

Inter-American Development Bank

Ordinary Capital



**Management's Discussion and Analysis
and
Condensed Quarterly Financial Statements
June 30, 2012
(Unaudited)**

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MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2012

INTRODUCTION

The resources of the Inter-American Development Bank (the Bank) consist of the Ordinary Capital, the Fund for Special Operations, the Intermediate Financing Facility Account, and the IDB Grant Facility. All financial information provided in this Management's Discussion and Analysis refers to the Bank's Ordinary Capital.

This document should be read in conjunction with the Bank's Information Statement dated March 9, 2012, which includes the Ordinary Capital financial statements for the year ended December 31, 2011. The Bank undertakes no obligation to update any forward-looking statements.

FINANCIAL STATEMENT REPORTING

The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of such financial statements requires management to make estimates and assumptions that affect the reported results. Management believes that some of the more significant estimates it uses to present the financial results in accordance with GAAP, for valuation of certain financial instruments carried at fair value, the allowances for loan and guarantee losses, and the valuation of pension and postretirement benefit plan-related liabilities, involve a relatively high degree of judgment and complexity and relate to matters that are inherently uncertain.

Most of the Bank's borrowings and all swaps, including borrowing and lending swaps, are measured at fair value through income. The reported income volatility resulting from the non-trading financial instruments is not fully representative of the underlying economics of the transactions as the Bank holds these instruments to maturity. Accordingly, the Bank excludes the impact of the fair value adjustments associated with these financial instruments from the regular results of its operations. The Bank defines Income before Net fair value adjustments on non-trading portfolios and Board of Governors approved transfers¹ as "Operating Income". Net fair value adjustments on non-trading portfolios and Board of Governors approved transfers are reported separately in the Condensed Statement of Income and Retained Earnings.

FINANCIAL HIGHLIGHTS

LENDING OPERATIONS: During the first six months of 2012, the Bank approved 56 loans totaling \$3,356 million compared to 27 loans that totaled \$1,543 million during the same period in 2011. There were two non-trade-related guarantees approved without sovereign counter-guarantee for \$20 million (2011 – two for \$40 million) and 136 trade-related guarantees

were issued for a total of \$340 million (2011 – 90 guarantees issued for a total of \$195 million).

The portfolio of non-sovereign-guaranteed loans increased to a level of \$3,624 million compared to \$3,316 million at December 31, 2011. The non-sovereign guarantees exposure increased \$44 million to \$891 million compared to \$847 million at the end of the previous year. As of June 30, 2012, 6.7% of the outstanding loans and guarantees exposure was non-sovereign-guaranteed, compared to 6.2% at December 31, 2011.

Total allowances for loan and guarantee losses amounted to \$215 million at June 30, 2012 compared to \$175 million at December 31, 2011. The Bank had non-sovereign-guaranteed loans with outstanding balances of \$264 million classified as impaired at June 30, 2012 compared to \$129 million at the end of the prior year. All impaired loans have specific allowances for loan losses amounting to \$82 million at June 30, 2012, compared to \$41 million at December 31, 2011.

In 2011, the Bank approved the Flexible Financing Facility (FFF), effective on January 1, 2012. The FFF is now the only financial product platform for approval of all new Ordinary Capital sovereign-guaranteed loans. With FFF loans, borrowers have the ability to tailor financial terms at approval or during the life of a loan, subject to market availability and operational considerations. The FFF platform allows borrowers to: (i) manage currency, interest rate and other types of exposures; (ii) address project changing needs by customizing loan repayment terms to better manage liquidity risks; (iii) manage loans under legacy financial products; and, (iv) execute hedges with the Bank at a loan portfolio level.

For 2012, the Board of Executive Directors approved a lending spread of 0.62%, a credit commission of 0.25% and no supervision and inspection fee, compared to a lending spread of 0.80%, a credit commission of 0.25% and no supervision and inspection fee in 2011.

BORROWING OPERATIONS: During the first six months of the year, the Bank issued bonds for a total face amount of \$7,176 million (2011 – \$1,098 million) that generated proceeds of \$6,478 million (2011 – \$1,098 million), representing increases of \$6,078 million and \$5,380 million, respectively, compared to the same period last year. The average life of new issues was 4.0 years (2011 – 3.7 years). The higher level of borrowing operations during the first semester of 2012 was mainly due to a larger funding program, in part based on a higher level of debt redemptions. In addition, last year's lower borrowings reflected the positive impact on the Bank's liquidity levels of the conversion of \$3,225 million of non-borrowing member currency holdings subject to maintenance of value.

¹ References to captions in the attached condensed quarterly financial statements and related notes are identified by the name of the caption beginning with a capital letter every time they appear in this Management's Discussion and Analysis.

FINANCIAL RESULTS: Operating Income during the first six months of 2012 was \$425 million, compared to \$628 million for the same period last year, a decrease of \$203 million. This decrease was mainly due to a decrease in net interest income of \$81 million, a decrease in net investment gains of \$44 million, an increase in net non-interest expense of \$20 million and an increase in the provision for loan and guarantee losses of \$63 million.

During the six months ended June 30, 2012, the trading investments portfolio experienced net mark-to-market gains of \$115 million, compared to \$159 million experienced during the six months ended June 30, 2011. The trading investments portfolio's net interest income, which excludes realized and unrealized investment gains and losses, added income of \$18 million during the first six months of the year compared to \$30 million during the same period in 2011.

The provision (credit) for loan and guarantee losses increased from \$(23) million in the first semester of 2011 to \$40 million in 2012 as a result of an increase in impaired loans in the non-sovereign-guaranteed portfolio.

With the election of the fair value option for a substantial number of the borrowings in 2008, the changes in fair value of the borrowing swaps are significantly offset by the changes in fair value of the associated borrowings. However, income volatility still results from changes in the Bank's credit spreads and swap basis spreads, which affect the valuation of borrowings and swaps, respectively, the changes in fair value of lending swaps, which are not offset by corresponding changes in the fair value of loans, as all Bank's loans are recorded at amortized cost, and the changes in fair value of equity duration swaps. To reduce, over time, the income volatility resulting from these financial instruments, effective January 1, 2011, the Bank modified its borrowing fair value option policy addressing income volatility on a financial instruments portfolio basis rather than on an instrument-by-instrument basis. Net fair value adjustments on non-trading portfolios for the six months ended June 30, 2012 amounted to a loss of \$88 million, compared to \$188 million for the same period last year. Fair value losses on lending swaps of \$185 million, losses associated with changes in the Bank's credit spreads on the borrowing portfolio (approximately \$5 million) and losses from changes in swap basis spreads (approximately \$50 million), were partially offset by gains on equity duration swaps (\$51 million) and gains on swaps where the associated bond was not elected for fair value treatment (\$101 million). (See Note I to the Condensed Quarterly Financial Statements for

further discussion on changes in fair value on non-trading portfolios).

CAPITALIZATION: On February 29, 2012, the ninth general increase in the resources of the Bank (IDB-9) entered into effect, which was also the effective date of the first installment. The IDB-9 provides for an increase in the Bank's Ordinary Capital of \$70,000 million to be subscribed to by Bank members in five annual installments. Of this amount, \$1,700 million is in the form of paid-in capital stock and the remainder constitutes callable capital stock. As of April 20, 2012, the deadline for member countries to commit to subscribe to additional ordinary capital stock, subscriptions from 46 member countries amounting to \$65,731 million were received by the Bank. The Netherlands and Venezuela did not subscribe to the respective shares of the increase that had been reserved for them amounting to \$4,269 million (of which \$237 million correspond to the shares reserved for the Netherlands, and \$4,032 million correspond to those for Venezuela). Of the total shares subscribed, 5,134,300 shares in the amount of \$61,937 million, or 88% of the total increase, were eligible for allocation, representing the amount of shares subscribed, less shares that were not allocated in order to comply with the associated minimum voting power requirements of the Agreement. Of the total shares allocated, \$1,504 million represents paid-in capital stock and \$60,433 million represents callable capital stock.

The shares of the increase that had been reserved for the Netherlands and Venezuela (19,639 and 334,278 shares, respectively) are being held by the Bank and will be reallocated by the Bank's Board of Governors.

On February 29, 2012, Canada notified the Bank that it was exercising its right to replace shares of non-voting callable capital stock with shares allocated under the IDB-9. Accordingly, effective March 30, 2012, Canada replaced 40,358 non-voting callable shares in the amount of \$487 million with an equal amount of voting callable shares under the IDB-9.

Despite the increased lending in response to the global financial crisis, the Bank's capital adequacy position remains strong, as determined by its capital adequacy policy. The capital adequacy framework provides rules that support the determination of capital requirements for credit and market risk, as well as operational risk.

The Total Equity-to-Loans Ratio (TELR) at June 30, 2012 was 32.1% compared to 31.3% at the end of last year (See Table 1).

Box 1: Selected Financial Data

(Amounts expressed in millions of United States dollars)			
	Six months ended		Year ended
	June 30,		December 31,
	2012	2011	2011
Lending Summary			
Loans and guarantees approved ⁽¹⁾	\$ 3,376	\$ 1,583	\$ 10,400
Undisbursed portion of approved loans	25,188	20,834	23,994
Gross loan disbursements	2,046	2,728	7,898
Net loan disbursements ⁽²⁾	(244)	368	3,297
Income Statement Data			
Operating Income ⁽³⁾	\$ 425	\$ 628	\$ 836
Net fair value adjustments on non-trading portfolios ⁽⁴⁾	(88)	(188)	(919)
Board of Governors approved transfers	(200)	(200)	(200)
Net income (loss)	137	240	(283)
Returns and Costs, after swaps			
Return on average loans outstanding	2.55%	2.80%	2.75%
Return on average liquid investments ⁽⁵⁾	2.02%	2.64%	0.65%
Average cost of borrowings outstanding during the period	0.92%	0.83%	0.81%
	June 30,	December 31,	
	2012	2011	2011
Balance Sheet Data			
Cash and investments-net ⁽⁶⁾ , after swaps	\$ 19,101	\$ 13,758	\$ 13,882
Loans outstanding ⁽⁷⁾	65,978	63,533	66,130
Borrowings outstanding ⁽⁸⁾ , after swaps	62,298	55,284	58,015
Equity	20,194	21,199	19,794
Total Equity ⁽⁹⁾ -to-Loans ⁽¹⁰⁾ Ratio	32.1%	33.7%	31.3%
<p>⁽¹⁾ Excludes guarantees issued under the Trade Finance Facilitation Program.</p> <p>⁽²⁾ Includes gross loan disbursements less principal repayments.</p> <p>⁽³⁾ See page 7 for a full discussion of Operating Income under Results of Operations.</p> <p>⁽⁴⁾ Net fair value adjustments on non-trading portfolios mostly relate to (a) the changes in the fair value of the Bank's lending swaps due to changes in USD interest rates (and for which the offsetting changes in value of the loans are not recognized since the loans are not fair valued), as well as (b) the changes in the fair value of the Bank's borrowings due to changes in the Bank's own credit spreads. See Note I to the financial statements for further details.</p> <p>⁽⁵⁾ Geometrically-linked time-weighted returns.</p> <p>⁽⁶⁾ Net of Payable for investment securities purchased and cash collateral received and receivable for investment securities sold.</p> <p>⁽⁷⁾ Excludes lending swaps in a net liability position of \$1,835 million as of June 30, 2012 (2011 - \$878 million) and \$1,546 million as of December 31, 2011.</p> <p>⁽⁸⁾ Net of premium/discount.</p> <p>⁽⁹⁾ "Total Equity" is defined as Paid-in capital stock less Capital subscriptions receivable, Retained earnings and the allowances for loan and guarantee losses, minus borrowing countries' local currency cash balances, net receivable from members (but not net payable to members) and the cumulative effects of Net fair value adjustments on non-trading portfolios.</p> <p>⁽¹⁰⁾ Includes loans outstanding and net guarantee exposure.</p>			

CAPITAL ADEQUACY

The capital adequacy framework consists of a policy on capital adequacy and systems that support the determination of capital requirements for credit and market risk in both the Bank's lending and treasury operations. In addition, the poli-

cy includes capital requirements for operational risk and the exposure from the obligation to fund any changes in the shortfall/surplus of the Bank's retirement funds.

