development Bank have more recently established their own "B" loan programs. Under these structures, the multilateral institution makes a loan to a private-sector borrower in an emerging market country, thereby becoming the "lender of record," i.e., the sole contractual lender on the books of the borrower, with this status acknowledged by the government of the borrower's country. However, instead of maintaining all of the loan on its own books, the multilateral maintains only a portion-the "A" loan-and participates the remainder-the "B" loan-to commercial banks and/or institutional lenders, either directly or through a securitization.

Multilateral lending institutions have historically enjoyed treatment as so-called "preferred creditors." As such, not only have governments made foreign exchange available to private-sector issuers (with sufficient local currency) for servicing loans from these institutions while withholding it from these same issuers for servicing loans from other lenders; but they have provided that foreign exchange even while defaulting on their own foreign currency obligations. Carefully drafted documentation ensures, through pro rata sharing provisions, that both "A" and "B" loans receive identical treatment, so that there is no way to default on a "B" loan without also defaulting on an "A" loan. Therefore, if a government is to accord preferred creditor treatment to the multilateral lender's "A" loan, it must also do so to each participant's "B" loan, in effect passing on the preferred access to foreign exchange to nonpreferred-creditor lenders (placing them "under the umbrella" of the multilateral lender).

The first rated securitization of a "B" loan was done in 1995 by the IFC for Apasco, the Mexican cement company. The $85 million portion of the IFC's $100 million loan that was securitized received a foreign currency rating of 'BBB+', equal to Apasco's local currency rating and four notches above Mexico's 'BB' long-term foreign currency rating at the time. It was this transaction that brought the rating enhancement capabilities of the preferred creditor status of multilateral lenders to the attention of the capital markets.

Government-sponsored and some private insurers have been selling political risk insurance, including T&C insurance, for many years-the U.S. government's Overseas Private Investment Corporation (OPIC), for instance, has been underwriting political risk insurance since 1971. However, only in 1999 was the first rated capital markets transaction benefiting from transfer and convertibility insurance (from OPIC) completed, this being the placement of $105 million of obligations of Otosan, the Ford-Koc Group joint venture automobile manufacturer domiciled in Turkey.

Standard & Poor's has rated numerous other "B" loan obligations. Last year, it rated the OPIC T&C-insured obligations of TGN, an Argentine gas pipeline company; a Multilateral Investment Guarantee Agency (MIGA, a member of the World Bank Group) T&C-insured pool of lease payments for medical equipment in Brazil; and an ACE Bermuda Insurance Ltd. T&C-insured sale of hydrocarbon royalty payments by the Argentine province of Salta. In all cases, the foreign currency ratings assigned were equal to the local currency sovereign credit ratings of the issuers, although this need not be the case. However, despite the equivalent ratings enhancement provided by "B" loan structures and T&C insurance to date, there are fundamental and important differences between them.

1. "B" loan enhancement stems from incentives for the government to provide the necessary foreign exchange; T&C insurance enhancement stems from the prospect of continued payment of debt service when a covered event of interference actually occurs.

The first distinction, critically important to those taking a strictly legal perspective, is the difference in the manner in which "B" loans and T&C insurance provide their sovereign risk mitigation. The country risk mitigation of the "B" loan structure depends completely upon the willingness and ability of a borrower's government to accord preferred creditor treatment in a time of severe financial stress and to provide foreign exchange so that loans made and participated by multilaterals may be serviced. If the government is unwilling or unable to do so, holders of "B" loans have no recourse to the multilateral lender or any third party. In such a situation, of course, the multilaterals, in addition to suffering the nonpayment of their "A" loans, also experience damage to their preferred creditor status. As a consequence, these institutions work diligently to ensure that foreign exchange is made available. For instance, the IFC, through its own operations and with the support of the World Bank, brings pressure on the borrower's government to meet its obligations. Nonetheless, had there been "B" loans to Iraqi borrowers outstanding in 1990, it is unlikely that participants would have benefited, since Iraq would in all likelihood have ceased to accord preferred creditor treatment to IFC following the invasion of Kuwait and the sanctions that were subsequently imposed, as it did to the World Bank.

It is also possible that a country otherwise disposed to respect preferred creditor status may find its foreign exchange position sufficiently dire that it makes the political decision not to meet its obligations to multilaterals, including the obligation to provide foreign exchange to private-sector borrowers with sufficient local currency to purchase foreign exchange at a rate reflective of severe financial stress. This appears to have been the case of Pakistan in 1998. While the government explicitly acknowledged IFC's preferred creditor status, it argued that it simply did not have the foreign exchange to provide to borrowers from the IFC. Once negotiations for a new loan from the World Bank were completed in early 1999 the foreign exchange situation eased, and foreign exchange for the payment of all IFC obligations was quickly provided.

