

RESEARCH

Inter-American Investment Corporation

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Major Rating Factors

Strengths:

- A strong capital position (the result of relatively large, ongoing capital contributions from most of its shareholders) and ample liquidity;
- An important policy purpose: to support the growth and development of small and midsize enterprises (SMEs) in Latin American and Caribbean member countries (LACMCs); and
- Membership in and support from the Inter-American Development Bank (IADB; 'AAA' [all institutional ratings herein are long-term issuer credit ratings]) group.

Issuer Credit Rating*Foreign Currency*
AA-/Stable/A-1+**Weaknesses:**

- The most challenging mandate of any rated multilateral development finance institution (MDFI);
- Small size, which has limited the corporation's impact on overall economic growth and development in its LACMCs and, consequently, its franchise value; and
- Failure of some of its members (including its largest) to pay their scheduled capital contributions on time.

Rationale

Inter-American Investment Corp. (IIC) began operations in 1989 with a mandate to finance the establishment, expansion, and modernization of SMEs 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 2006, including all IADB LACMCs.

IIC had shareholders' equity of US\$587 million at year-end 2006, the least of any rated MDFI. Its total assets at year-end 2006 were US\$940 million, of which US\$619 million was loans and US\$67 million was equity investments.

The corporation's difficult mandate contributed to loan and equity portfolios that performed poorly for many years. However, following a management change, its performance improved steadily recent years. This culminated in operating income of US\$39 million in 2006, equal to a 4.9% operating return on average assets plus guarantees and a 7.5% return on average shareholders' equity, both very high for an MDFI.

In December 1999, IIC's members approved an increase in its authorized capital to US\$703.7 million from US\$203.7 million, all of which was subscribed as of year-end 2006. The last installment of capital contributions is due by October 2007, although it appears that some members will not meet this deadline.

Combined with the relatively slow growth of its loans, equity investments, and guarantees (together, its development-related exposure [DRE]), these installments of paid-in capital contributed to an increasingly strong financial profile. Even after the 38% increase in outstanding DRE during 2006, IIC's ratio of provisions for losses plus shareholders' equity (its narrow risk-bearing capacity) to DRE was nearly 91% at year-end, among the highest for rated MDFIs.

IIC had more than US\$260 million in cash and marketable securities at year-end 2006, almost 28% of total assets. It also had an unused credit facility of US\$300 million from IADB and smaller amounts from

commercial financial institutions. With only US\$342 million in outstanding borrowings (the first US\$50 million of which is payable in 2009), IIC has a very strong liquidity position.

The corporation's mandate has been challenging for IIC's management. However, in recent years its shareholders have relaxed some of the strictures under which it formerly operated, and management has changed some of its policies and practices. This has resulted in markedly better-performing loan and equity portfolios. Nonetheless, in the absence of additional capital after the final installments of the 1999 capital increase are received, and despite the improvement in its financial performance and its impact at the microeconomic level, IIC will continue to suffer diseconomies of scale and be frustrated in its efforts to have a significant macroeconomic impact on the development of its LACMCs.

Outlook

The stable outlook balances IIC's difficult mandate; the prospect of the end of members' capital contributions in 2007; its lack of timely support from some member countries; the prospect that it will continue to have a small aggregate developmental impact; and its expected increasing gearing against its current strong capital and liquidity positions and improved financial performance.

Membership And Voting Power

IIC came into formal existence in 1986 and had 34 member countries at year-end 1988. All 26 of IADB's LACMCs were members by year-end 1999, and only four of its 21 nonregional members had not joined by year-end 2006: Canada ('AAA'; all country ratings are long-term foreign currency sovereign ratings as of June 14, 2007), the U.K. ('AAA'), and the Republics of Croatia ('BBB') and Slovenia ('AA').

LACMCs had subscribed to 52.5% of total subscribed shares as of year-end 2006; the U.S. ('AAA'), 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 those of two-thirds of the governors, is necessary to authorize a major capital increase, and 80% is required to amend the agreement, also including those of two-thirds of the governors.

Governance And Organization

Under the agreement establishing IIC, each country appoints a governor to IIC's board of governors. These are typically the governors of IADB. The chairman of the board of governors of 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 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; nine executive directors are elected by governors of the LACMCs; and three executive directors are elected by governors of the nonregional member countries.