The capital adequacy policy allows the Bank to measure the inherent risk in its loan portfolio due to the credit quality of its borrowers and the concentration of its loans, and to make flexible adjustments to changing market conditions. As such, specific risk limits in terms of capital requirements for investments and derivatives are included that enable Management to design more efficient funding and investment strategies following the risk tolerance established by the Board of

Executive Directors. As determined under the policy, the Bank is well capitalized.

Table 1 presents the composition of the TELR as of June 30, 2012 and December 31, 2011. It shows that the TELR increased from 31.3% to 32.1% mainly due to an increase in Total Equity, and lower loans outstanding and net guarantee exposure.

Table 1: TOTAL EQUITY-TO-LOANS RATIO
(Amounts expressed in millions of United States dollars)

	<u>June 30,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Equity		
Paid-in capital stock.....	\$ 4,640	\$ 4,339
Less: Capital subscriptions receivable.....	<u>(61)</u>	<u>-</u>
	4,579	4,339
Retained earnings:		
General reserve ⁽¹⁾	13,050	12,890
Special reserve ⁽¹⁾	<u>2,565</u>	<u>2,565</u>
	20,194	19,794
Plus:		
Allowances for loan and guarantee losses.....	215	175
Minus:		
Borrowing countries' local currency cash balances.....	164	173
Net receivable from members.....	85	76
Cumulative net fair value adjustments on non-trading portfolios.....	<u>(1,329)</u>	<u>(1,241)</u>
Total Equity	\$ 21,489	\$ 20,961
Loans outstanding and net guarantee exposure	\$ 66,921	\$ 67,030
Total Equity-to-Loans Ratio	<u><u>32.1%</u></u>	<u><u>31.3%</u></u>

⁽¹⁾ Includes Accumulated other comprehensive income.

CONDENSED BALANCE SHEET

LOAN PORTFOLIO: The Bank offers loans and guarantees to its borrowing member countries to help meet their development needs. In addition, under certain conditions and subject to certain limits, the Bank may make loans and guarantees without a sovereign guarantee (i) in all economic sectors, and (ii) directly to private sector or sub-national entities carrying out projects in borrowing member countries. The Bank also lends to other development institutions without sovereign guarantee. Non-sovereign guaranteed operations are currently capped to an amount such that risk capital requirements for such operations do not exceed 20% of Total Equity².

The loan portfolio is the Bank's principal earning asset of which, at June 30, 2012, 95% was sovereign-guaranteed. At June 30, 2012, the total volume of outstanding loans was

\$65,978 million, compared with \$66,130 million as of December 31, 2011. The slight decrease in the loan portfolio was mostly due to a higher level of loan collections (\$2,290 million) than disbursements (\$2,046 million), that was partially offset by positive currency translation adjustments (\$91 million).

As of June 30, 2012, 6.7% of the outstanding loans and guarantees exposure was non-sovereign-guaranteed compared to 6.2% at December 31, 2011. The non-sovereign-guaranteed loan portfolio totaled \$3,624 million, compared to \$3,316 million at December 31, 2011.

INVESTMENT PORTFOLIO: The Bank's investment portfolio is mostly comprised of highly-rated debt securities and bank deposits. Its volume is maintained at a level sufficient to ensure that adequate resources are available to meet future cash flow needs. Net investment levels, after swaps, increased \$5,317 million during the first six months of 2012, mainly resulting from net cash inflows from borrowings (\$4,231 million), net loan collections (\$244 million), collection of

²As of March 31, 2012, the date of the latest quarterly report to the Board of Executive Directors, the risk capital requirements of non-sovereign-guaranteed operations was \$1,144 million, or 5.4% of Total Equity.

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capital subscriptions under the IDB-9 (\$240 million), net cash inflows from operating activities (\$404 million), and mark-to-market gains (\$115 million), partially offset by negative currency translation adjustments (\$36 million).

BORROWING PORTFOLIO: The portfolio of borrowings is mostly comprised of medium- and long-term debt raised directly in capital markets. Borrowings outstanding, after swaps, increased \$4,283 million compared with December 31, 2011, primarily due to a larger amount of new borrowings than maturities (\$4,231 million), the accretion of discount on borrowings (\$218 million), and collection of the accretion of discount on borrowing swaps (\$75 million), partially offset by a net decrease in the fair value of borrowings and related swaps (\$181 million), and negative currency translation adjustments (\$43 million).

EQUITY: Equity at June 30, 2012 was \$20,194 million, an increase of \$400 million from December 31, 2011, reflecting paid-in capital received under the IDB-9 of \$240 million, net income of \$137 million, and the reclassification of unrecognized actuarial losses of \$28 million to net income, partially offset by currency translation adjustments of \$5 million.

RESULTS OF OPERATIONS

Table 2 shows a breakdown of Operating Income. For the six months ended June 30, 2012, Operating Income was \$425 million compared to \$628 million for the same period last year, a decrease of \$203 million. This decrease was mainly due to a decrease in net interest income, lower net investment

gains, and increases in non-interest expense and the provision for loan and guarantee losses.

The Bank had net interest income of \$629 million during the first semester of 2012, compared to \$710 million for the same period last year, a decrease of \$81 million mainly due to a reduction in net interest income from loans. The lending spread on most of the Bank's loans decreased from 0.80% in 2011 to 0.62% in 2012.

The Bank's trading investments portfolio contributed net mark-to-market gains of \$115 million during the period, compared to \$159 million for the same period in 2011, as the portfolio's recovery continued to be in line with the world financial markets. Net losses of \$85 million (relative to purchased price) were realized, compared to \$1 million in 2011.

Non-interest expense increased \$20 million mainly due to higher net periodic pension costs of \$28 million as a result of the amortization of unrecognized net actuarial losses and an increase in the service cost due to the decrease in the discount rate at the end of 2011, partially offset by a decrease in special programs of \$6 million.

The provision (credit) for loan and guarantee losses increased from (\$23) million in the first semester of 2011 to \$40 million in the first semester of 2012 mostly due to an increase in non-sovereign-guaranteed impaired loans.

Table 2: OPERATING INCOME
(Expressed in millions of United States dollars)

	Six months ended	
	June 30,	
	<u>2012</u>	<u>2011</u>
Loan interest income	\$ 805	\$ 845
Investment interest income	49	48
Other interest income	<u>52</u>	<u>51</u>
	906	944
Less:		
Borrowing expenses	<u>277</u>	<u>234</u>
Net interest income	629	710
Other loan income	32	27
Net investment gains	115	159
Other expenses:		
Provision (credit) for loan and guarantee losses	40	(23)
Net non-interest expense	<u>311</u>	<u>291</u>
Total	<u>351</u>	<u>268</u>
Operating Income	<u>\$ 425</u>	<u>\$ 628</u>

The average interest-earning asset and interest-bearing liability portfolios, after swaps, and the respective financial returns

and costs for the six months ended June 30, 2012 and 2011 and the year ended December 31, 2011 are shown in Table 3.

Table 3: ASSET/LIABILITY PORTFOLIOS AND FINANCIAL RETURNS/COSTS
(Amounts expressed in millions of United States dollars)

	Six months ended June 30, 2012		Six months ended June 30, 2011		Year ended December 31, 2011	
	Average balance	Return/Cost %	Average balance	Return/Cost %	Average balance	Return/Cost %
Loans ⁽¹⁾	\$ 66,021	2.45	\$ 62,767	2.71	\$ 63,420	2.65
Liquid investments ⁽²⁾⁽³⁾	16,815	2.02	15,648	2.64	15,110	0.65
Total earning assets	<u>\$ 82,836</u>	<u>2.36</u>	<u>\$ 78,415</u>	<u>2.70</u>	<u>\$ 78,530</u>	<u>2.27</u>
Borrowings	<u>\$ 60,493</u>	<u>0.92</u>	<u>\$ 56,677</u>	<u>0.83</u>	<u>\$ 56,794</u>	<u>0.81</u>
Net interest margin ⁽⁴⁾		<u>1.53</u>		<u>1.83</u>		<u>1.82</u>

⁽¹⁾ Excludes loan fees.

⁽²⁾ Geometrically-linked time-weighted returns.

⁽³⁾ Includes gains and losses.

⁽⁴⁾ Represents annualized net interest income as a percent of average earning assets.

COMMITMENTS

GUARANTEES: The Bank makes partial non-trade related guarantees with or without a sovereign counter-guarantee. In addition, the Bank provides credit guarantees without sovereign counter-guarantee for trade-finance transactions under its Trade Finance Facilitation Program. During the six months ended June 30, 2012, there were two non-trade-related guarantees approved without sovereign counter-guarantee for \$20 million (2011 – two for \$40 million). Also, the Bank issued 136 trade-related guarantees for a total of \$340 million (2011 – 90 guarantees issued for a total of \$195 million).

CONTRACTUAL OBLIGATIONS: The Bank's most significant contractual obligations relate to undisbursed loans and the repayment of borrowings. At June 30, 2012, undisbursed loans amounted to \$25,188 million and the average maturity of the medium- and long-term borrowing portfolio, after swaps, was 4.4 years with contractual maturity dates through 2042³.

LIQUIDITY MANAGEMENT

Credit markets were mixed in the second quarter of 2012 due to uncertainty in the economic recovery of many European countries. Other economies, notably that of the United States, further showed signs of deceleration or weakness prompting downward revisions to global growth projections. In this environment, rates in various markets continued the trend lower due to growing expectations of further official stimuli.

The Bank's exposure to structured assets continued to be reduced through repayments at par of \$217 million during the first six months of the year (2011—\$503 million) and selected asset sales. While the market for structured assets continued to be depressed with limited liquidity, the Bank executed a number of sales thereby reducing exposure to the sector at higher prices. Valuations on the remaining portfolio continue to be impacted by market factors, such as uneven liquidity, rating agency actions, and the prices at which actual transactions occur. The Bank continues to maximize, where possible, the use of the market inputs in the valuation of its investments, including external pricing services, independent dealer prices, and observable market yield curves.

