STANDARD & POOR'S

FULL ANALYSIS

South Gate

Primary Credit Analysts:
Olga Kalinina
CFA
New York
(1) 212-438-7350
olga_kalinina@
standardandpoors.com

Secondary Credit Analysts:
Larry Hays
Ph.D.
New York
(1) 212-438-7347
larry_hays@
standardandpoors.com

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Inter-American Investment Corp.

Major Rating Factors

Strengths:

- A strong capital position derived from ample liquidity and a large capital contribution from its shareholders;
- An important policy purpose in supporting growth and development of small and midsize enterprises in Latin American and Caribbean member countries (LACMCs); and
- Membership in and support from the Inter-American Development Bank group.

Weaknesses:

- The most challenging mandate of any rated multilateral development finance institution; and
- Small size, limiting the corporation's impact on economic growth and development in LACMCs and, consequently, its franchise value.

Rationale

The ratings on Inter-American Investment Corp. (IIC) reflect its important policy purpose, strong capital position, ample liquidity, and membership in and support from the Inter-American Development Bank (IADB) group. The positive outlook on IIC stems from the lower embedded risk in its portfolio, its better diversity of funding sources, an increase in profitability, and a strengthening of its institutional framework.

IIC began operations in 1989 with a mandate to finance the establishment, expansion, and modernization of small and midsize enterprises (SMEs). It does this by providing equity and short-, medium-, and long-term loans without government guarantees; by mobilizing funding from other investors; and by providing a variety of financial and technical advisory services. It had 43 member countries at year-end 2007, including all IADB Latin American and Caribbean member countries (LACMCs).

IIC had shareholders' equity of $735 million at year-end 2007, among the lowest of rated multilateral development finance institutions (MDFIs). Its total assets at year-end 2007 were $1.24 billion, of which $797 million was loans and $43 million was equity investments.

Inefficient operational policies, exacerbated by the international economic crisis of 1998 to 2001, hurt IIC's profitability, asset quality, and capitalization ratios. However, the corporation's performance has improved markedly over the past five years. In response, IIC has undertaken changes in its management, revised its financial and operational policies and risk management practices, and, since 2000, received additional capital from its members. The corporation also began shifting more staff from its Washington headquarters to the region, increasing the efficiency and speed of operations. These changes contributed to markedly better financial performance in recent years, culminating in operating income of $84 million in 2007. This is equal to a 7.6% operating return on average assets plus guarantees and a 12.6% return on average shareholders' equity (though including a one-time gain of $45 million from the sale of an equity investment).

IIC's capital base was also significantly strengthened by the member countries' 1999 decision to increase IIC's capital by $500 million, to $703.7 million. With all but $51.6 million of this paid by July 2008, IIC's capitalization and risk-bearing capacity has strengthened significantly. We expect the shortfalls—$46.1 million from the United States of America (AAA/Stable/A-1+; all sovereign credit ratings cited in this report are foreign currency ratings as of July 30, 2008) and $5.5 million from the Republic of Argentina (B+/Negative/B)—to be eliminated by 2010 (subject to a two-year extension if partial payments are received). The ratio of IIC's provisions for losses plus its shareholders' equity (its narrow-risk-bearing capacity) to development-related assets (loans, equity investments, and guarantees) was 91% at year-end 2007, the same as one year earlier, among the highest for rated MDFIs.

IIC's liquidity position is also strong. It had more than $410 million in cash and marketable securities at year-end 2007, 33% of total assets. It also had an unused credit facility of $300 million from the IADB and nearly $610 million in credit facilities from commercial financial institutions (of which about $380 million was drawn as of year-end 2007). This compares with $499 million in outstanding borrowings and long-term debt, the first $30 million of which is payable in 2009.

Despite these significant improvements in its financial profile, IIC continues to face a difficult mandate: maintaining the value of shareholders' capital while maximizing the developmental impact of its operations. Despite the $500 million capital increase, IIC continues to suffer from diseconomies of scale and to be challenged in its ability to make a meaningful developmental impact as compared with larger institutions. Recognizing this intrinsic challenge, IIC's directors have made a number of important strategic and operational changes that have better positioned the corporation to maintain this difficult equilibrium. The organization has introduced a new strategic framework, the portfolio approach, which looks at IIC's operations in a broader, portfolio-oriented perspective, in which each project is assessed based on its development impact and financial contribution. On the operational side, IIC has also relaxed some of the strictures under which the corporation formerly operated, now permitting lending to larger companies, a shift toward lending through financial institutions, and the provision of shorter term lending in challenging markets. At the same time, the corporation has strengthened its risk management policies. This, combined with a favorable economic cycle in the past few years, has resulted in markedly better performing loan and equity portfolios. Only 1.7% of outstanding loans were in nonaccrual status in 2007, compared with 23% in 2002.

Outlook

The positive outlook reflects the improvement in IIC's financial profile and the strategic and operational initiatives it has put in place to preserve the sound financial performance of the past few years while maximizing the developmental impact of its operations. Although the corporation's small size and difficult mandate remain inherent credit constraints, IIC's improved financial fundamentals, more resilient policies, and new, more balanced strategic framework should make it better able to meet its operational goals without endangering its financial position. These developments also make IIC better prepared to weather the negative impact of an ongoing global slowdown. However, a slowdown more severe and protracted than expected, impairing the corporation's asset quality and profitability, would put downward pressure on the outlook. Similarly, if IIC were to divert from its currently conservative leverage policies, Standard & Poor's Ratings Services would consider an outlook revision. On the other hand, a combination of the U.S.'s regularizing of its capital payments with IIC or continued improvement in IIC's financial performance could result in an upgrade.