IADB's president is ex-officio chairman of the board of executive directors. A general manager is appointed by the board of executive directors to serve as chief executive officer. The current general manager, Mr. 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 2006, IIC had a headcount of 98. Of these positions, 76 were based in Washington, D.C., (53 professionals, 11 administrative, and 12 consultants) and 22 (19 professionals and three administrative) were based in Santiago, Republic of Chile ('A'); Bogotá, Republic of Colombia ('BB+'); San Jose, Republic of Costa Rica ('BB'); Asuncion, Republic of Paraguay ('B'); Montevideo, Republic of Uruguay ('B+'); Tegucigalpa, Republic of Honduras (not rated); and Managua, Republic of Nicaragua (not rated). Of the Washington, D.C., based professional positions, 16 are dedicated to originating and developing new projects and four to portfolio supervision.

Only modest additional increases in staffing are expected during the next several years because management intends to leverage its staff more effectively than in the past. As part of this effort, staff members will likely continue to be reallocated to IIC's regional member countries. Moreover, more of its lending activities will be conducted through local financial institutions.

IIC's relationship with IADB extends well beyond the previously mentioned links. For instance, IIC obtains some administrative and overhead services from IADB, including the sharing of facilities for its overseas staff. It also coordinates with IADB in the development of the private sector segments of LACMC strategies

and programming, and receives a large committed credit facility from IADB. Finally, IADB's president has, on occasion, intervened with member governments to ensure IIC's preferred creditor treatment.

Balance Sheet

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

- Its small size, despite the rapid growth of 2006. Total assets equaled US\$940 million and shareholders' equity US\$587 million at year-end 2006, making it the second-smallest of rated MDFIs by assets (behind the newly formed Eurasian Development Bank) and the smallest by shareholders' equity;
- The acceleration in the growth of its loans during 2006 to 43%, continuing the pickup of the previous year;
- The rapid growth in its paid-in capital, which averaged 16.8% per year over the preceding five years;
- The rapid growth in its still relatively modest liabilities, to US\$353 million at year-end 2006 from US\$207 one year earlier;
- Its retained earnings of US\$8 million at year-end 2006 and the elimination of the accumulated deficit, which was as high as US\$51 million at year-end 2002; and
- Accumulated other comprehensive income of US\$11 million, the result of the 2006 adoption of the FASB's Statement of Accounting Standards 158 (which requires that IIC's overfunding of its postretirement benefits be included in comprehensive income).

Table 1
IIC Balance Sheet

(Mil. US\$)	-- As of Dec. 31--				
	2006	2005	2004	2003	2002
Assets					
Cash and cash equivalents	69	49	64	19	20
Investment securities	191	158	46	66	58
Loan investments	619	432	342	306	269
Allowance for loan losses	(40)	(48)	(45)	(45)	(46)
Equity investments	67	69	101	112	114
Allowance for losses on equity investments	0	0	(31)	(41)	(41)
Mortgage-backed securities	0	0	0	0	5
Receivables and other assets	33	15	11	9	7
Total assets	940	676	487	426	385
Liabilities					
Accounts payable and other liabilities	11	11	9	7	18
Borrowings	342	196	80	80	85
Total liabilities	353	207	89	87	103
Capital					
Paid-in capital	568	501	444	388	333
Retained earnings/(accumulated deficit)	8	(32)	(45)	(49)	(51)
Accumulated other comprehensive income	11	0	0	0	0
Total shareholders' equity	587	469	399	340	282
Memo items:					
Maximum amount payable under guarantees	4	1	5	0	0
Undisbursed loans and equity investments	38	66	81	129	130

Risk

For risk-assessment purposes, IIC's activities may be broken into treasury activities (which result in holdings of cash and investments as well as borrowings) and development-related activities (which result in loans, equity investments, and the issuance of guarantees).

Treasury activities

Like most other MDFIs, IIC does not view its treasury activities as a major source of income for the corporation. Rather, they are intended to fund a portion of the corporation's assets and ensure adequate liquidity in a conservative yet cost-effective manner.

Treasury credit risk. 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'.