The Bank continues to closely monitor the asset quality of its investments portfolio, analyzing and assessing the fundamental value of its securities, with a particular focus on its asset-backed and mortgage-backed securities.

During the six months ended June 30, 2012, the Bank recognized \$115 million of mark-to-market gains in its trading investments portfolio (2011 – \$159 million). These investment gains, to a major extent, relate to gains recognized in the \$1,726 million asset-backed and mortgage-backed securities portion of the portfolio and, the general recovery in credit assets. As of June 30, 2012, 45.5% of this portfolio is still rated AAA and AA, and 72.2% is rated investment grade compared to 48.2% and 72.9%, respectively, at December 31, 2011.

³ The maturity structure of medium- and long-term borrowings outstanding at the end of 2011 is presented in Appendix I-4 to the December 31, 2011 financial statements.

Table 4 shows a breakdown of the trading investments portfolio and related swaps at June 30, 2012 and December 31, 2011, by major security class, together with unrealized gains

and losses included in Income from Investments – Net gains on securities held at the end of the respective period.

Table 4: TRADING INVESTMENTS PORTFOLIO BY MAJOR SECURITY CLASS
(Expressed in millions of United States dollars)

	June 30, 2012		December 31, 2011	
	Fair Value ⁽¹⁾	Unrealized Gains (Losses) ⁽²⁾	Fair Value ⁽¹⁾	Unrealized Gains (Losses) ⁽²⁾
Obligations of the United States Government and its corporations and agencies	\$ 5,467	\$ (1)	\$ 1,974	\$ -
U.S. Government-sponsored enterprises	635	-	841	-
Obligations of non-U.S. governments and agencies	7,865	37	5,586	(7)
Bank obligations	3,723	(32)	3,323	(6)
Mortgage-backed securities	1,050	27	1,269	(41)
U.S. residential	348	12	444	(7)
Non-U.S. residential	353	16	419	(54)
U.S. commercial	140	(1)	167	13
Non-U.S. commercial	209	-	239	7
Asset-backed securities	676	9	750	27
Collateralized loan obligations	438	13	470	22
Other collateralized debt obligations	110	(6)	125	4
Other asset-backed securities	128	2	155	1
Total investments-trading	19,416	40	13,743	(27)
Currency and interest rate swaps	(59)	32	(96)	(41)
Total	\$ 19,357	\$ 72	\$ 13,647	\$ (68)

⁽¹⁾ Includes accrued interest of \$33 million (2011 - \$40 million) for trading investments and \$15 million (2011 - \$27 million) for currency and interest rate swaps, presented in the Condensed Balance Sheet under Accrued interest and other charges.

⁽²⁾ Represents unrealized gains and losses included in Income from Investments-Net gains for the corresponding period.

COMMERCIAL CREDIT RISK

Commercial credit risk is the exposure to losses that could result from the default of one of the Bank's investment, trading or swap counterparties. The main sources of commercial credit risk are the financial instruments in which the Bank invests its liquidity. In accordance with its conservative risk policies, the Bank will only invest in high quality debt instruments issued by governments, government agencies, multilateral organizations, financial institutions, and corporate entities, including asset-backed securities.

Table 5 provides details of the estimated current credit exposure on the Bank's investment and swap portfolios, net of collateral held, by counterparty rating category. As of June 30, 2012, the credit exposure amounted to \$19,873 million, compared to \$14,121 million as of December 31, 2011. The credit quality of the portfolios continues to be high, as 87.4% of the counterparties are rated AAA and AA, 8.4% are rated A, 1.2% are rated BBB, and 3.0% are rated below BBB, compared to 88.8%, 4.8%, 2.5% and 3.9%, respectively, at December 31, 2011.

As of June 30, 2012, out of the Bank's total current credit exposure in Europe of \$7,392 million (\$6,718 million at December 31, 2011) the direct exposure to three Eurozone countries rated BBB+ or lower (Italy, Portugal, and Spain) was \$18 million (\$147 million at December 31, 2011). The exposure was entirely composed of government agencies. In addition, in the countries specified, the Bank had \$331 million (\$401 million at December 31, 2011) of exposure in asset-backed and mortgage-backed securities, generally rated higher than the sovereigns, and \$1 million exposure on swaps (\$24 million at December 31, 2011). All the remaining European current exposure of \$7,042 million (\$6,146 million at December 31, 2011), regardless of asset class, was in countries rated AA or higher.

Table 5: Current Credit Exposure, Net of Collateral Held, by Counterparty Rating Category
(Amounts expressed in millions of United States dollars)

June 30, 2012						
Counterparty rating	Investments			Net Swap Exposure	Total Exposure on Investments and Swaps	% of Total
	Governments and Agencies	Banks	ABS and MBS			
AAA ⁽¹⁾	\$ 5,333	\$ 331	\$ 115	\$ -	\$ 5,779	29.1
AA	7,631	2,937	670	356	11,594	58.3
A	865	455	243	101	1,664	8.4
BBB	18	-	218	-	236	1.2
BB	120	-	83	-	203	1.0
B	-	-	129	-	129	0.6
CCC	-	-	152	-	152	0.8
CC and below	-	-	116	-	116	0.6
Total	<u>\$ 13,967</u>	<u>\$ 3,723</u>	<u>\$ 1,726</u>	<u>\$ 457</u>	<u>\$ 19,873</u>	<u>100.0</u>

⁽¹⁾ Includes \$914 million of Governments and agencies rated A1+, the highest short-term rating.

December 31, 2011						
Counterparty rating	Investments			Net Swap Exposure	Total Exposure on Investments and Swaps	% of Total
	Governments and Agencies	Banks	ABS and MBS			
AAA ⁽¹⁾	\$ 3,756	\$ 490	\$ 273	\$ -	\$ 4,519	32.0
AA	4,436	2,587	701	290	8,014	56.8
A	147	246	202	88	683	4.8
BBB	62	-	296	-	358	2.5
BB	-	-	60	-	60	0.4
B	-	-	140	-	140	1.0
CCC	-	-	213	-	213	1.5
CC and below	-	-	134	-	134	1.0
Total	<u>\$ 8,401</u>	<u>\$ 3,323</u>	<u>\$ 2,019</u>	<u>\$ 378</u>	<u>\$ 14,121</u>	<u>100.0</u>

⁽¹⁾ Includes \$105 million of Governments and agencies rated A1+, the highest short-term rating.

OTHER DEVELOPMENTS

FINANCIAL REFORM—THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT:

In July 2010, the President of the United States of America signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act seeks to reform the U.S. financial regulatory system by introducing new regulators and extending regulation over new markets, entities, and activities. The implementation of the Act is dependent on the development of various rules to clarify and interpret its requirements. Pending the implementation of these rules, the Bank continues to assess the future impact of this financial regulatory reform on its operations.

PATIENT PROTECTION AND AFFORDABLE CARE ACT (PPACA) AND HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010 (HCERA):

In March 2010, the President of the United States signed into law the PPACA and the HCERA. The new legislation seeks to reform aspects of the U.S. health care system and its various provisions will be regulated and become effective over the following several years. It is the Bank's intention to implement provisions of the legislation to the extent not already reflected in the Bank's employee medical insurance program and as may be deemed appropriate given its status as an international organization. The Bank continues to closely monitor the implementation of the legislation. Management believes that the impact of the legislation will not be material to the Bank's financial position and results of operations.

LITIGATION: On July 17, 2012, the Bank was notified that a local court in one of the Bank's borrowing member countries had issued an order in a litigation relating to a non-sovereign guaranteed loan operation, pursuant to which the Bank may be required to pay an amount in connection with such litigation equivalent to approximately \$40 million. The Bank is currently examining legal alternatives to contest the payment of this amount.

MANAGEMENT CHANGES: On July 20, 2012, Mr. Jorge da Silva was appointed Executive Auditor of the Bank, effective September 1, 2012.

On June 1, 2012, Ms. Daisy Seebach was appointed Ethics Officer of the Bank, effective August 1, 2012.

On April 12, 2012, Mr. Jose Juan Ruiz Gomez was appointed General Manager of the Department of Research and Chief Economist, effective May 16, 2012.

CHANGE IN EXTERNAL AUDITOR: After a competitive bidding process, KPMG LLP was selected as the External Auditors of the Bank for the five-year period 2012-2016, as Ernst & Young LLP completed its second and last five-year term in early 2012 in compliance with the Bank's mandatory rotation policy.

**Condensed Quarterly Financial Statements
(Unaudited)**

ORDINARY CAPITAL
INTER-AMERICAN DEVELOPMENT BANK

CONDENSED BALANCE SHEET*(Expressed in millions of United States dollars)*

	June 30, 2012		December 31, 2011	
	(Unaudited)		(Unaudited)	
ASSETS				
Cash and investments				
Cash- Note P.....	\$ 1,644		\$ 1,189	
Investments - Trading - Notes C, G, H and P.....	<u>19,383</u>	\$ 21,027	<u>13,703</u>	\$ 14,892
Loans outstanding - Notes D, E and P.....	65,978		66,130	
Allowance for loan losses.....	<u>(192)</u>	65,786	<u>(150)</u>	65,980
Accrued interest and other charges.....		807		851
Receivable from members.....		294		295
Currency and interest rate swaps - Notes G, H, I and P				
Investments - trading.....	28		11	
Loans.....	44		112	
Borrowings.....	6,854		6,702	
Other.....	<u>267</u>	7,193	<u>215</u>	7,040
Other assets.....		415		374
Total assets.....		<u>\$ 95,522</u>		<u>\$ 89,432</u>
LIABILITIES AND EQUITY				
Liabilities				
Borrowings - Notes F, G, H, I and P				
Short-term.....	\$ 810		\$ 898	
Medium- and long-term:				
Measured at fair value.....	48,219		48,901	
Measured at amortized cost.....	<u>19,472</u>	\$ 68,501	<u>14,124</u>	\$ 63,923
Currency and interest rate swaps - Notes G, H, I and P				
Investments - trading.....	72		80	
Loans.....	1,879		1,658	
Borrowings.....	651		794	
Other.....	<u>1</u>	2,603	<u>-</u>	2,532
Payable for investment securities purchased and cash collateral received....		1,900		943
Amounts payable to maintain value of currency holdings.....		209		219
Due to IDB Grant Facility - Note J.....		403		272
Accrued interest on borrowings.....		533		538
Liabilities under retirement benefit plans.....		803		796
Other liabilities.....		<u>376</u>		<u>415</u>
Total liabilities.....		75,328		69,638
Equity				
Capital stock - Note K				
Subscribed 9,688,828 shares (2011 - 8,702,335 shares).....	116,880		104,980	
Less callable portion.....	<u>(112,240)</u>		<u>(100,641)</u>	
Paid-in capital stock.....	4,640		4,339	
Capital subscriptions receivable.....	(61)		-	
Retained earnings.....	15,625		15,488	
Accumulated other comprehensive income (loss).....	<u>(10)</u>	20,194	<u>(33)</u>	19,794
Total liabilities and equity.....		<u>\$ 95,522</u>		<u>\$ 89,432</u>

The accompanying notes are an integral part of these condensed quarterly financial statements.