In rating the "B" loan obligations created by IFC, Standard & Poor's looked closely at the historical record of treatment of obligations to the IFC, which has been very good. To date, no IFC loan has been included in a general rescheduling of a country's debts, nor has IFC, or any participant in its loans, been requested to put up new money in the context of a general country debt rescheduling. Moreover, while there have been occasional sovereign-induced delays in servicing of IFC loans, these have ordinarily been short.

Standard & Poor's recognizes that there could be failures to accord preferred creditor treatment, and, as a consequence, always explicitly considers three factors in rating these transactions:

- The historical and expected future treatment of preferred creditor institutions by the government of the country of domicile of the borrower;
- Whether the current political regime has good relations with multilateral institutions and is integrated into the global trade and financial systems; and

- Whether debt to preferred creditor institutions-along with debt from structured finance transactions, which also may claim the most senior status-is an uncomfortably large percentage of external debt. In this regard, the multilaterals have generally demonstrated prudence in managing their preferred creditor exposure levels in individual countries and in aggregate.

By contrast, claims payments from a T&C insurance policy are made following an event of sovereign interference with the conversion of local currency to foreign currency or the transfer of that foreign currency abroad. As long as the terms of the policy are satisfied, payment depends entirely upon the willingness and ability of the T&C provider to pay claims in a timely manner and is not contingent upon the behavior of the government of the issuer. Thus, in the examples of both Iraq and Pakistan, assuming that the requirements of the policy and the claims process were satisfied and that the insurer was willing and able to meet its obligations, lenders would have received debt service payments in a timely manner up to the limit of the policy.

2. "B" loan enhancement covers all debt service and related payments; T&C insurance may only cover a portion.

By virtue of its lender-of-record status and the associated loan and participation agreements, all debt service and other transaction-related payments are typically made directly to the multilateral lender, including all payments destined for "B" loan participants. Accordingly, all payments including principal, interest, fees, and penalties enjoy the benefit of the institution's preferred creditor status.

By contrast, what payments and how much of these payments are covered by T&C insurance depends upon the terms of the policy, which can vary substantially from transaction to transaction. For instance, on the Otosan transaction mentioned above, OPIC insured 100% of principal and interest on the rated securities. However, in some subsequent transactions, insurance applicable to only a portion of total debt service has been proposed. Standard & Poor's criteria now permit the rating of a foreign currency obligation to be elevated, sometimes as high as the local currency rating of the obligor, even when the insurance covers less than 100% of interest and principal (see "New Rating Approach Gives Private-Sector Issuers Credit for Partial Coverage of T&C Risk," RatingsDirect, Oct. 19, 2000; also available at www.standardandpoors.com under ResourceCenter-RatingsCriteria-Sovereigns). The degree of elevation will depend upon the country of domicile of the issuer, how much transfer and convertibility insurance is provided relative to the debt service payments, the pattern of debt service payments, the expected timing and duration of any sovereign interference, and the rating of the insurance provider.

3. Multilateral lenders are invariably concerned about the commercial success of the borrower; nonmultilateral insurers have little cause for concern.

While "B" loans may not enhance the underlying creditworthiness of an issuer, multilateral lenders have a different relationship with borrowers than do most insurers, particularly private-sector insurers, which some "B" loan participants value highly. A multilateral lender is invariably concerned with the commercial viability of the borrowers under its "B" loan program. Not only is the multilateral always a lender, and typically the largest single lender; but it also structures the transaction, negotiates the credit agreement with the borrower, and conducts the due diligence. As "B" loans become increasingly important to the multilaterals-and IFC's "B" loans, for instance, were larger than its own loan portfolio at end-June 1997 and 1998, although lower than that during the past two years-it is increasingly important for them to build and maintain strong relationships with participants, which are damaged when there are problems with timely repayment of "B" loans for commercial reasons.

More broadly, a multilateral has a long-term commitment to facilitate private-sector investment in the countries in which it operates. Should new government policies, a weakening regulatory environment, or a breach of government commitments imperil projects in which the multilateral is lending, a multilateral will use its influence with the government to overcome such problems. This can be an important factor in facilitating successful project implementation.

While multilateral providers of T&C insurance have similar broad concerns, other providers of T&C insurance have little at stake in the commercial viability of an issuer, since they lose nothing except premium income when an issuer defaults for commercial reasons. Their real concern is that the borrower's country of domicile not take action resulting in a claim under its T&C policy. Indeed, in a time of severe financial distress, when the probability of sovereign interference with payment of foreign currency obligations increases, the position of the insurer will actually be improved by the bankruptcy and liquidation of the borrower. This is because the insurer is not obligated to pay under its T&C policy if the borrower does not have local currency sufficient to purchase the foreign currency required to make its debt service payments.