Membership And Voting Powers: Forty-Three Members By End Of 2007

Inter-American Investment Corp. (IIC) came into formal existence in 1986 and had 34 member countries at year-end 1988. Membership grew to 43 by year-end 2005, by which time all 26 of the LACMCs of the Inter-American Development Bank (IADB) and all but four of the bank's 21 nonregional members had joined IIC. The countries that did not join IIC are Canada, the U.K., Croatia**,** and Slovenia. LACMCs had subscribed to 52.5% of total subscribed shares as of year-end 2007; the U.S., 25.0%; and the 16 nonregional countries, 22.5%. Each member has one vote for each fully paid share it holds. Although decisions are usually made by a majority of the votes cast, qualified majorities are required for some decisions. For example, at least 75% of the votes, including two-thirds of the governors, is necessary to authorize a major capital increase, and 80%, also including two-thirds of the governors, is required to amend the agreement.

Governance And Organization: Focus On Expansion Of Regional Presence

Under the agreement establishing IIC, each country appoints a governor to IIC's board of governors. These are typically the governors of the IADB. In practice, the chairman of the board of governors of the IADB also serves as the chairman of IIC's board of governors. The board of governors delegates all but a list of specified powers to IIC's board of executive directors. IIC's 13 executive directors are typically appointed or elected from among the IADB's executive directors or alternates, although this need not be the case. The U.S. appoints one executive director by virtue of its being the largest single shareholder, the governors from the LACMCs elect nine executive directors, and governors from the nonregional member countries elect three executive directors.

The IADB's president is ex officio chairman of the board of executive directors. The board of executive directors appoints a general manager to serve as chief executive officer. The current general manager, Jacques Rogozinski, took office in January 2000; he was confirmed for a second five-year term in January 2005.

IIC's staff has always been small, having peaked at about 115 in the early 1990s. At year-end 2007, IIC had an authorized staff of 98. Of these positions, 77 were based in Washington, and the rest were based in Argentina, Chile, Colombia, Costa Rica**,** Paraguay**,** Uruguay, Honduras, and Nicaragua. That compares with just three countries where IIC was present at the beginning of 2003. In 2008, the corporation is expanding its regional presence to four more countries, including some in Central America and the Caribbean, and IIC's staff will grow by eight people.

Additional increases in staffing should be modest during the next several years because management intends to leverage its staff more effectively than it has in the past. For instance, from 2003 through 2007, the number of annual approvals per origination staff member increased to four from one, and the volume of annual approvals per originator increased to $25 million from $5 million. As part of this effort, IIC will likely continue to reallocate staff members to its member countries. The proportion of the field staff increased to 24% of overall staff in 2007 from 13% in 2004.

IIC's relationship with the IADB extends well beyond the above-mentioned links. For instance, IIC obtains some administrative and overhead services from the IADB, including the sharing of facilities for its overseas staff. It receives a large committed credit facility from the IADB. It also coordinates with the IADB the development of the private-sector segments of LACMC strategies and programming. In fact, we project more integration, cooperation, and cross-benefit between IIC and the IADB because of the establishment of the Vice Presidency for Private Sector and Non-Sovereign-Guaranteed Operations within the recently realigned IADB. Finally, the IADB's president has, on occasion, intervened with member governments to ensure IIC's preferred-creditor treatment.

Balance Sheet: One Of The Smallest Among Multilateral Development Banks

IIC's financial statements are prepared under U.S. generally accepted accounting principles and audited by the McLean, Va., office of Ernst & Young. Table 1 summarizes IIC's balance sheet. The most notable features of the balance sheet are:

- Its small size despite double-digit growth in the past five years. Total assets equaled $1.2 billion, and shareholders' equity was $735 million at year-end 2007, making IIC the second-smallest of rated MDFIs by assets (behind the newly formed Eurasian Development Bank) and the smallest by shareholders' equity.
- The high growth in its loans, averaging 25% per year in the past five years and 33% per year over the past three years.
- The rapid growth in its paid-in capital, which has averaged 14% per year over the past five years.
- The rapid growth in its still relatively modest liabilities, to $510 million at year-end 2007 from $353 one year earlier.
- Its significant positive turnaround in retained earnings, which totaled $90 million at year-end 2007, from $8 million in 2006 and in contrast to the deficits of the preceding five years.

Table 1

Inter-American Investment Corp.—Balance Sheet

	— As of Dec. 31—				
	2007	2006	2005	2004	2003
(Mil. $)					
Assets					
Cash and cash equivalents	70.0	69.5	49.4	63.5	19.1
Investment securities	340.3	190.8	158.4	46.3	65.8
Loan investments	796.9	619.4	432.3	342.0	306.3
Allowance for loan losses	(39.5)	(39.9)	(47.7)	(45.5)	(45.3)
Equity investments	43.0	67.4	69.0	100.9	112.4
Allowance for losses on equity investments	0	0	0	(30.7)	(41.2)
Mortgage-backed securities	0	0	0	0	0
Receivables and other assets	33.4	32.8	14.7	10.9	9.0
Total assets	1,244.2	939.9	676.0	487.4	426.2
Liabilities					
Accounts payable and other liabilities	10.7	10.7	11.0	8.9	6.7
Borrowings	499.0	342.2	195.7	80.0	80.0
Total liabilities	509.7	353.0	206.7	88.9	86.7
Capital					
Paid-in capital	636.5	568.1	500.9	443.9	388.4
Retained earnings/(accumulated deficit)	90.2	7.8	(31.6)	(45.3)	(48.9)
Accumulated other comprehensive income	7.8	11.0	0	0	0
Total shareholders' equity	734.5	586.9	469.3	398.5	339.5
Memo items					
Maximum amount payable under guarantees	10.6	4.4	0.7	5.2	0
Undisbursed loans and equity investments	82.2	37.7	65.5	81.0	128.5