Interest-rate risk. The corporation's loans traditionally were all floating rate. However, fixed-rate loans recently became more prominent, accounting for more than 24% of total loans at year-end 2006, up from less than 18% one year 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, most of IIC's loans (and other assets) have been funded by its capital. Accordingly, income from loans reflects changes in the level of interest rates, declining when rates fall and increasing when they rise. IIC's fixed-rate loans and a fixed-rate, hold-to-maturity treasury portfolio the corporation is creating will weaken this link.

Exchange-rate risk. All of IIC's capital and borrowings, as well as virtually all of its loans and other financial assets, traditionally have been denominated in U.S. dollars. In December 2005, the corporation issued approximately US\$66 million in Colombian peso bonds; however, the proceeds were immediately disbursed in pesos to provide financing for SMEs in Colombia. Accordingly, the risk of loss arising directly from exchange-rate changes is minimal.

In sum, the risk arising from IIC's treasury activities is very limited, particularly relative to the corporation's risk-bearing capacity.

Development-related activities

IIC borrowers are predominantly domiciled in what have sometimes been difficult economic environments. At year-end 2006, only three of 18 countries where IIC had loans outstanding were rated investment grade by Standard & Poor's Ratings Services. However, IIC's loans are increasingly to entities domiciled in these countries: almost 20% at year-end 2006, up from 11% one year earlier

Compounding the effects of the difficult economic environments in which most of IIC's private sector clients sometimes operate is its mandate to give preferential support to SMEs. IIC's focus on SMEs is operationalized through the use of 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

IIC Client Size Criteria

Enterprise	Assets (Mil. US\$)	Sales (Mil. US\$)	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

IIC's board of executive directors has recognized the difficulty in lending only to SMEs, and in 2003 it authorized a two-year program under which the corporation could submit up to 33% of cumulative project approvals for larger companies (those with annual sales or assets of up to US\$150 million). A three-year extension of the program (until 2007) was approved in June 2004.

In addition to targeting private sector enterprises, IIC's agreement also 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. That more than 71% of IIC's lending at year-end 2006 was to the financial services sector reflects its increasing practice of providing financing to smaller borrowers through local financial institutions. This enables IIC to more efficiently reach its smallest borrowers and enhance the quality of its loan portfolio, since IIC takes the credit risk of the financial institution under this arrangement.

Table 3**IIC Loans By Sector**

-- As of Dec. 31--

	2006		2005		2004		2003		2002	
	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total
Financial services	443	71.6	245	56.7	151	44.1	131	42.8	111	41.4
Agriculture and agribusiness	48	7.7	47	11.0	33	9.8	34	11.1	19	7.2
Aquaculture and fisheries	22	3.5	20	4.7	24	6.9	20	6.7	20	7.5
Chemicals and plastics	19	3.1	13	2.9	6	1.8	8	2.8	13	4.9
Utilities and infrastructure	18	2.9	17	4.0	17	4.8	20	6.5	20	7.3
Education	12	2.0	14	3.2	15	4.5	10	3.4	1	0.4
Wood, pulp, and paper	11	1.8	13	2.9	15	4.3	12	3.8	10	3.8
Livestock and poultry	9	1.4	11	2.6	8	2.3	0	0.0	0.0	0.0
Food, bottling, and beverages	7	1.2	9	2.2	10	3.0	7	2.2	9	3.4
Industrial processing zones	6	1.0	8	1.8	9	2.7	6	2.0	8	2.8
Tourism and hotels	5	0.9	7	1.7	9	2.6	13	4.1	11	4.2
General manufacturing	5	0.8	10	2.4	15	4.5	12	4.0	11	3.9
Transportation and warehousing	4	0.7	4	0.9	14	4.1	15	4.9	15	5.6
Textiles, apparel, and leather	3	0.5	4	1.0	6	1.8	3	1.0	5	1.7
Other	5	0.8	8	1.9	10	2.8	15	4.8	16	6.0
Total	619	100.0	432	100.0	342	100.0	306	100.0	269	100.0

Loan pricing. IIC's loan pricing is generally 100 basis points (bps)-600 bps over one-, three-, or six-month LIBOR. Spreads are based upon the cost of recent sovereign syndicated loans to the borrower's country of domicile (or to a similarly rated country if no loan to 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 falling in the five-to-eight-year range, with 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. During 2006 there appears to have been a turnaround from the shortening of the maturity profile of IIC's loans in recent years: At year-end 2006, 11.6% of IIC's outstanding loans had final maturities of more than five years, an increase from 6.5% one year earlier, while 14.2% had final maturities of one year or less, a decrease from 20.5% one year earlier.