ORDINARY CAPITAL
INTER-AMERICAN DEVELOPMENT BANK

CONDENSED STATEMENT OF INCOME AND RETAINED EARNINGS

(Expressed in millions of United States dollars)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
	(Unaudited)		(Unaudited)	
Income				
Loans, after swaps - Notes D and G.....	\$ 413	\$ 449	\$ 837	\$ 872
Investments - Notes C and G:				
Interest.....	24	24	49	48
Net gains.....	18	30	115	159
Other interest income.....	27	26	52	51
Other.....	7	1	22	10
Total income.....	<u>489</u>	<u>530</u>	<u>1,075</u>	<u>1,140</u>
Expenses				
Borrowing expenses, after swaps - Notes F and G.....	135	104	277	234
Provision (credit) for loan and guarantee losses - Note E.....	(11)	(25)	40	(23)
Administrative expenses.....	164	147	313	275
Special programs.....	12	16	20	26
Total expenses.....	<u>300</u>	<u>242</u>	<u>650</u>	<u>512</u>
Income before Net fair value adjustments on non-trading portfolios and Board of Governors approved transfers.....	189	288	425	628
Net fair value adjustments on non-trading portfolios - Notes F, G and L.....	(171)	(238)	(88)	(188)
Board of Governors approved transfers - Note J.....	-	-	(200)	(200)
Net income.....	18	50	137	240
Retained earnings, beginning of period.....	15,607	15,961	15,488	15,771
Retained earnings, end of period.....	\$ 15,625	\$ 16,011	\$ 15,625	\$ 16,011

CONDENSED STATEMENT OF COMPREHENSIVE INCOME

(Expressed in millions of United States dollars)

	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
	(Unaudited)		(Unaudited)	
Net income.....	\$ 18	\$ 50	\$ 137	\$ 240
Other comprehensive income (loss)				
Translation adjustments.....	9	(1)	(5)	(1)
Reclassification to income - amortization of net unrecognized actuarial losses and prior service cost on retirement benefits plans.....	14	-	28	-
Total other comprehensive income (loss).....	<u>23</u>	<u>(1)</u>	<u>23</u>	<u>(1)</u>
Comprehensive income.....	\$ 41	\$ 49	\$ 160	\$ 239

The accompanying notes are an integral part of these condensed quarterly financial statements.

ORDINARY CAPITAL
INTER-AMERICAN DEVELOPMENT BANK

CONDENSED STATEMENT OF CASH FLOWS

(Expressed in millions of United States dollars)

	Six months ended	
	June 30,	
	2012	2011
	(Unaudited)	
Cash flows from lending and other activities		
Lending:		
Loan disbursements (net of participations).....	\$ (2,046)	\$ (2,728)
Loan collections (net of participations).....	2,290	2,360
Net cash provided by (used in) lending activities.....	244	(368)
Miscellaneous assets and liabilities.....	(36)	(75)
Net cash provided by (used in) lending and other activities.....	208	(443)
Cash flows from financing activities		
Medium- and long-term borrowings:		
Proceeds from issuance.....	6,374	1,219
Repayments.....	(2,055)	(5,701)
Short-term borrowings, net.....	(88)	1,409
Cash collateral received.....	553	24
Collection of capital subscriptions.....	240	19
Payments of maintenance of value to members.....	(11)	(243)
Net cash provided by (used in) financing activities.....	5,013	(3,273)
Cash flows from operating activities		
Gross purchases of trading investments.....	(11,820)	(9,548)
Gross proceeds from sale or maturity of trading investments.....	6,652	12,650
Loan income collections, after swaps.....	867	875
Interest and other costs of borrowings, after swaps.....	(117)	(126)
Income from investments.....	(25)	53
Other interest income.....	47	51
Other income.....	22	10
Administrative expenses.....	(291)	(278)
Special programs.....	(30)	(27)
Transfers to the IDB Grant Facility.....	(69)	-
Net cash (used in) provided by operating activities.....	(4,764)	3,660
Effect of exchange rate fluctuations on cash.....	(2)	1
Net increase (decrease) in cash.....	455	(55)
Cash, beginning of year.....	1,189	242
Cash, end of period.....	\$ 1,644	\$ 187

The accompanying notes are an integral part of these condensed quarterly financial statements.

ORDINARY CAPITAL
INTER-AMERICAN DEVELOPMENT BANK

**NOTES TO THE CONDENSED QUARTERLY
FINANCIAL STATEMENTS (UNAUDITED)**

NOTE A – FINANCIAL INFORMATION

The primary activities of the Inter-American Development Bank (the Bank) are conducted through the Ordinary Capital, which is supplemented by the Fund for Special Operations (FSO), the Intermediate Financing Facility Account, and the IDB Grant Facility. Unless otherwise indicated, all financial information provided in these Condensed Quarterly Financial Statements refers to the Ordinary Capital. The Condensed Quarterly Financial Statements should be read in conjunction with the December 31, 2011 financial statements and notes therein. Management believes that the condensed quarterly financial statements reflect all adjustments necessary for a fair presentation of the Ordinary Capital's financial position and results of operations in accordance with accounting principles generally accepted in the United States of America (GAAP). The results of operations for the first six months of the current year are not necessarily indicative of the results that may be expected for the full year.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements are prepared in conformity with GAAP. The preparation of such financial statements requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. Areas in which significant estimates have been made include, but are not limited to, the valuation of certain financial instruments carried at fair value, the allowances for loan and guarantee losses, and the valuation of pension and postretirement benefit plan-related liabilities.

Accounting pronouncements

In 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11 "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities", that requires disclosure of both gross information and net information about financial and derivative instruments eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement, for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. The required disclosures should be provided retrospectively for all comparative periods presented. The Bank is in

the process of assessing the impact that these new disclosures will have on its financial statements.

NOTE C – INVESTMENTS

As part of its overall portfolio management strategy, the Bank invests in government, agency, corporate, and bank obligations, asset-backed and mortgage-backed securities, and related financial derivative instruments, primarily currency and interest rate swaps.

For government and agency obligations, including securities issued by an instrumentality of a government or any other official entity, the Bank's policy is to invest in obligations issued or unconditionally guaranteed by governments of certain countries with a minimum credit quality equivalent to a AA- rating (agency asset-backed and mortgage-backed securities require a credit quality equivalent to a AAA rating). Obligations issued by multilateral organizations require a credit quality equivalent to a AAA rating. In addition, the Bank invests in bank obligations issued or guaranteed by an entity with a senior debt securities rating of at least A+, and in corporate entities with a minimum credit quality equivalent to a AA- rating (asset-backed and mortgage-backed securities require a credit quality equivalent to a AAA rating). The Bank also invests in short-term securities of the eligible investment asset classes mentioned above, provided that they carry only the highest short-term credit ratings.

Net unrealized gains of \$72 million on trading portfolio instruments held at June 30, 2012 compared to \$123 million at June 30 2011, were included in Income from Investments-Net gains. Unrealized gains recognized are to a large extent related to the asset-backed and mortgage-backed securities portion of the portfolio, which at June 30, 2012 amounted to \$1,726 million (\$2,705 million at June 30, 2011) and, the general recovery in credit assets.

In the second quarter of 2012, the recovery of the investments portfolio slowed down as a result of mixed markets in the wake of increased macroeconomic uncertainty in the world's major economies. Valuations on the asset-backed and mortgage-backed portion of the portfolio continue to be impacted by market factors, such as uneven liquidity, rating agency actions, and the prices at which actual transactions occur. The Bank continues to maximize, where possible, the use of market inputs in the valuation of its investments, including external pricing services, independent dealer prices, and observable market yield curves.

A summary of the trading investments portfolio at June 30, 2012 and December 31, 2011 is shown in Note H – "Fair Value Measurements".

NOTE D – LOANS AND GUARANTEES

LOAN CHARGES: For 2012, the Board of Executive Directors approved a lending spread of 0.62%, a credit commission of 0.25%, and no supervision and inspection fee. These charges apply to sovereign-guaranteed loans, excluding emergency loans, comprising approximately 93% of the loan portfolio, and are subject to annual review and approval by the Board of Executive Directors.

GUARANTEES: During the six months ended June 30, 2012, there were two non-trade-related guarantees approved without sovereign counter-guarantee for \$20 million (2011 – two for \$40 million). As of June 30, 2012, the Bank had approved, net of cancellations and maturities, non-trade-related guarantees without sovereign counter-guarantees of \$1,114 million (\$1,094 million as of December 31, 2011). In addition, the Bank has approved a guarantee with sovereign counter-guarantee of \$60 million.

Under its non-sovereign-guaranteed Trade Finance Facilitation Program (TFFP), in addition to direct loans, the Bank provides credit guarantees on short-term trade related transactions. The TFFP authorizes lines of credit in support of approved issuing banks and non-bank financial institutions, with an aggregate program limit of up to \$1,000 million outstanding at any time. During the first six months of the year, the Bank issued 136 guarantees for a total of \$340 million under this program (2011 – 90 guarantees for a total of \$195 million).

At June 30, 2012, guarantees of \$1,022 million (\$980 million at December 31, 2011), including \$396 million issued under the TFFP (\$418 million at December 31, 2011), were outstanding and subject to call. This amount represents the maximum potential undiscounted future payments that the Bank could be required to make under these guarantees. An amount of \$38 million (\$38 million at December 31, 2011) of guarantees outstanding has been re-insured to reduce the Bank's exposure. Outstanding guarantees have remaining maturities ranging from 1 to 13 years, except for trade related guarantees that have maturities of up to three years. No guarantees provided by the Bank have ever been called.

At June 30, 2012 and December 31, 2011, the Bank's exposure on guarantees without sovereign counter-guarantee, net of reinsurance, amounted to \$891 million and \$847 million, respectively, and was classified as follows (in millions):

Internal Credit Risk Classification	June 30, 2012	December 31, 2011
Excellent.....	\$ 104	\$ 140
Very Strong.....	255	159
Strong.....	163	146
Satisfactory.....	258	253
Fair.....	12	27
Weak.....	96	106
Possible loss.....	3	16
Total	<u>\$ 891</u>	<u>\$ 847</u>

NOTE E – CREDIT RISK FROM LOAN PORTFOLIO

The loan portfolio credit risk is the risk that the Bank may not receive repayment of principal and/or interest on one or more of its loans according to the agreed-upon terms. The loan portfolio credit risk is determined by the credit quality of, and exposure to, each borrower.

The Bank manages two principal sources of credit risk from its loan activities: sovereign-guaranteed loans and non-sovereign-guaranteed loans. Approximately 95% of the loans are sovereign-guaranteed.

SOVEREIGN-GUARANTEED LOANS: When the Bank lends to public sector borrowers, it generally requires a full sovereign guarantee or the equivalent from the borrowing member state. In extending credit to sovereign entities, the Bank is exposed to country risk which includes potential losses arising from a country's inability or unwillingness to service its obligations to the Bank.