Lending: Rapid Growth In Development-Related Exposure

Development-related exposure (DRE)—loans, equity investments, and guarantees—represents the large majority of IIC's portfolio. Loans and equity totaled 68% of total assets at year-end 2007. DRE growth was in double digits in each of the past three years and 23% during 2007. The rapid growth in DRE was made possible by the increase in the corporation's capital but also by the improvement in its operational efficiency stemming from revamped lending and approval procedures, new products, and more productive staff utilization. IIC's goal is to increase DRE by 45% from 2008 through 2010. Although loans are set to increase by about 20% in 2008, the rise in repayments in 2009 and 2010 should contain this growth. Going forward, the corporation is looking at new ways of increasing loan volume, such as managing funds from third parties.

IIC borrowers are predominantly domiciled in what have sometimes been difficult economic environments. At year-end 2007, only three of 19 countries where IIC had loans and equity outstanding were rated investment grade by Standard & Poor's. On a positive note, IIC's loans and equity are increasingly to entities domiciled in these countries: 19% at year-end 2007, up from 21% in 2006 and 14% in 2005. These ratios will improve substantially in 2008, following the recent upgrades of both the Federative Republic of Brazil (BBB-/Stable/A-3) and the Republic of Peru (BBB-/Stable/A-3). We raised the foreign currency ratings on these sovereigns to 'BBB-' in April and July 2008, respectively. Loan and equity exposure to Brazil and Peru amounted to 21% and 17% of IIC total loan and equity investment, respectively, at year-end 2007.

Compounding the effects of the difficult economic environments in which most of IIC's private-sector clients operate is its mandate to give preferential support to SMEs. At the same time, IIC balances this operational goal with the financial goal established by its shareholders. To achieve this challenging equilibrium, the organization introduced a new strategic framework, the "portfolio approach," for its 2008-through-2010 business plan. Specifically, the portfolio approach looks at IIC's operations in a broader, portfolio perspective, assessing each project based on its development impact and financial contribution. All projects are to be assessed on their development effectiveness and contribution, to target a universe of projects, both large and small. Large ones would typically provide more of a financial contribution, improving IIC's credit risk profile, and smaller, riskier ones would be high in development contribution, compensating for the higher expense per dollar invested. To help with this task, the corporation deployed in 2008 the development additionality and scoring system as a new tool to measure development effectiveness. On the operational side, IIC has relaxed some of the strictures under which the corporation formerly operated. It now permits lending to larger companies, increasing lending through financial institutions (operating in effect as a second-floor bank), and providing shorter term lending in challenging markets.

IIC puts its focus on SMEs by using three criteria to measure size: assets, sales, and employees. Enterprises are classified in the smallest category for which two of the size criteria are satisfied. IIC's size standards are shown in table 2.

Table 2

Inter-American Investment Corp.—Client Size Criteria

Enterprise	*Assets (Mil. $)*	*Annual Sales (Mil. $)*	*Employees*
Small	Less than 10	Less than 10	Fewer than 250
Medium	10-35	10-35	250-750
Large	More than 35	More than 35	More than 750

In addition to targeting private-sector enterprises, IIC's agreement provides that "enterprises with partial share participation by government or other public entities, whose activities strengthen the private sector of the economy, are eligible for financing by the Corporation."

Lending by industry

IIC has wide scope for its financing, consistent with its focus on SMEs. Table 3 shows IIC's lending by industrial sector. IIC's lending at year-end 2007 was directed mainly to the financial services sector, at 75%, up from 72% in 2006 and a significant increase from 44% in 2004, reflecting the corporation's increasing practice of providing financing to smaller borrowers through local financial institutions. This enables IIC to more efficiently reach its smallest borrowers. It also enhances the quality of its loan portfolio because IIC takes on the credit risk of the financial institution under this arrangement.

Table 3

Inter-American Investment Corp.—Loans By Sector

	— As of Dec. 31—				
	2007	2006	2005	2004	2003
(% of total)					
Financial services	75.2	71.6	56.7	44.1	42.8
Agriculture and agribusiness	6.7	7.7	11.0	9.8	11.1
Aquaculture and fisheries	2.0	3.5	4.7	6.9	6.7
Utilities and infrastructure	3.1	2.9	4.0	4.8	6.5
Education	1.3	2.0	3.2	4.5	3.4
Chemicals and plastics	1.4	3.1	2.9	1.8	2.8
Wood, pulp, and paper	1.0	1.8	2.9	4.3	3.8
Livestock and poultry	0.9	1.4	2.6	2.3	0
General manufacturing	1.5	0.8	2.4	4.5	4.0
Food, bottling, and beverages	2.3	1.2	2.2	3.0	2.2
Industrial processing zones	0.6	1.0	1.8	2.7	2.0
Tourism and hotels	0.4	0.9	1.7	2.6	4.1
Textiles, apparel, and leather	2.7	0.5	1.0	1.8	1.0
Transportation and warehousing	0.5	0.7	0.9	4.1	4.9
Other	0.3	0.8	1.9	2.8	4.8
Total	100.0	100.0	100.0	100.0	100.0

Loan pricing

IIC's loan pricing is generally 100 basis points (bps) to 600 bps above the one-, three-, or six-month LIBOR. Spreads are based on the cost of recent syndicated loans to the borrower's country of domicile (or to a similarly rated country if no loan in that country has been made recently), plus an additional spread to compensate for the individual borrower's risk and the illiquidity of the loan.