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 its 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 7.2% of total assets at year-end 2006, down from almost 30% at year-end 2002. Disbursements for equity investments totaled US\$4.7 million in 2006, compared to US\$283 million for loans, and receipts from sales of equity investments totaled US\$20.0 million. 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 nearly 68% of equity investments at year-end 2006; and regional equity funds were nearly 62%.

Table 4**IIC Equity Investments By Sector**

--As of Dec. 31--

	2006		2005		2004		2003		2002	
	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total
Investment funds	46	67.7	49	71.2	76	75.2	87	77.1	87	76.0
Financial services	22	32.3	20	28.8	23	22.8	23	20.7	21	18.6
Agriculture and agribusiness	0	0.0	0	0.0	2	2.0	2	1.8	2	1.8
Acquaculture and fisheries	0	0.0	0	0.0	0	0.0	*	0.4	4	3.6

Total	67	100.0	69	100.0	101	100.0	112	100.0	114	100.0
Memo item:										
Regional equity funds	42	61.7	43	62.1	60	59.7	73	64.9	70	61.5

*Less than US\$500,000.

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 2006, this percentage was 124%, implying 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 US\$67 million at year-end 2006 (US\$22 million in direct and quasi-equity investments and US\$46 million in private equity and venture capital funds) against shareholders' equity of more than US\$587 million.

Investment concentration. IIC's policies limiting concentration in its loan and equity investment portfolios include:

- Country concentration. The higher of either 15% of the net active approved portfolio of loans and equity (US\$122 million at year-end 2006) or 15% of shareholders' equity (US\$88 million). IIC's largest country exposure at year-end 2006 was US\$121 million in Colombia (21% of shareholders' equity), followed by US\$110 million in the Federative Republic of Brazil ('BB+'). By contrast, at year-end 1999, IIC had more than US\$80 million in exposure to the Republic of Argentina ('B+'), which was nearly 39% of shareholders' equity (see Table 5). This dropped to US\$57 million (21% of shareholders' equity) by year-end 2001, during Argentina's financial crisis, and fell further to US\$14 million (2.4% of shareholders' equity) by year-end 2006. The relatively small size of IIC's loan portfolio means that the country composition of loans can change quite quickly.

Table 5

IIC Loan And Equity Concentration

	--As of Dec. 31--									
	2006		2005		2004		2003		2002	
	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total	Mil. US\$	% of total
Colombia	121	17.7	92	18.3	19	4.4	23	5.6	15	3.8
Brazil	110	16.1	85	17.0	64	14.4	38	9.2	34	8.8
Chile	78	11.4	42	8.4	44	9.9	47	11.1	37	9.7
Mexico	69	10.0	27	5.5	34	7.7	35	8.5	30	7.8
Peru	68	10.0	20	4.1	27	6.1	24	5.7	16	4.2
Ecuador	37	5.4	25	5.1	18	4.1	17	4.1	6	1.5
El Salvador	24	3.5	11	2.2	10	2.2	1	0.3	0	0.0
Costa Rica	16	2.3	18	3.5	21	4.8	17	4.2	18	4.6
Uruguay	15	2.2	20	4.1	14	3.1	7	1.6	7	1.8
Nicaragua	14	2.1	17	3.5	10	2.3	15	3.5	15	3.9
Argentina	14	2.0	21	4.1	27	6.2	36	8.7	42	11.0
Paraguay	11	1.5	5	1.0	5	1.1	6	1.4	8	2.1
Honduras	10	1.5	12	2.4	16	3.5	12	2.9	14	3.7
Venezuela	6	0.9	12	2.3	15	3.3	16	3.9	16	4.2
Dominican Republic	5	0.7	0	0.0	0	0.0	7	1.6	15	4.0
Bolivia	4	0.6	9	1.9	9	1.9	6	1.4	13	3.4
Panama	3	0.5	7	1.3	17	3.9	20	4.7	10	2.7
Jamaica	2	0.3	3	0.5	3	0.8	0	0.0	0	0.0
Trinidad & Tobago	1	0.1	1	0.1	2	0.4	2	0.6	3	0.8
Guyana	*	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Guatemala	0	0.0	*	0.0	4	1.0	7	1.6	9	2.4
Belize	0	0.0	0	0.0	1	0.2	1	0.2	1	0.3
Bahamas	0	0.0	0	0.0	0	0.0	*	0.0	*	0.1
Regional	78	11.3	74	14.7	83	18.7	81	19.3	74	19.4