For the Bank, the likelihood of experiencing a credit event in its sovereign-guaranteed loan portfolio is different than commercial lenders. The Bank does not renegotiate or reschedule its sovereign-guaranteed loans and historically has always received full principal and interest due at the resolution of a sovereign credit event. Accordingly, the probabilities of default to the Bank assigned to each country are adjusted to reflect the Bank's expectation of full recovery of all its sovereign-guaranteed loans. However, even with full repayment of principal and interest at the end of a credit event, the Bank suffers an economic loss from not charging interest on overdue interest while the credit event lasts.

The credit quality of the sovereign-guaranteed loan portfolio as of June 30, 2012 and December 31, 2011, as represented by the long-term foreign credit rating assigned to each borrower country by Standard & Poor's (S&P), is as follows (in millions):

Country Ratings	June 30, 2012	December 31, 2011
A+ to A-.....	\$ 1,233	\$ 1,266
BBB+ to BBB-.....	37,566	35,864
BB+ to BB-.....	5,242	6,995
B+ to B-.....	17,972	18,478
CCC+ to CCC-.....	341	211
Total	<u>\$ 62,354</u>	<u>\$ 62,814</u>

The ratings presented above have been updated as of June 30, 2012 and December 31, 2011, respectively.

NON-SOVEREIGN-GUARANTEED LOANS: The Bank does not benefit from full sovereign guarantees when lending to non-sovereign-guaranteed borrowers. Risk and performance for these loans are evaluated by scoring the individual risk factors under each of the borrower and transaction dimensions. The major risk factors evaluated at the transaction level consider the priority that the loans made by the Bank have in relation to other obligations of the borrower; the type of security col-

lateralizing the agreement; and the nature and extent of the covenants that the borrower must comply. The major credit risk factors considered at the borrower level may be grouped into three major categories: political risk, commercial or project risk, and financial risk.

The country rating is considered a proxy of the impact of the macro-economic environment on the ability of the borrower to reimburse the Bank and as such, it is considered a ceiling for the transaction dimension risk rating. The credit quality of the non-sovereign-guaranteed loan portfolio as of June 30, 2012 and December 31, 2011, excluding loans to other development institutions, as represented by the Bank's internal credit risk classification system, is as follows (in millions):

Risk Classification	Outstanding balance at		S&P/Moody's Rating Equivalent
	June 30, 2012	December 31, 2011	
Excellent.....	\$ 217	\$ 117	BBB / Baa3 or higher
Very Strong.....	577	494	BB+ / Ba1
Strong.....	1,330	1,270	BB / Ba2
Satisfactory.....	496	517	BB- / Ba3
Fair.....	319	319	B+ / B1
Weak.....	34	114	B / B2
Possible Loss.....	221	183	B- / B3
Impaired.....	264	129	CCC-D / Caa-D
Total	\$ 3,458	\$ 3,143	

In addition, as of June 30, 2012, the Bank has loans to other development institutions of \$166 million (2011 – \$173 million), which are rated AAA, A+ and A-.

Past due and Non-accrual loans

As of June 30, 2012, there were no loans considered past due. Non-sovereign-guaranteed loans with an outstanding balance of \$264 million were in non-accrual status (\$129 million at December 31, 2011), including \$134 million whose maturity has been accelerated.

Impaired loans

The Bank has non-sovereign-guaranteed loans with outstanding balances of \$264 million classified as impaired at June 30, 2012. Impaired loans have specific allowances for loan losses amounting to \$82 million (\$41 million at December 31, 2011).

The following table provides financial information related to impaired loans as of June 30, 2012 and December 31, 2011 (in millions):

	June 30, 2012	December 31, 2011
Recorded investment at end of period.....	\$ 264	\$ 129
Average recorded investment during the period.....	187	126

In addition, a summary of financial information related to impaired loans affecting the results of operations for the three and six months ended June 30, 2012 and 2011 is as follows (in millions):

	Three months ended June 30,	
	2012	2011
Loan income recognized.....	\$ 3	\$ -
Loan income that would have been recognized on an accrual basis during the period.....	4	1
	Six months ended June 30,	
	2012	2011
Loan income recognized.....	\$ 4	\$ 2
Loan income that would have been recognized on an accrual basis during the period.....	6	4

Allowance for Loan and Guarantee Losses

SOVEREIGN-GUARANTEED PORTFOLIO: A collective evaluation of collectibility is performed for sovereign-guaranteed loans and guarantees. The performance of said portfolio has been excellent, particularly given the market credit ratings of many of the Bank's borrowing countries. However, in the past the Bank has experienced delays in the receipt of debt service payments, sometimes for more than six months. Since the Bank does not charge interest on missed interest payments for these loans, such delay in debt service payments is viewed as a potential impairment as the timing of the cash flows are not met in accordance with the terms of the loan contract.

NON-SOVEREIGN-GUARANTEED PORTFOLIO: For non-sovereign-guaranteed loans and guarantees, a collective loss allowance is determined based on the Bank's internal credit risk classification system. The first step in the calculation of the collective loan and guarantee loss allowance is the estimation of an expected rate of transition of projects from non-impaired risk categories to the impaired/default category. This impairment/default rate is applied to each risk category. Transitions of debt instruments from various risk categories to impairment/default status are modeled utilizing worldwide non-sovereign data gathered from the documented experience of rated non-sovereign-guaranteed debt issuances of similar risk levels.

An appropriate estimated rate of loss from projects once impaired is determined based upon the Bank's specific experience gained in the assessment of the losses stemming from impairments in its own non-sovereign-guaranteed portfolio. Based upon (i) the impairment/default rate for each risk category, (ii) the distribution of the non-sovereign-guaranteed portfolio in each of these categories and (iii) the loss rate once defaulted, the required level of the collective loss allowance is determined.

The changes in the allowance for loan and guarantee losses for the periods ended June 30, 2012 and December 31, 2011 were as follows (in millions):

	June 30, 2012	December 31, 2011
Balance, beginning of year	\$ 175	\$ 172
Provision for loan and guarantee losses	<u>40</u>	<u>3</u>
Balance, end of period	<u>\$ 215</u>	<u>\$ 175</u>
Composed of:		
Allowance for loan losses	\$ 192	\$ 150
Allowance for guarantee losses ⁽¹⁾	<u>23</u>	<u>25</u>
Total	<u>\$ 215</u>	<u>\$ 175</u>

⁽¹⁾ The allowance for guarantee losses is included in Other liabilities in the Condensed Balance Sheet.

As of June 30, 2012, the total allowance for loan and guarantee losses is composed of \$10 million related to the sovereign-guaranteed portfolio and \$205 million related to the non-sovereign-guaranteed portfolio (2011 - \$9 million and \$166 million, respectively). The provision for loan and guarantee losses include provisions of \$1 million and \$1 million related to sovereign-guaranteed loans in 2012 and 2011, respectively.

During the first six months of 2012, there were no changes to the Bank's policy with respect to the allowance for loan and guarantee losses from the prior year. Except for the impaired loans on the non-sovereign-guaranteed portfolio, all loans and guarantees have been collectively evaluated for impairment. The collective allowance for loan and guarantee losses as of June 30, 2012 amounted to \$133 million (2011 - \$134 million), including \$123 million (2011 - \$125 million) related to the non-sovereign-guaranteed portfolio.

Troubled debt restructurings

The Bank does not reschedule its sovereign-guaranteed loans. A modification of a loan is considered a troubled debt restructuring when the borrower is experiencing financial difficulty and the Bank has granted a concession to the borrower.

A restructured loan is considered impaired when it does not perform in accordance with the contractual terms of the restructuring agreement. A loan restructured under a troubled debt restructuring is considered impaired, but it is not disclosed as such after the year it was restructured, unless there is a noncompliance under the terms of the restructured agreement.

During the first six months of 2012, there were no troubled debt restructurings or payment defaults associated with the loan modified as a troubled debt restructuring in 2011.

NOTE F – FAIR VALUE OPTION

In 2008, the Bank elected the fair value option under GAAP for most of its medium- and long-term debt to reduce the income volatility resulting from the previous accounting asymmetry of marking to market borrowing swaps through income while recognizing all borrowings at amortized cost. The changes in the fair value of elected borrowings are now also recorded in income.

In order to reduce the income volatility resulting from the changes in fair value of its lending swaps, which are not offset by corresponding changes in the fair value of loans, as all the Bank's loans are recorded at amortized cost, the Bank modified in 2011 its borrowing fair value option policy to address income volatility on a financial instruments (i.e., borrowings and loans) portfolio basis rather than on an instrument-by-instrument basis.

The changes in fair value for borrowings elected under the fair value option have been recorded in the Condensed Statement of Income and Retained Earnings for the three and six months ended June 30, 2012 and 2011, as follows (in millions):

	Three months ended June 30,	
	2012	2011
Borrowing expenses, after swaps	\$ (483)	\$ (535)
Net fair value adjustments on non-trading portfolios	<u>112</u>	<u>(1,105)</u>
Total changes in fair value included in Net income	<u>\$ (371)</u>	<u>\$ (1,640)</u>
	Six months ended June 30,	
	2012	2011
Borrowing expenses, after swaps	\$ (977)	\$ (1,069)
Net fair value adjustments on non-trading portfolios	<u>(25)</u>	<u>(963)</u>
Total changes in fair value included in Net income	<u>\$ (1,002)</u>	<u>\$ (2,032)</u>

The difference between the fair value amount and the unpaid principal outstanding of borrowings measured at fair value as of June 30, 2012 and December 31, 2011, was as follows (in millions):

	June 30, 2012	December 31, 2011
Fair value	\$ 48,638 ⁽¹⁾	\$ 49,335 ⁽¹⁾
Unpaid principal outstanding	<u>44,739</u>	<u>45,571</u>
Fair value over unpaid principal outstanding	<u>\$ 3,899</u>	<u>\$ 3,764</u>

⁽¹⁾ Includes accrued interest of \$419 million at June 30, 2012 and \$434 million at December 31, 2011.

NOTE G – DERIVATIVES

RISK MANAGEMENT STRATEGY AND USE OF DERIVATIVES:

The Bank faces risks that result from market movements, primarily changes in interest and exchange rates, that are mitigated through its integrated asset and liability management framework. The objective of the asset and liability management framework is to align the currency composition, maturity profile and interest rate sensitivity characteristics of the assets and liabilities for each liquidity and lending product portfolio in accordance with the particular requirements for that product and within prescribed risk parameters. When necessary, the Bank employs derivatives to achieve this alignment. These instruments, mostly currency and interest rate swaps, are used primarily for economic hedging purposes.

es, but are not designated as hedging instruments for accounting purposes.

A significant number of the current borrowing operations include swaps to economically hedge a specific underlying liability, producing the funding required (i.e., the appropriate currency and interest rate type). The Bank also uses lending swaps to economically hedge fixed-rate, fixed-base cost rate and local currency loans, and investment swaps that hedge a particular underlying investment security and produce the appropriate vehicle in which to invest existing cash. In addition, the Bank utilizes interest rate swaps to maintain the duration of its equity within a prescribed policy band of 4 to 6 years.

ACCOUNTING FOR DERIVATIVES: All derivatives are recognized in the Condensed Balance Sheet at their fair value and are classified as either assets or liabilities, depending on the nature (debit or credit) of their net fair value amount.