Loan maturities

Historically, IIC has concentrated on medium- and long-term lending, with maturities typically of five to eight years, to a maximum of 15 years. In 2003, IIC began making short-term loans with tenors of one to two years, for working capital and export finance purposes. Such loans meet a pressing need for many of IIC's SME clients and tend to improve the quality of its loan portfolio. Still small in size, these short-term loans did not significantly affect the maturity composition of IIC's portfolio. At year-end 2007, 12% of IIC's outstanding loans had final maturities of more than five years, the same as in 2006, but these had increased from 6.5% in 2005. And 15% had final maturities of one year or less, up from 14% in 2006 but a decrease from 21% in 2005.

Equity investments

Table 4 shows IIC's equity investments by industrial sector. IIC's founders were hopeful that equity investments would constitute a major portion of the corporation's assets—in the form of either direct investments or holdings in equity funds targeted at LACMCs. In practice, IIC's equity investments have been smaller than expected and in recent years have fallen, not only relative to loans but also in absolute terms. Gross equity investments were 3.5% of total assets at year-end 2007, half their 2006 level and down from almost 30% at year-end 2002. IIC has moved away from direct investments and has increasingly focused its limited equity investments on funds of one type or another. As shown in table 4, investment funds were 71% of equity investments and regional equity funds were 66% at year-end 2007. IIC's business plan from 2008 through 2010 envisions an increase in equity investments, an area of high development value, through the use of financial instruments. IIC initially projected the net increase in equity investments at about $60 million to $75 million from 2008 through 2010. It will likely be smaller, judging by the activity in the first half of 2008.

Table 4

Inter-American Investment Corp.—Equity Investments By Sector

	— As of Dec. 31—				
	2007	2006	2005	2004	2003
(% of total)					
Investment funds	71.1	67.7	71.2	75.2	77.1
Financial services	28.9	32.3	28.8	22.8	20.7
Agriculture and agribusiness	0	0	0	2.0	1.8
Acquaculture and fisheries	0	0	0	0	0.4
Food, bottling, and beverages	0	0	0	0	0
Manufacturing	0	0	0	0	0
Mining and oil	0	0	0	0	0
Livestock and poultry	0	0	0	0	0
Total	100.0	100.0	100.0	100.0	100.0
Memo items					
Regional equity funds	66.1	61.7	62.1	59.7	64.9

Total loan and equity limits

IIC does not have specific limits on its total loans. However, the sum of disbursed and committed but undisbursed loans and guarantees, equity investments, and LACMC mortgaged-backed securities is limited to 400% of IIC's shareholders' equity. At year-end 2007, this was 127%, up from 124% in 2006. This implies that, in principle, the corporation has huge leeway to increase its DRE plus committed but undisbursed exposure.

The corporation's current sublimit for equity and quasi-equity investments as a percentage of shareholders' equity is 40%. Disbursed equity and quasi-equity investments totaled $43 million at year-end 2007 against shareholders' equity of more than $735 million, implying ample room for more equity investments.

Investment concentration

IIC has policies limiting concentration in its loan and equity investment portfolios:

- Country concentration: the higher of either 15% of the net active approved portfolio of loans and equity ($180 million at year-end 2007) or 15% of equity ($110 million). IIC's largest country exposure at year-end 2007 was $145.7 million in Colombia, representing 20% of shareholders' equity, followed by $144.8 million in Brazil. The country exposure has changed significantly in the past five years, as seen in table 5. For example, IIC's exposure in Argentina was 15% of the total, the largest of its country exposures. That diminished to less than 5% in 2007. The relatively small size of IIC's loan portfolio means that the country composition of loans can change quite quickly. Further diversification of its loan portfolio is one of the corporation's core objectives.

- Sector concentration: the greater of 10% of the total net active approved portfolio or 10% of shareholders' equity (except for financial institutions, for which the limit is 75% as of January 2008).
- Company concentration. IIC's financing of any one project is subject to two different types of constraints. First, IIC will generally finance no more than 33% of any single project's investment cost for new enterprises. Second, its total financing per company can be no more than the higher of 5% of its total portfolio or 5% of equity.
- Equity investment concentration. IIC's share of the total paid-in capital in any company is limited to 33%. The sum of equity and quasi-equity investments in any company is limited to 2%, and total exposure is limited to 5% of IIC's equity.