Balance sheet total	687	100.0	501	100.0	443	100.0	419	100.0	383	100.0
Country exposure concentration										
Two largest exposures	232	33.7	177	35.3	108	24.3	85	20.3	79	20.6
Three largest exposures	310	45.1	219	43.7	142	32.0	121	28.9	113	29.4
Four largest exposures	378	55.1	246	49.1	169	38.2	157	37.4	142	37.2
Five largest exposures	447	65.0	272	54.2	196	44.3	180	43.1	160	41.8

*Less than US\$500,000.

- Sector concentration. The greater of either 10% of the total net active approved portfolio or 10% of shareholders' equity (except for financial institutions, for which the limit is 40%).
- 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 (except for expansion projects, where it may finance as much as 50%). Second, its total financing per company can be no more than the higher of 5% of IIC's total portfolio or 5% of shareholders' 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% of IIC's shareholders' equity, and total exposure is limited to 5% of IIC's shareholders' equity.

With the exception of its exposure to financial institutions, IIC has operated well within its guidelines in recent years.

Nonaccrual and arrears policies. IIC policies call for it to classify a loan as nonaccrual when payments are 60 days past due; however, in practice, the classification is often earlier. Disbursements of loans will ordinarily be suspended when payments of principal, interest, or fees are 60 days past due, although management may suspend disbursements earlier if warranted.

Loan portfolio quality. All of IIC's loans are to private sector or quasi-public sector entities, none carry sovereign guarantees, and recipients of these loans have been predominantly SMEs—most of which are operating in what have sometimes been difficult economic environments. These factors result in a level of embedded credit risk in IIC's loan portfolio that is much higher than that found in other MDFIs. Moreover, in 2001-2003, 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 result is a weighted-average default rate, which is the index. The higher the index number, the more stressful the economic conditions. This index 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, slowly improved to 10.1 at year-end 2004, then fell sharply to 8.3 at year-end 2005 and fell further to 6.1 at year-end 2006.

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 percentage of loans outstanding at the previous year-end reached 5.5%. Improvements began during 2003, and all metrics of portfolio performance were markedly better at year-end 2005 than four years earlier; they generally improved further during 2006, although loan write-offs increased to US\$9 million from US\$4 million. As a consequence, the allowance for loan losses relative to impaired and nonaccrual loans at year-end 2006 was the highest in recent years. Earlier in its existence, IIC did not always adequately provision its loans on an ongoing basis, resulting in volatile provisioning and net income. However, its current management revamped procedures for determining appropriate loan-loss provisions, and Standard & Poor's expects these to be more stable in the future.

Table 6

IIC Loan Portfolio Quality Indicators And Provisions

	--As of year ended Dec. 31--				
	2006	2005	2004	2003	2002
Distribution of development-related exposure by country rating categories (%)					
A-' and above	13	10	12	14	12
BBB'	11	8	11	11	11
BB'	57	53	45	27	27