The interest component of the changes in fair value of investment, lending, borrowing, and equity duration derivatives is recorded in Income from Investments - Interest, Income

from Loans, after swaps, Borrowing expenses, after swaps, and Other interest income, respectively, over the life of the derivative contract, with the remaining changes in the fair value included in Income from Investments-Net gains for investment derivatives and in Net fair value adjustments on non-trading portfolios for lending, borrowing and equity duration derivative instruments.

The Bank occasionally issues debt securities that contain embedded derivatives; these securities are carried at fair value.

FINANCIAL STATEMENTS PRESENTATION: The Bank's derivative instruments as of June 30, 2012 and December 31, 2011, and their related gains and losses for the three and six months ended June 30, 2012 and 2011, are presented in the Condensed Balance Sheet, the Condensed Statement of Income and Retained Earnings and the Condensed Statement of Comprehensive Income as follows (in millions):

Condensed Balance Sheet

Derivatives not Designated as Hedging Instruments	Balance Sheet Location	June 30, 2012 ⁽¹⁾		December 31, 2011 ⁽¹⁾	
		Assets	Liabilities	Assets	Liabilities
Currency Swaps	Currency and interest rate swaps				
	Investments - Trading	\$ 28	\$ 30	\$ 11	\$ 45
	Loans	41	271	109	186
	Borrowings	4,839	556	4,785	703
	Accrued interest and other charges	108	(62)	113	(69)
Interest Rate Swaps	Currency and interest rate swaps				
	Investments - Trading	-	42	-	35
	Loans	3	1,608	3	1,472
	Borrowings	2,015	95	1,917	91
	Other	267	1	215	-
	Accrued interest and other charges	243	72	252	89
		<u>\$ 7,544</u>	<u>\$ 2,613</u>	<u>\$ 7,405</u>	<u>\$ 2,552</u>

⁽¹⁾ Balances are reported gross, prior to counterparty netting in accordance with existing master netting derivative agreements.

Condensed Statement of Income and Retained Earnings and Condensed Statement of Comprehensive Income

Derivatives not Designated as Hedging Instruments	Location of Gain (Loss) from Derivatives	Three months ended June 30,		Six months ended June 30,	
		2012	2011	2012	2011
Currency Swaps					
Investments - Trading	Income from investments:				
	Interest	\$ (4)	\$ (7)	\$ (9)	\$ (13)
	Net gains	-	(6)	11	12
Loans	Income from loans, after swaps	(21)	(25)	(43)	(48)
	Net fair value adjustments on non-trading portfolios	49	(71)	(144)	(104)
Borrowings	Borrowing expenses, after swaps	262	305	531	596
	Net fair value adjustments on non-trading portfolios	(244)	825	(26)	858
	Other comprehensive income (loss)-Translation adjustments	27	(10)	32	(6)
Interest Rate Swaps					
Investments - Trading	Income from investments:				
	Interest	(6)	(7)	(12)	(13)
	Net gains	(4)	(9)	(3)	(2)
	Other comprehensive income (loss)-Translation adjustments	15	(36)	32	(84)
Loans	Income from loans, after swaps	(90)	(103)	(188)	(206)
	Net fair value adjustments on non-trading portfolios	(349)	(281)	(136)	(116)
Borrowings	Borrowing expenses, after swaps	200	208	394	425
	Net fair value adjustments on non-trading portfolios	270	323	96	13
	Other comprehensive income (loss) -Translation adjustments	(4)	3	(1)	9
Other	Other interest income	26	26	52	51
	Net fair value adjustments on non-trading portfolios	78	84	51	41
		<u>\$ 205</u>	<u>\$ 1,219</u>	<u>\$ 637</u>	<u>\$ 1,413</u>

The Bank is not required to post collateral under its derivative agreements as long as it maintains a AAA credit rating. Should the Bank credit rating be downgraded from the current AAA, the standard swap agreements detail, by swap counterparty, the collateral requirements that the Bank would need to satisfy in this event. The aggregate fair value of all derivative instruments with credit-risk related contingent features that are in a liability position at June 30, 2012 is \$258 million (\$180 million at December 31, 2011) (after consideration of master netting derivative agreements). If the Bank was downgraded one notch from the current AAA credit rating, it would be required to post collateral in the amount of \$20 million at June 30, 2012 (2011 - \$81 million).

The following tables provide information on the contract value/notional amounts of derivative instruments as of June 30, 2012 and December 31, 2011 (in millions). Currency swaps are shown at face value and interest rate swaps are shown at the notional amount of each individual payable or receivable leg. Included in the other category are interest rate swaps used to maintain the equity duration within policy limits.

Derivative type/ Rate type	June 30, 2012			
	Currency swaps		Interest Rate swaps	
	Receivable	Payable	Receivable	Payable
Investments - trading				
Fixed	\$ -	\$ 1,888	\$ -	\$ 2,073
Adjustable	1,918	-	2,073	-
Loans				
Fixed	5	967	124	11,996
Adjustable	2,165	1,188	11,996	124
Borrowings				
Fixed	20,061	208	36,525	349
Adjustable	3,700	20,180	5,007	39,801
Other				
Fixed	-	-	7,823	-
Adjustable	-	-	-	7,823

Derivative type/ Rate type	December 31, 2011			
	Currency swaps		Interest Rate swaps	
	Receivable	Payable	Receivable	Payable
Investments - trading				
Fixed	\$ -	\$ 1,345	\$ -	\$ 2,297
Adjustable	1,351	-	2,297	-
Loans				
Fixed	-	932	141	12,750
Adjustable	2,171	1,137	12,950	341
Borrowings				
Fixed	19,863	144	31,656	349
Adjustable	4,014	20,336	5,408	36,142
Other				
Fixed	-	-	6,143	-
Adjustable	-	-	-	6,143

NOTE H – FAIR VALUE MEASUREMENTS

The framework for measuring fair value establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives higher priorities to unadjusted quoted prices in active markets for identical and unrestricted assets or liabilities (Level 1) and adjusted quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for similar assets or liabilities (Level 2), and the lowest priority to unobservable inputs (i.e., supported by little or no market activity) (Level 3).

The Bank's investment instruments valued based on quoted market prices in active markets, a valuation technique consistent with the market approach, include obligations of the United States and Japanese governments. Such instruments are classified within Level 1 of the fair value hierarchy. As required by the framework for measuring fair value, the Bank does not adjust the quoted price for such instruments.

Substantially all other Bank investment instruments are valued based on quoted prices in markets that are not active, external pricing services, where available, solicited broker/dealer prices, or prices derived from alternative pricing models, utilizing available observable market inputs and discounted cash flows. These methodologies apply to investments, including government agencies and corporate bonds, asset-backed and mortgage-backed securities, bank obligations, and related financial derivative instruments (primarily currency and interest rate swaps). These instruments are classified within Level 2 of the fair value hierarchy and are measured at fair value using valuation techniques consistent with the market and income approaches.

The main methodology of external pricing service providers involves a "market approach" that requires a predetermined activity volume of market prices to develop a composite price. The market prices utilized are provided by orderly transactions being executed in the relevant market; transactions that are not orderly and outlying market prices are filtered out in the determination of the composite price. Other external price providers utilize evaluated pricing models that vary by asset class and incorporate available market information through benchmark curves, benchmarking of like securities, sector groupings, and matrix pricing to prepare valuations.

Investment securities are also valued with prices obtained from brokers/dealers. Brokers/dealers' prices may be based on a variety of inputs ranging from observed prices to proprietary valuation models. The Bank reviews the reasonability of brokers/dealers' prices via the determination of fair value estimates from internal valuation techniques that use observable market inputs.

Medium-and long-term borrowings elected under the fair value option and all currency and interest rate swaps are valued using quantitative models, including discounted cash flow models as well as more advanced option modeling techniques, when necessary depending on the specific structures of the instruments. These models and techniques require the use of various market inputs including market yield curves, exchange rates, interest rates, spreads, volatilities and correlations. Significant market inputs are observable during the full term of these instruments. The Bank considers, consistent with the requirements of the framework for measuring fair value, the impact of its own creditworthiness in the valuation of its liabilities. These instruments are classified within Level 2 of the fair value hierarchy in view of the observability of the significant inputs to the models and are measured at fair value using valuation techniques consistent with the market and income approaches.

Level 3 investment, borrowing and swap instruments, if any, are valued using Management's best estimates utilizing available information including (i) external price providers, where available, or broker/dealer prices; when less liquidity exists, a quoted price is out of date or prices among brokers/dealers vary significantly, other valuation techniques may be used (i.e., a combination of the market approach and the income approach) and (ii) market yield curves of other instruments, used as a proxy for the instruments' yield curves, for borrowings and related swaps. These methodologies are valuation techniques consistent with the market and income approaches.

The following tables set forth the Bank's financial assets and liabilities that were accounted for at fair value as of June 30, 2012 and December 31, 2011 by level within the fair value hierarchy (in millions):

Financial assets:

<u>Assets</u>	Fair Value Measurements			
	June 30, 2012⁽¹⁾	Level 1	Level 2	Level 3
Investments - Trading:				
Obligations of the United States Government and its corporations and agencies.....	\$ 5,467	\$ 5,266	\$ 201	\$ -
U.S. Government-sponsored enterprises.....	635	-	635	-
Obligations of non-U.S. governments and agencies.....	7,865	539	7,326	-
Bank obligations	3,723	-	3,723	-
Mortgage-backed securities	1,050	-	1,045	5
U.S. residential.....	348	-	348	-
Non-U.S. residential.....	353	-	348	5
U.S. commercial.....	140	-	140	-
Non-U.S. commercial.....	209	-	209	-
Asset-backed securities	676	-	608	68
Collateralized loan obligations.....	438	-	438	-
Other collateralized debt obligations.....	110	-	42	68
Other asset-backed securities.....	128	-	128	-
Total Investments - Trading.....	19,416	5,805	13,538	73
Currency and interest rate swaps.....	7,544	-	7,544	-
Total.....	<u>\$ 26,960</u>	<u>\$ 5,805</u>	<u>\$ 21,082</u>	<u>\$ 73</u>

⁽¹⁾ Represents the fair value of the referred assets, including their accrued interest presented in the Condensed Balance Sheet under Accrued interest and other charges of \$33 million for trading investments and \$351 million for currency and interest rate swaps.

<u>Assets</u>	Fair Value Measurements			
	December 31, 2011⁽¹⁾	Level 1	Level 2	Level 3
Investments - Trading:				
Obligations of the United States Government and its corporations and agencies.....	\$ 1,974	\$ 1,974	\$ -	\$ -
U.S. Government-sponsored enterprises.....	841	-	841	-
Obligations of non-U.S. governments and agencies.....	5,586	143	5,443	-
Bank obligations	3,323	-	3,323	-
Mortgage-backed securities	1,269	-	1,264	5
U.S. residential.....	444	-	444	-
Non-U.S. residential.....	419	-	414	5
U.S. commercial.....	167	-	167	-
Non-U.S. commercial.....	239	-	239	-
Asset-backed securities	750	-	680	70
Collateralized loan obligations.....	470	-	470	-
Other collateralized debt obligations.....	125	-	55	70
Other asset-backed securities.....	155	-	155	-
Total Investments - Trading.....	13,743	2,117	11,551	75
Currency and interest rate swaps.....	7,405	-	7,405	-
Total.....	<u>\$ 21,148</u>	<u>\$ 2,117</u>	<u>\$ 18,956</u>	<u>\$ 75</u>

⁽¹⁾ Represents the fair value of the referred assets, including their accrued interest presented in the Condensed Balance Sheet under Accrued interest and other charges of \$40 million for trading investments and \$365 million for currency and interest rate swaps.