Table 5

Inter-American Investment Corp.—Loan And Equity Concentration

	—As of Dec. 31—									
	2007		2006		2005		2004		2003	
	Mil. $	% Of Total	Mil. $	% Of Total	Mil. $	% Of Total	Mil. $	% Of Total	Mil. $	% Of Total
By country										
Regional*	62	9.0	78	11.3	74	14.4	83	18.7	81	19.3
Colombia	146	21.2	121	17.7	92	18.0	19	4.4	23	5.6
Brazil	145	21.1	110	16.1	85	16.7	64	14.4	38	9.2
Chile	95	13.8	78	11.4	44	8.6	44	9.9	47	11.1
Mexico	62	9.1	69	10.0	29	5.7	34	7.7	35	8.5
Argentina	32	4.7	14	2.0	21	4.0	27	6.2	36	8.7
Peru	116	16.9	68	10.0	20	4.0	27	6.1	24	5.7
Uruguay	15	2.2	15	2.2	20	4.0	14	3.1	7	1.6
Costa Rica	32	4.7	16	2.3	18	3.5	21	4.8	17	4.2
Nicaragua	35	5.0	14	2.1	17	3.4	10	2.3	15	3.5
Honduras	11	1.7	10	1.5	12	2.4	16	3.5	12	2.9
Venezuela	0	0	6	0.9	12	2.3	15	3.3	16	3.9
El Salvador	21	3.1	24	3.5	11	2.1	10	2.2	1	0.3
Bolivia	3	0.4	4	0.6	9	1.8	9	1.9	6	1.4
Panama	2	0.3	3	0.5	7	1.3	17	3.9	20	4.7
Paraguay	12	1.8	11	1.5	5	1.0	5	1.1	6	1.4
Jamaica	1	0.2	2	0.3	3	0.5	3	0.8	0	0
Trinidad & Tobago	1	0.1	1	0.1	1	0.1	2	0.4	2	0.6
Guyana	0	0	0	0	0	0	0	0	0	0
Guatemala	0	0	0	0	0	0	4	1.0	7	1.6
Belize	2	0.2	0	0	0	0	1	0.2	1	0.2
Dominican Republic	5	0.7	5	0.7	0	0	0	0	7	1.6
Bahamas	0	0	0	0	0	0	0	0	0	0
Ecuador	39	5.7	37	5.4	25	5.0	18	4.1	17	4.1

Table 5

Inter-American Investment Corp.—Loan And Equity Concentration (cont.'d)

	—As of Dec. 31—									
	2007		2006		2005		2004		2003	
	Mil. $	% Of Total	Mil. $	% Of Total	Mil. $	% Of Total	Mil. $	% Of Total	Mil. $	% Of Total
Suriname	4	0	0	0	0	0	0	0	0	0
Balance sheet total	840	100.0	687	100.0	511	100.0	443	100.0	419	100.0
Country exposure concentration										
Two largest exposures	291	34.6	232	33.7	177	34.7	108	24.3	85	20.3
Three largest exposures	407	48.4	310	45.1	221	43.3	142	32.0	121	28.9
Four largest exposures	501	59.7	378	55.1	250	49.0	169	38.2	157	37.4
Five largest exposures	564	67.1	447	65.0	276	54.0	196	44.3	180	43.1

*Lending to projects that extend beyond one country.

Except for its exposure to financial institutions, IIC has operated well within its guidelines in recent years.

Risk: Significant Improvement In Portfolio Credit Quality Since 2003

Development-related exposure risk and asset quality

IIC's policies call for it to classify a loan as nonaccrual when payments are 90 days past due; in practice, however, the classification is often earlier. Disbursements of loans will ordinarily be suspended when payments of principal, interest, or fees are past due.

All of IIC's loans are to private- or quasi-public-sector entities, none carry sovereign guarantees, and recipients of these loans have been predominantly SMEs—most of which operate in what have sometimes been difficult economic environments. These factors result in embedded credit risk in IIC's loan portfolio that is much higher than that found in other MDFIs.

Moreover, from 2001 through 2003, the economic conditions under which many of IIC's clients were operating deteriorated sharply, although conditions have since improved. Table 6 documents this in the index of country economic conditions. This index is calculated by determining the percentage of IIC's loans and equity investments in each member country, grouping these percentages by the ratings on the countries, and applying a default rate to each of these percentages. The resulting weighted average default rate is the index. The higher the index number, the more stressful economic conditions are. The number increased to 13.2 at year-end 2001 from 8.6 at year-end 2000, chiefly as the result of Argentina's slide into default. The index has been improving since then, reflecting the improving creditworthiness of many of IIC's borrowers' members. The index stood at 10.1 in 2004 and fell to 8.4 in 2005, 6.1 in 2006, and 5.5 in 2007.

Table 6

Inter-American Investment Corp.—Loan Portfolio Quality Indicators And Provisions

	—Year ended Dec. 31—				
	2007	2006	2005	2004	2003
Index of country economic conditions*	5.5	6.1	8.4	10.1	12.6
Portfolio					

Table 6

Inter-American Investment Corp.—Loan Portfolio Quality Indicators And Provisions (cont.'d)

	—Year ended Dec. 31—				
	2007	**2006**	**2005**	**2004**	**2003**
Impaired loans (Mil. $)	1.0	9.3	32.8	32.5	43.5
Impaired loans/outstanding loans (%)	0.1	1.5	7.6	9.5	14.2
Nonaccrual loans (Mil. $)	13.9	28.7	51.1	64.3	51.8
Nonaccural loans/outstanding loans (%)	1.7	4.6	11.8	18.8	16.9
Interest collection rate (%)	97.3	96.2	89.9	91.9	81.8
Loan write-offs (Mil. $)	5.5	8.8	3.7	N.M.	2.6
Loan write-offs/outstanding loans at previous year-end (%)	0.9	2.0	1.1	0.1	1.0
Recoveries of loans previously written off (Mil. $)	2.0	2.7	2.5	6.5	7.1
Provision (release of provision) for loan losses (Mil. $)	3.1	(1.6)	3.5	(6.0)	(4.9)
Allowance for loan losses (Mil. $)	39.5	39.9	47.7	45.5	45.3
Allowance for loan losses/impaired loans (%)	3,948.1	427.5	145.5	139.7	104.1
Allowance for loan losses/nonaccrual loans (%)	283.2	139.1	93.5	70.7	87.3
Allowance for loan losses/outstanding loans (%)	5.0	6.4	11.0	13.3	14.8
Equity investments written off (Mil. $)	0	0	0	19.9	4.6
Equity investment write-offs/outstanding equity investments at previous year-end (%)	0	0	0	17.7	4.0
Provision for losses on equity investments (Mil. $)	0	0	0	9.3	4.4
Allowance for losses on equity investments (Mil. $)	0	0	0	30.7	41.2
Allowance for losses on equity investments/outstanding equity investments (%)	0	0	0	30.4	36.6
Memo items (Mil. $)					
Outstanding loans¶	796.9	619.4	432.3	342.0	306.3
Outstanding equity investments	43.0	67.4	69.0	100.9	112.4
Allowance for losses on loans and equity investments	39.5	39.9	47.7	76.1	86.4