4. If the issuer has the required local currency, the relevant willingness and ability to supply foreign exchange under a "B" loan is that of the borrower's government; with T&C insurance, it is that of the insurer.

The issues of willingness and ability to pay are qualitatively different for multilaterals and T&C insurance providers. In the case of "B" loans, multilaterals act only as intermediaries and not as providers of formal insurance to the "B" loan participants. The issues of willingness and ability to make foreign exchange available in a timely fashion to borrowers with sufficient local currency relate entirely to the sovereign, whose decisions are made in light of the preferred creditor status of the multilateral.

By contrast, the willingness and ability of providers of T&C insurance to pay in a timely manner are key. Ability to pay is extremely strong in the case of OPIC-its obligations are backed by the full faith and credit of the U.S. government-and very strong for other bilateral official insurers from most highly rated countries or highly rated multilaterals. However, Standard & Poor's looks closely at not only the stand-alone financial strength of an official insurer, but also at the degree and manner of expected support from its government owners. The ability of a private insurer to pay claims is determined by its financial strength rating, and no transaction enhanced by T&C insurance from a private insurer will be rated without a rating of the insurer.

The ability to pay must be accompanied by the willingness to pay, and in a timely manner. The best evidence of willingness to pay is a long history of satisfactory claims paying behavior, such as that of OPIC. Moreover, OPIC has tailored its claims processing procedures explicitly to address the issue of timeliness, and Standard & Poor's is comfortable that a valid claim will be processed and paid in a manner consistent with the rating of the insured transaction. The claims-paying behavior of other long-active insurers-mostly official-would be subject to a similar review, as would the tailoring of their claims processing procedures. The absence of a long claims-paying history would require in-depth discussions with the senior management of the insurer and, if appropriate, its parent.

Two aspects of willingness that must be considered are those of policy exclusions and the insurer's approach to handling claims. T&C insurance is not a guarantee of timely payment, and claims are payable only if the requirements of the policy and other documentation have been satisfied. For instance, in the case of the OPIC insurance policy, grounds for denying payment of a claim could be the lack of a satisfactory effort by the insured to use all reasonable efforts to convert local currency and transfer it, or a finding that an unreasonable act by the insured was the primary cause of the sovereign interference. Similarly, the "company support agreement" between OPIC and the borrower includes covenants relating to corrupt practices, environmental matters, and worker rights, violation of which are grounds for the denial of a claim or the cancellation of the policy. In general, covenants of this nature seem more likely to appear in policies of official rather than private insurers, since they reflect the policy concerns of the government sponsor.

The second aspect of willingness to pay concerns the way certain issues relating to claims payments are handled and has been highlighted by recent experience with some providers of financial guarantees. The policies of so-called "monoline insurers"-companies whose only business is providing financial guarantees-are standardized to meet the requirements of the rating agencies with respect to timeliness of payment and the approach to disputed claims. In short, they are expected to pay on time and to challenge the claim later. However, recently more "multiline" insurers have begun issuing financial guarantees. In some of these institutions, the culture is one of paying a claim only after a challenge to that claim has been adjudicated-for instance, in the case of suspicion of fraud, monoline insurers are expected to make the scheduled payment and then pursue remedies, whereas some multiline policies allow the insurer the right to review a claim prior to paying and refuse payment if it feels that the claim is invalid. As a consequence, Standard & Poor's has determined that in some cases the willingness of a multiline insurance company to pay on a timely basis may be considerably weaker than its ability to pay. In light of this, Standard & Poor's has developed

"financial enhancement ratings," which explicitly address both ability and willingness to pay (see "Criteria for Insurer Financial Enhancement Ratings Introduced," RatingsDirect, July 20, 2000). In all cases, a very close reading of all related documents and a clear understanding of exactly what is being insured are essential to the rating.

Summary

While "B" loan structures and T&C insurance can both elevate the foreign currency credit ratings of obligations of private-sector borrowers from emerging market countries as high as the borrowers' local currency credit ratings, they do so in very different ways. "B" loan structures ultimately rely upon the willingness and ability of the borrower's government to afford preferred creditor treatment to the multilateral providing the "B" loans; T&C insurance relies upon the willingness and ability of the insurer to pay in accord with the terms of its policy in a timely manner once sovereign interference has actually occurred. Insurance may cover only a portion of debt service payments, while "B" loans, by their nature, cover all payments. Insurance also generally introduces more documentary complexity, which must be assessed to determine whether difficulties could arise that would affect the ability to successfully claim under the insurance policy.

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