Financial liabilities:

<u>Liabilities</u>	<u>Fair Value Measurements</u>			
	<u>June 30, 2012⁽¹⁾</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Borrowings measured at fair value	\$ 48,638	\$ -	\$ 48,638	\$ -
Currency and interest rate swaps	2,613	-	2,613	-
Total	<u>\$ 51,251</u>	<u>\$ -</u>	<u>\$ 51,251</u>	<u>\$ -</u>

⁽¹⁾ Represents the fair value of the referred liabilities, including their accrued interest presented in the Condensed Balance Sheet under Accrued interest on borrowings of \$419 million for borrowings and under Accrued interest and other charges of \$9 million for currency and interest rate swaps.

<u>Liabilities</u>	<u>Fair Value Measurements</u>			
	<u>December 31, 2011⁽¹⁾</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Borrowings measured at fair value	\$ 49,335	\$ -	\$ 49,335	\$ -
Currency and interest rate swaps	2,552	-	2,552	-
Total	<u>\$ 51,887</u>	<u>\$ -</u>	<u>\$ 51,887</u>	<u>\$ -</u>

⁽¹⁾ Represents the fair value of the referred liabilities, including their accrued interest presented in Condensed Balance Sheet under Accrued interest on borrowings of \$434 million for borrowings and under Accrued interest and other charges of \$20 million for currency and interest rate swaps.

The tables below show a reconciliation of the beginning and ending balances of all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2012 and 2011 (in millions). There were no financial liabilities measured at fair value using significant unobservable inputs for the six months ended June 30, 2012 and 2011. In addition, the tables show the total gains and losses included in Net

income as well as the amount of these gains and losses attributable to the change in unrealized gains and losses relating to assets still held as of June 30, 2012 and 2011 (in millions) and a description of where these gains or losses are reported in the Condensed Statement of Income and Retained Earnings.

Financial assets:

	<u>Three months ended June 30,</u>					
	<u>2012</u>			<u>2011</u>		
	<u>Fair Value Measurements Using Significant Unobservable Inputs (Level 3)</u>			<u>Fair Value Measurements Using Significant Unobservable Inputs (Level 3)</u>		
	<u>Investments - Trading</u>	<u>Currency and Interest Rate Swaps</u>	<u>Total</u>	<u>Investments - Trading</u>	<u>Currency and Interest Rate Swaps</u>	<u>Total</u>
Balance, beginning of period	\$ 81	\$ -	\$ 81	\$ 105	\$ -	\$ 105
Total gains (losses) included in:						
Net income	1	-	1	2	-	2
Other comprehensive income (loss)	(4)	-	(4)	1	-	1
Settlements	(5)	-	(5)	(6)	-	(6)
Transfers out of Level 3	-	-	-	(7)	-	(7)
Balance, end of period	<u>\$ 73</u>	<u>\$ -</u>	<u>\$ 73</u>	<u>\$ 95</u>	<u>\$ -</u>	<u>\$ 95</u>
Total gains (losses) for the period included in:						
Net income attributable to the change in unrealized gains or losses related to assets still held at the end of the period	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2</u>	<u>\$ -</u>	<u>\$ 2</u>

	Six months ended June 30,					
	2012			2011		
	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)			Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Investments - Trading	Currency and Interest Rate Swaps	Total	Investments - Trading	Currency and Interest Rate Swaps	Total
Balance, beginning of year	\$ 75	\$ -	\$ 75	\$ 100	\$ -	\$ 100
Total gains (losses) included in:						
Net income	13	-	13	14	-	14
Other comprehensive income (loss)	(2)	-	(2)	4	-	4
Settlements	(13)	-	(13)	(16)	-	(16)
Transfers out of Level 3	-	-	-	(7)	-	(7)
Balance, end of period	<u>\$ 73</u>	<u>\$ -</u>	<u>\$ 73</u>	<u>\$ 95</u>	<u>\$ -</u>	<u>\$ 95</u>
Total gains (losses) for the period included in:						
Net income attributable to the change in unrealized gains or losses related to assets still held at the end of the period	<u>\$ 12</u>	<u>\$ -</u>	<u>\$ 12</u>	<u>\$ 13</u>	<u>\$ -</u>	<u>\$ 13</u>

As of June 30, 2012, the investment portfolio includes \$73 million of securities classified as Level 3. The pricing information for these securities is not developed or adjusted by the Bank, and is obtained through external pricing sources.

The significant unobservable inputs used in the fair value measurements of the Bank's investments in other collateralized debt obligations and non-U.S. residential mortgage-backed securities classified as Level 3 are prepayment rates, probability of default, and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss

severity and a directionally opposite change in the assumption used for prepayment rates.

The Treasury Division is responsible for mark to market valuations for financial statement purposes of investments, borrowings, and derivatives, including those with significant unobservable inputs, and reports to the Treasurer of the Bank. The Accounting Division is responsible for monitoring, controlling, recording and reporting fair values related to investments, borrowings and all derivatives. The two groups work in close coordination to monitor the reasonableness of fair values. Such monitoring includes but is not limited to validation against counterparty values, internally developed models, and independent price quotes for similar instruments, when available.

Gains (losses) are included in the Condensed Statement of Income and Retained Earnings as follows (in millions):

	Three months ended June 30,			
	2012		2011	
	Total Gains (Losses) included in Net Income for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period	Total Gains (Losses) included in Net Income for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period
Income from investments	<u>\$ 1</u>	<u>\$ -</u>	<u>\$ 2</u>	<u>\$ 2</u>
Total	<u>\$ 1</u>	<u>\$ -</u>	<u>\$ 2</u>	<u>\$ 2</u>

	Six months ended June 30,			
	2012		2011	
	Total Gains (Losses) included in Net Income for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period	Total Gains (Losses) included in Net Income for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period
Income from investments	\$ 13	\$ 12	\$ 14	\$ 13
Total	<u>\$ 13</u>	<u>\$ 12</u>	<u>\$ 14</u>	<u>\$ 13</u>

The Bank accounts for its loans and certain borrowings at amortized cost with their corresponding fair value disclosures included in Note P – Fair Values of Financial Instruments.

The fair value of the loan portfolio, which amounted to approximately \$71,102 million as of June 30, 2012 (\$70,882 million as of December 31, 2011) was determined using a discounted cash flow method (income approach) by which cash flows are discounted at (i) applicable market yield curves adjusted for the Bank's own funding cost plus its lending spread, for sovereign-guaranteed loans, and (ii) market yield curves consistent with the borrower's S&P credit rating equivalent, for non-sovereign-guaranteed loans. This methodology has been developed based on valuation assumptions that management believes a hypothetical market participant would use in pricing the Bank's loans. Those valuation assumptions include observable inputs, such as the market yield curves mainly based on LIBOR, and unobservable inputs, such as internal credit risk assumptions. Due to the fact that the unobservable inputs are considered significant, the fair value disclosure of the Bank's loan portfolio has been classified as Level 3.

The fair value of borrowings recorded at amortized cost, which amounted to approximately \$20,867 million as of June 30, 2012 (\$15,463 million as of December 31, 2011) was determined using the same inputs and valuation techniques as disclosed above for the borrowings recorded at fair value. Such valuation techniques are based on discounted cash flows or pricing models (income approach) and utilize market observable inputs. Accordingly, the fair value disclosure for borrowings recorded at amortized cost is considered Level 2 under the fair value hierarchy.

NOTE I – NET FAIR VALUE ADJUSTMENTS ON NON-TRADING PORTFOLIOS

Net fair value adjustments on non-trading portfolios on the Condensed Statement of Income and Retained Earnings for the three and six months ended June 30, 2012 and 2011 comprise the following (in millions):

	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Change in fair value of derivative instruments due to movements in:				
Exchange rates	\$ (465)	\$ 560	\$ (199)	\$ 725
Interest rates	269	330	40	(33)
Total change in fair value of derivatives	<u>(196)</u>	<u>890</u>	<u>(159)</u>	<u>692</u>
Change in fair value of borrowings due to movements in:				
Exchange rates	549	(552)	103	(814)
Interest rates	(437)	(553)	(128)	(149)
Total change in fair value of borrowings	<u>112</u>	<u>(1,105)</u>	<u>(25)</u>	<u>(963)</u>
Currency transaction gains (losses) on borrowings and loans at amortized cost	(87)	(13)	96	83
Total	<u>\$ (171)</u>	<u>\$ (238)</u>	<u>\$ (88)</u>	<u>\$ (188)</u>

Net fair value gains on non-trading derivatives resulting from changes in interest rates were \$40 million for the first six months of 2012. These gains were offset by fair value losses on borrowings of \$128 million. The income volatility related to movements in interest rates, which amounted to a loss of \$88 million for the six months period ended June 30, 2012, compared to a loss of \$182 million for the same period last year, was primarily due to fair value losses on lending swaps (\$185 million), losses associated with changes in the Bank's credit spreads on the borrowing portfolio (approximately \$5 million) and losses from changes in swap basis spreads (approximately \$50 million), which were partially offset by gains on equity duration swaps (\$51 million) and gains on swaps where the associated bond was not elected for fair value treatment (\$101 million).

The Bank's borrowings in non-functional currencies are fully swapped to functional currencies, thus protecting the Bank against fluctuations in exchange rates. During the first six months of 2012, exchange rate changes decreased the value of borrowings and loans, resulting in a net gain of \$199 million (2011 – net loss of \$731 million), which was offset by a net loss from changes in the value of the borrowing and lending swaps of \$199 million (2011 – net gain of \$725 million).

NOTE J – BOARD OF GOVERNORS APPROVED TRANSFERS

As part of the ninth general increase in the resources of the Bank (IDB-9), the Board of Governors agreed, in principle and subject to annual approvals by the Board of Governors and in accordance with the Agreement, to provide \$200 million annually in transfers of Ordinary Capital income to the IDB Grant Facility, beginning in 2011 and through 2020. At

its annual meeting in Montevideo, Uruguay, in March 2012, the Board of Governors approved the \$200 million transfer corresponding to 2012. Such transfers are recognized as an expense when approved by the Board of Governors and funded in accordance with the IDB Grant Facility funding requirements. The undisbursed portion of approved transfers is presented under Due to IDB Grant Facility on the Condensed Balance Sheet.

NOTE K – CAPITAL STOCK

Effective January 18, 2012, the Board of Governors adopted a resolution authorizing the IDB-9, that provides for an increase in the Bank's Ordinary Capital of \$70,000 million to be subscribed to by Bank members in five annual installments. Of this amount, \$1,700 million is in the form of paid-in capital stock and the remainder constitutes callable capital stock.