*Increase denotes less favorable conditions. N.M.—Not meaningful (less than $500,000).

From 2000 to 2002, IIC's impaired and nonaccrual loans increased sharply, interest collection rates fell to less than 80%, and loan write-offs as a portion of loans outstanding at the previous year-end reached 5.5%. Improvements began during 2003, positively affecting all metrics of portfolio performance during the past five years. As a consequence, impaired loans decreased to 0.1% of outstanding loans in 2007 from 1.5% in 2006, and 17% in 2002. The allowances for loan losses relative to impaired and nonaccrual loans at year-end 2007 were the highest they had been in recent years, standing at almost 4,000% and 283%, respectively. Earlier in its existence, IIC did not always provision its loans adequately and on an ongoing basis; this resulted in volatile provisioning and net income. However, its current management revamped its procedures for determining appropriate loan loss provisions, and Standard & Poor's expects these to continue to be more stable in the future.

Historically, IIC maintained a large allowance for losses on equity investments, which varied from 27% to 61% during the five years ended 2005. However, in 2006, IIC's accounting for equity investments changed. Direct equity investments and certain other equity investments where the corporation does not have significant influence are now carried at cost less impairment, and the corporation's investments in companies in which it has significant influence are accounted for under the fair-value method. Accordingly, IIC no longer carries reserves for losses on its equity investments.

The corporation has taken various measures to strengthen its credit policies and procedures over the past few years:

- A reduction in the country exposure limit to 15% from the former 20%;
- A revised risk-rating system, which affects loan pricing and drives the determination of appropriate provisions;
- An increase in the percentage of the loan portfolio that may be lent to financial institutions—relatively low risk for IIC—to 75% from 30%;
- The ability to lend larger amounts to individual financial institutions, which will strengthen IIC's relationship with larger LACMC financial institutions;
- The authority to make short-term loans for working capital and export finance; and
- The ability to lend more than originally contemplated to larger, less risky borrowers.

IIC has also tightened its organizational structure by separating loan origination from loan supervision, fostering both specialization and expertise while aligning responsibility. Also, it has been successful in more aggressively seeking to realize value from its problem loans, including those it has written off. In anticipation of further loan growth, IIC will be adding more people to its portfolio supervision department.

The cumulative effect of these changes in policies, procedures, and organization, combined with improving economic conditions in its countries of exposure, has discernibly improved the quality of IIC's loan portfolio. However, as long the main recipients of its loans continue to be SMEs, portfolio quality will continue to be a fundamental concern, especially when economic conditions in countries of operation deteriorate.

Treasury-related risk

Overall, the risk arising from IIC's treasury activities is very limited, particularly compared with the corporation's risk-bearing capacity.

IIC's policies require it to place its cash and deposits with highly rated banks. Its marketable securities are sovereign, agency, bank, or corporate obligations rated 'AA' or better and asset-backed securities rated 'AAA'. IIC did not have any investment in asset- or mortgage-backed securities as of year-end 2007 and had invested only 4% of its trading portfolio in asset-backed securities at the end of 2006.

The corporation's loans traditionally were all floating rate. However, fixed-rate loans recently became more prominent, growing to 27.5% of total loans at year-end 2007 from less than 18% two years earlier. Similarly, borrowings have traditionally been floating rate, minimizing the risk from interest rate mismatches on the portion of the loan portfolio funded by borrowings. However, to date, IIC has funded most of its loans and other assets with capital. Accordingly, income from loans has reflected changes in interest rates, declining when rates fall and increasing when they rise. IIC's fixed-rate loans and the fixed-rate, hold-to-maturity treasury portfolio the corporation is creating will weaken this link.

All of IIC's capital and borrowings, and virtually all of its loans and other financial assets, traditionally have been denominated in U.S. dollars. In December 2005, the corporation started to provide local-currency financing (financed by local-currency bonds, the proceeds of which are immediately disbursed in the same currency). By year-end 2007, it had established 11 local-currency operations in six countries, for a total of $141 million. Overall, the risk of loss arising directly from exchange rate changes is minimal.

Capital, Risk-Bearing Capacity, And Capital Adequacy: Capitalization Is Strong But Needs To Be Preserved

IIC's narrow-risk-bearing capacity consists of its allowances for losses and its shareholders' equity. Since it has no callable capital, its broad-risk-bearing capital is the same as its narrow-risk-bearing capital. As shown in table 7, IIC's shareholders' equity at year-end 2007 was $735 million, having increased from $587 million, more than 25%, from one year earlier and representing a fifth consecutive year of double-digit growth. This increase resulted from three very different factors: additional installments of paid-in capital of $68 million; net income of $83 million; and small adjustments and losses totaling $4.3 million.

Table 7

Inter-American Investment Corp.—Capital And Capital Adequacy

	—Year ended Dec. 31—				
	2007	**2006**	**2005**	**2004**	**2003**
(Mil. $)					
Authorized capital	703.7	703.7	703.7	703.7	703.7
Subscribed capital	703.7	703.7	700.7	696.3	696.3
Subscriptions receivable	(67.2)	(135.6)	(199.8)	(252.5)	(307.9)
Paid-in capital	636.5	568.1	500.9	443.9	388.4
Retained earnings/(accumulated deficit)	90.2	7.8	(31.6)	(45.3)	(48.9)
Accumulated other comprehensive income	7.8	11.0	0	0	0
Total shareholders' equity	734.5	586.9	469.3	398.5	339.5
Allowance for loan losses and guarantees	39.6	40.0	47.7	45.5	45.3
Allowance for equity losses	0	0	0	30.7	41.2
Narrow risk-bearing capacity*	774.1	626.9	517.0	474.7	426.0
Total assets	1,244.2	939.9	676.0	487.4	426.2
Total development-related exposure	850.6	691.2	502.0	448.2	418.7
Ratios (%)					
Shareholders' equity/total assets	59.0	62.4	69.4	81.8	79.7
Narrow risk-bearing capacity/total assets	62.2	66.7	76.5	97.4	99.9
Narrow risk-bearing capacity/total development-related exposure	91.0	90.7	103.0	105.9	101.7
Memo items (Mil. $)					
Gross loans¶	796.9	619.4	432.3	342.0	306.3
Gross equity investments	43.0	67.4	69.0	100.9	112.4
Maximum amount of payments under guarantees	10.6	4.4	0.7	5.2	0
Total development-related exposure	850.6	691.2	502.0	448.2	418.7

*Total shareholders' equity plus allowances for loan and equity losses.¶Includes mortgage-backed securities in 2003.

Pursuant to the December 1999 agreement that authorized a $500 million increase in IIC's capital, subscriptions were payable beginning in 2000 and ending in October 2007. All of the nearly $704 million of total authorized capital was subscribed at year-end 2007. As often happens with capital increases for MDFIs, some members' payments for IIC's 1999 capital increase were delayed. As of July 2008, two members—Argentina and the U.S.—had not paid their scheduled contributions in full. The shortfalls amounted to $51.6 million, of which $5.5 million was due from Argentina (down from $20.4 million in December 2007) and $46.1 million from the U.S. (the same as in December 2007). The contribution delays reflect country-specific issues, and both countries have underscored their obligation to clear the arrears, reconfirming their strong commitment to IIC's important mission. In recognition of the country-specific financial circumstances, IIC extended the deadline for paying all authorized shares until Dec. 31, 2010, subject to a two-year extension if partial payments are received. Argentina plans to meet its contribution commitments by April 2009. At the same time, a number of countries have expressed interest in acquiring as-yet-unpaid authorized shares. Therefore, IIC's management expects to receive all of the subscribed capital in the near term, one way or another.

As table 7 also shows, IIC has historically maintained a strong capital position despite its poor profitability, and this capital position has been improving in recent years because of both a capital increase and improving net income. IIC's ratio of shareholders' equity to assets at year-end increased steadily to 82% in 2004 from 58% in 2000 before declining to 59% in 2007. More importantly, its ratio of narrow-risk-bearing capacity to DRE has exhibited a similar pattern, increasing to almost 106% at year-end 2004 from less than 69% at year-end 2000, before declining to 91% at year-end 2007. This ratio continues to be one of the highest among MDFIs. Preservation of the high capitalization is crucial for a small institution such as IIC, and the corporation cautiously monitors its gearing ratios.

Net Income: Steady Improvement Since 2002

Like other MDFIs, IIC was never intended to be a profit-maximizing institution. Indeed, in light of the difficulty of its mandate, some shareholders believed at the time of its establishment that the corporation should seek simply to break even. However, that sentiment was not reflected in IIC's agreement.

As is true of other MDFIs, the drivers of IIC's net income are interest rates (because equity continues to fund most of IIC's interest-bearing assets), the spread between interest earned on its interest-bearing assets and its cost of borrowing (for those assets funded with borrowings), the income from its equity investments, its provisions for losses on its loan portfolio, and noninterest expenses (principally administrative).

IIC's net income historically has been volatile, and the corporation suffered large losses in 1999, 2001, and 2002 because of large provisions for losses on its loans and equity investments. Current management has been more willing to provision problem assets in a timely manner, which reduces loan losses as a source of volatility in net income.

IIC's profitability, both in absolute and relative terms, such as return on average assets plus guarantees (ROAG) and average shareholders' equity (return on equity, ROE), have steadily improved over the past five years (see table 8). Its 2007 operating income of $84 million represented a 7.6% ROAG and a 12.6% ROE, up from 4.9% and 7.5%, respectively, one year earlier. These are very high returns for an MDFI. It is also significantly more than the 3% targeted ROE set by shareholders following the 1999 capital increase.