On February 29, 2012, the IDB-9 entered into effect, which was also the effective date of the first installment. The IDB-9 provides for an increase in the Bank's Ordinary Capital of \$70,000 million to be subscribed to by Bank members in five annual installments. Of this amount, \$1,700 million is in the form of paid-in capital stock and the remainder constitutes callable capital stock. As of April 20, 2012, the deadline for member countries to commit to subscribe to additional ordinary capital stock, subscriptions from 46 member countries amounting to \$65,731 million were received by the Bank. The Netherlands and Venezuela did not subscribe to the respective shares of the increase that had been reserved for them amounting to \$4,269 million (of which \$237 million correspond to the shares reserved for the Netherlands, and \$4,032 million correspond to those for Venezuela). Of the total shares subscribed, 5,134,300 shares in the amount of \$61,937 million, or 88% of the total increase, were eligible for allocation, representing the amount of shares subscribed, less shares that were not allocated in order to comply with the associated minimum voting power requirements of the Agreement. Of the total shares allocated, \$1,504 million represents paid-in capital stock and \$60,433 million represents callable capital stock.

The shares of the increase that had been reserved for the Netherlands and Venezuela (19,639 and 334,278 shares, respectively) are being held by the Bank and will be reallocated by the Bank's Board of Governors.

On February 29, 2012, Canada notified the Bank that it was exercising its right to replace shares of non-voting callable capital stock with shares allocated under the IDB-9. Accordingly, effective March 30, 2012, Canada replaced 40,358 non-voting callable shares in the amount of \$487 million with an equal amount of voting callable shares under the IDB-9.

The changes in subscribed capital during the six months ended June 30, 2012 were as follow (in millions):

	Subscribed capital			
	Shares	Paid-in	Callable	Total
Balance at				
January 1, 2012.....	8,702,335	\$ 4,339	\$ 100,641	\$ 104,980
Subscriptions				
during 2012.....	1,026,851	301	12,086	12,387
Canada's return of				
callable capital.....	(40,358)	-	(487)	(487)
Balance at				
June 30, 2012.....	<u>9,688,828</u>	<u>\$ 4,640</u>	<u>\$ 112,240</u>	<u>\$ 116,880</u>

As of June 30, 2012, the Bank has collected \$240 million of the \$301 million paid-in subscribed capital. The remaining \$61 million has been recorded as Capital subscriptions receivable reducing equity in the Condensed Balance Sheet.

NOTE L – PENSION AND POSTRETIREMENT BENEFIT PLANS

The Bank has two defined benefit retirement plans (Plans) for providing pension benefits to employees of the Bank: the Staff Retirement Plan for international employees, and the Local Retirement Plan for national employees in the country offices. The Bank also provides health care and certain other benefits to retirees under the Postretirement Benefits Plan (PRBP).

CONTRIBUTIONS: All contributions are made in cash. Contributions from the Bank to the Plans and the PRBP during the first six months of 2012 were \$43 million (2011 – \$46 million). As of June 30, 2012, the estimate of contributions expected to be paid to the Plans and the PRBP during 2012 was \$50 million and \$36 million, respectively, the same amount disclosed in the December 31, 2011 financial statements. Contributions for 2011 were \$59 million and \$34 million, respectively.

PERIODIC BENEFIT COST: Net periodic benefit costs are allocated between the Ordinary Capital and the FSO in accordance with an allocation formula approved by the Board of Governors for administrative expenses and are included under Administrative expenses in the Condensed Statement of Income and Retained Earnings.

The following table summarizes the benefit costs associated with the Plans and the PRBP for the three and six months ended June 30, 2012 and 2011 (in millions):

	Pension Benefits			
	Three months ended		Six months ended	
	June 30,	June 30,	June 30,	June 30,
	2012	2011	2012	2011
Service cost.....	\$ 22	\$ 16	\$ 43	\$ 33
Interest cost.....	37	38	75	75
Expected return on plan assets.....	(46)	(47)	(92)	(94)
Amortization of:				
Prior service cost.....	-	-	-	1
Unrecognized net actuarial losses..	8	-	16	-
Net periodic benefit cost.....	<u>\$ 21</u>	<u>\$ 7</u>	<u>\$ 42</u>	<u>\$ 15</u>
Of which:				
ORC's share.....	\$ 20	\$ 7	\$ 41	\$ 15
FSO's share.....	\$ 1	\$ -	\$ 1	\$ -

	Postretirement Benefits			
	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Service cost.....	\$ 12	\$ 9	\$ 23	\$ 17
Interest cost.....	19	19	37	37
Expected return on plan assets.....	(19)	(19)	(37)	(37)
Amortization of:				
Prior service cost.....	2	9	4	18
Unrecognized net actuarial losses.....	4	-	9	-
Net periodic benefit cost.....	<u>\$ 18</u>	<u>\$ 18</u>	<u>\$ 36</u>	<u>\$ 35</u>
Of which:				
ORC's share.....	\$ 17	\$ 17	\$ 35	\$ 34
FSO's share.....	\$ 1	\$ 1	\$ 1	\$ 1

NOTE M – VARIABLE INTEREST ENTITIES

The Bank has identified loans and guarantees in Variable Interest Entities (VIEs) in which it is not the primary beneficiary but in which it is deemed to hold significant variable interest at June 30, 2012. The majority of these VIEs do not involve securitizations or other types of structured financing. These VIEs are mainly: (i) investment funds, where the general partner or fund manager does not have substantive equity at risk; (ii) operating entities where the total equity investment is considered insufficient to permit such entity to finance its activities without additional subordinated financial support; and (iii) entities where the operating activities are so narrowly defined by contracts (e.g. concession contracts) that equity investors are considered to lack decision making ability.

The Bank's involvement with these VIEs is limited to loans and guarantees, which are reflected as such in the Bank's financial statements. Based on the most recent available data, the size of the VIEs measured by total assets in which the Bank is deemed to hold significant variable interests totaled \$2,967 million at June 30, 2012 and December 31, 2011. The Bank's total loans and guarantees outstanding to these VIEs were \$356 million and \$92 million, respectively (\$356 million and \$90 million, respectively, at December 31, 2011). Amounts committed not yet disbursed related to such loans and guarantees amounted to \$0 million (\$3 million at December 31, 2011), which combined with outstanding amounts results in a total Bank exposure of \$448 million at June 30, 2012 (\$449 million at December 31, 2011).

The Bank has made a loan amounting to approximately \$32 million to one VIE for which the Bank is deemed to be the primary beneficiary. The Bank's involvement with this VIE is limited to such loan, which is reflected as such in the Bank's financial statements. Based on the most recent available data, the size of this VIE measured by total assets amounted to approximately \$32 million, which is considered immaterial and, thus, not consolidated with the Bank's financial statements.

NOTE N – RECONCILIATION OF NET INCOME TO NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES

A reconciliation of Net income to Net cash (used in) provided by operating activities, as shown on the Condensed Statement of Cash Flows, is as follows (in millions):

	Six months ended	
	June 30,	
	2012	2011
Net income.....	\$ 137	\$ 240
Difference between amounts accrued and amounts paid or collected for:		
Loan income.....	30	3
Investment income.....	(117)	(31)
Other interest income.....	(5)	-
Net unrealized gain on trading investments.....	(72)	(123)
Interest and other costs of borrowings, after swaps.....	160	108
Administrative expenses, including depreciation.....	23	(3)
Special programs.....	(10)	(1)
Net fair value adjustments on non-trading portfolios.....	88	188
Transfers to the IDB Grant Facility.....	131	200
Net (increase) decrease in trading investments.....	(5,169)	3,102
Provision (credit) for loan and guarantee losses.....	40	(23)
Net cash (used in) provided by operating activities.....	<u>\$ (4,764)</u>	<u>\$ 3,660</u>

Supplemental disclosure of noncash activities

Increase (decrease) resulting from exchange rate fluctuations:		
Trading investments.....	\$ (36)	\$ 194
Loans outstanding.....	(11)	43
Borrowings.....	(43)	230
Receivable from members-net.....	-	(13)

NOTE O – SEGMENT REPORTING

Management has determined that the Bank has only one reportable segment since the Bank does not manage its operations by allocating resources based on a determination of the contributions to net income of individual operations. The Bank does not differentiate between the nature of the products or services provided, the preparation process, or the method for providing the services among individual countries.

For the six months ended June 30, 2012 and 2011, loans made to or guaranteed by three countries individually generated in excess of 10% of loan income, before swaps, as follows (in millions):

	Six months ended	
	June 30,	
	2012	2011
Brazil.....	\$ 186	\$ 209
Mexico.....	191	187
Argentina.....	155	167

NOTE P – FAIR VALUES OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used by the Bank in measuring the fair value for its financial instruments:

Cash: The carrying amount reported in the Condensed Balance Sheet for cash approximates fair value.

Investments: Fair values for investment securities are based on quoted prices, where available; otherwise they are based on external pricing services, independent dealer prices, or discounted cash flows.

Loans: The Bank is one of very few lenders of development loans to Latin American and Caribbean countries. It does not sell its loans nor does it believe there is a comparable market

for its loans. The absence of a secondary market for the Bank's loans made it difficult to estimate their fair value despite the flexibility offered by the fair value framework. However, effective in 2011, Management, in recognition of a steady practice of several years in the multilateral development institutions industry, made the decision of estimating and disclosing the fair value of the Bank's loan portfolio using a discounted cash flow method, by which cash flows are discounted at (i) applicable market yield curves adjusted for the Bank's own funding cost plus its lending spread, for sovereign-guaranteed loans, and (ii) market yield curves consistent with the borrower's S&P credit rating equivalent, for non-sovereign-guaranteed loans.

Swaps: Fair values for interest rate and currency swaps are based on discounted cash flows or pricing models.

Borrowings: The fair values of borrowings are based on discounted cash flows or pricing models.

The following table presents the fair values of the financial instruments, along with the respective carrying amounts, as of June 30, 2012 and December 31, 2011 (in millions):

	2012 ⁽¹⁾		2011 ⁽¹⁾	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash.....	\$ 1,644	\$ 1,644	\$ 1,189	\$ 1,189
Investments - trading.....	19,416	19,416	13,743	13,743
Loans outstanding, net.....	66,218	71,102	66,446	70,882
Currency and interest rate swaps receivable				
Investments - trading.....	23	23	5	5
Loans.....	36	36	103	103
Borrowings.....	7,208	7,208	7,077	7,077
Others.....	277	277	220	220
Borrowings				
Short-term.....	810	810	898	898
Medium- and long-term				
Measured at fair value.....	48,638	48,638	49,335	49,335
Measured at amortized cost..	19,586	20,867	14,228	15,463
Currency and interest rate swaps payable				
Investments - trading.....	83	83	101	101
Loans.....	1,955	1,955	1,738	1,738
Borrowings.....	574	574	713	713
Others.....	1	1	-	-

⁽¹⁾ Includes accrued interest.

NOTE Q – SUBSEQUENT EVENTS

Management has evaluated subsequent events through August 3, 2012, which is the date the financial statements were issued. As a result of this evaluation, there are no subsequent events that require recognition or disclosure in the Bank's Condensed Quarterly Financial Statements as of June 30, 2012.