Table 8

Inter-American Investment Corp.—Net Income

	—Year ended Dec. 31—				
	2007	*2006*	*2005*	*2004*	*2003*
(Mil. $)					
Income from investment securities	12.4	10.0	5.3	1.1	1.3
Income from loan investments, of which:	57.2	41.7	24.1	18.6	13.4
Interest income from loans	55.0	39.9	22.3	17.1	11.9
Other loan-related income	2.2	1.8	1.8	1.5	1.6
Income from commitment fees	0.2	0.2	0.4	0.3	0.3
Income from front-end fees	1.5	1.3	1.0	0.8	0.7
Other loan-related income	0.5	0.4	0.4	0.4	0.5
Release of provisions for (provisions for) loan and guarantee losses	(3.2)	1.6	(3.5)	6.0	4.9
Total loan income	54.0	43.3	20.6	24.6	18.3
Income from mortgage-backed securities	0	0	0	0	(0.3)
Income from equity investments, of which:	56.0	15.8	5.8	4.2	2.6
Gain from sale of equity investments	48.7	8.2	0.4	1.6	0.9
Change in the carrying value of equity investments	5.2	5.6	3.4	0	0
Dividends, distributions, and other equity investment income	2.2	2.1	2.0	2.7	1.7
Dividends and distributions	2.0	1.4	1.9	1.7	1.7
Other equity investment income	0.1	0.6	0.2	1.0	0
Provision for losses on equity investments	0.0	0	0	(9.3)	(4.4)
Advisory service, cofinancing, and other income	6.1	4.4	4.3	2.5	3.0
TOTAL INCOME	131.8	71.9	39.6	26.4	20.0
Borrowing and long-term debt expense	(23.5)	(14.2)	(5.2)	(2.9)	(2.9)
Operating expenses, of which:	(21.6)	(19.7)	(18.8)	(16.7)	(15.5)
Administrative expenses	(22.3)	(19.1)	(18.7)	(16.7)	(15.5)
TOTAL EXPENSES	(45.1)	(34.0)	(24.0)	(19.6)	(18.4)
NET INCOME BEFORE PROVISIONS	86.7	37.9	15.6	6.8	1.7
NET INCOME AFTER PROVISIONS	83.5	39.5	12.1	3.5	2.2
OPERATING INCOME	83.5	39.5	12.1	3.5	2.2
(Loss)/gain on nontrading derivatives instruments	0	(0.1)	1.7	0	0
NET INCOME	83.5	39.4	13.7	3.5	2.2
Memo items (%)					
Operating return on average assets and guarantees	7.6	4.9	2.1	0.8	0.5
Operating return on average shareholders' equity	12.6	7.5	2.8	1.0	0.7

All parts of IIC's operations contributed to this extraordinary performance:

- Interest income from loans increased to $55 million from $40 million one year earlier, the consequence of sharply higher loans outstanding;
- Interest income from investment securities increased to $12 million from $10 million, a very positive result compared with many of IIC's peers', whose investment income shrunk because of losses

associated with asset- and mortgage-backed securities (IIC had a very small exposure to these in 2006 and closed out its positions completely during 2007); and

- Income from IIC's equity investments ballooned to $56 million from $16 million one year earlier, principally as the result of a realized gain of $49 million on the sale of equity investments.

The outlook for IIC's profitability during 2008 is more conservative amid a more turbulent global environment and after the one-off gain on the sale of an equity investment it realized in 2007. This gain is unlikely to be repeated in 2008. Cognizant of the deteriorating credit environment, IIC has been proactively increasing its loan prices in the past six months, preparing to assume higher interest costs in the near future.

Borrowings And Liquidity: Liquidity Among The Strongest Of Rated MDFIs

IIC's extremely strong capital position of recent years has resulted in little need to borrow. Nevertheless, in anticipation of uncertain credit conditions, IIC increased its borrowing in 2007 and the corporation's debt stood at $499 million at year-end from $342 million a year earlier.

As a result of this prefinancing, IIC's cash and marketable securities amounted to $410 million in 2007, a 58% increase from the 2006 level and representing nearly 33% of total assets. The cost of keeping so much liquidity in times of declining interest rates is high, but that's a justifiable compromise for a small and cycle-dependent entity such as IIC. In 2008 and beyond, however, the absence of significant increases in paid-in capital implies that continued rapid growth in IIC's DRE portfolio will require more borrowing and erode, at least somewhat, IIC's historically strong liquidity position.

IIC's policies require liquidity to cover 100% of undisbursed commitments. Further, cash and marketable securities must cover at least 30% of these requirements. At year-end 2007, IIC's undisbursed commitments were $82 million.

For the purpose of calculating its liquidity, IIC includes the undrawn balances under committed credit facilities from financial institutions rated 'AA' or higher. Not all of them are 'AA' institutions, but at year-end 2007, IIC had in place credit facilities from 11 different commercial financial institutions, up from seven in 2006. These facilities totaled $610 million, up from $475 million, of which $380 million was drawn; $530 million of the facilities had expiration dates after June 2010. In the first half of 2008, IIC increased the size of the credit facilities with some of the banks.

In addition to these facilities, however, IIC has a $300 million facility from the IADB. This expires in November 2010 and was completely undrawn at year-end 2007. Including this facility, IIC's liquidity position is among the strongest of rated MDFIs.

Comparative Data: See Supranationals Report For 2007

Comparative data for IIC and 15 other multilateral lending institutions can be found in Standard & Poor's "SUPRANATIONALS Special Edition 2007," available as a PDF file on www.standardandpoors.com. Click on United States (under Americas, if not already on the United States page as indicated at top), then Ratings, and Sovereigns, and find the title listed at the bottom of the page. Comparative data as of year-end 2006 for 14 multilateral lending institutions and as of the end of June 2007 for two others (the International Bank for Reconstruction and Development and the International Finance Corporation) are shown on pages 56 through 60 of the report. We will update this information in the 2008 edition, available in October 2008.

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