B'	12	23	20	28	30
CCC' and below	6	6	12	20	21
Index of country economic conditions (increase denotes less favorable conditions)	6.1	8.3	10.1	12.5	12.9
Impaired loans (mil. US\$)	9	33	33	43	46
As a % of outstanding loans	1.5	7.6	9.5	14.2	16.9
Nonaccrual loans (mil. US\$)	29	51	64	52	62
As a % of outstanding loans	4.6	11.8	18.8	16.9	22.8
Interest collection rate (%)	96.2	89.9	91.9	81.8	79.3
Loans written off (mil. US\$)	9	4	*	3	15
Loan writeoffs as a % of outstanding loans at previous year end	2.0	1.1	0.1	1.0	5.5
Recoveries of loans previously written off (mil. US\$)	3	2	7	7	1
Provision (release of provision) for loan losses (mil. US\$)	(2)	4	(6)	(5)	30
Allowance for loan losses (mil. US\$)	40	48	45	45	46
As a % of impaired loans	427.5	145.5	139.7	104.1	98.9
As a % of nonaccrual loans	139.1	93.5	70.7	87.3	73.2
As a % of outstanding loans	6.4	11.0	13.3	14.8	16.7
Equity investments written off (mil. US\$)	0	0	20	5	0.3
Equity investment writeoffs as a % of outstanding equity investments at previous year end	0	0.0	17.7	4.0	0.3
Provision for losses on equity investments (mil. US\$)	0	0	9	4	14
Allowance for losses on equity investments (mil. US\$)	0	0	31	41	41
As a % of outstanding equity investments	0	0	30.4	36.6	36.1

*Less than US\$500,000.

Historically, IIC maintained a large allowance for losses on equity investments that varied from 27% to 61% during the five years ended 2005. However, during 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, while the corporations' investments in companies where it has significant influence are accounted for under the equity 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. Policy changes include:

- 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 (which has been relatively low risk for IIC) to 40% 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 limited amounts than originally contemplated to larger, less-risky borrowers.

IIC has also tightened up its organizational structure by separating loan origination from loan supervision, fostering both specialization and expertise while aligning responsibility. In addition, it has been successful in more aggressively seeking to realize value from its problem loans, including those it has written off.

The cumulative effect of these changes in policies, procedures, and organization, combined with improving economic conditions in its countries of exposure, has had a discernible impact on the quality of IIC's loan portfolio. However, as long as most of 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.

Risk-Bearing Capacity And Capital Adequacy

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 identical to its narrow risk-bearing capital. As shown in Table 7, IIC's shareholders' equity at year-end 2006 was US\$587 million, having increased from

US\$469 million, more than 25%, from one year earlier. This increase resulted from three very different factors: additional installments of paid-in capital of US\$67 million; net income of US\$39 million; and US\$11 million resulting from the corporation's adoption of SFAS158, which calls for companies to recognize in their statements of financial position the overfunding or underfunding of their postretirement plans (IIC's postretirement plans were overfunded by that amount at year-end 2006).

Table 7**IIC Capital And Capital Adequacy**

(Mil. US\$, unless otherwise indicated)	--Year ended Dec. 31--				
	2006	2005	2004	2003	2002
Authorized capital	704	704	704	704	704
Subscribed capital	704	701	696	696	692
Subscriptions receivable	(136)	(200)	(252)	(308)	(359)
Paid-in capital	568	501	444	388	333
Retained earnings/(accumulated deficit)	8	(32)	(45)	(49)	(51)
Accumulated other comprehensive income	11	0	0	0	0
Total shareholders' equity	587	469	399	340	282
Allowance for loan losses	40	48	45	45	46
Allowance for equity losses	0	0	31	41	41
Narrow risk-bearing capacity*	627	517	475	426	369
Total assets	940	676	487	426	385
Total development-related exposure	691	502	448	419	388
Shareholders' equity/total assets (%)	62.4	69.4	81.8	79.7	73.2
Narrow risk-bearing capacity/total assets (%)	66.7	76.5	97.4	99.9	95.7
Narrow risk-bearing capacity/total development-related exposure (%)	90.7	103.0	105.9	101.7	95.1

*Total shareholders' equity plus allowances for loan losses.

The increases in paid-in capital are pursuant to a December 1999 agreement that authorized a US\$500 million increase in IIC's authorized capital, with subscriptions to be paid in roughly equal annual installments beginning in 2000 and ending in October 2007. All of the nearly US\$704 million of total authorized capital was subscribed at year-end 2006, and nearly US\$136 million in capital contributions are scheduled to be received between end-2006 and end-October 2007.

As often happens with capital increases for MDFIs, there have been delays by some members in making payments for IIC's 1999 capital increase. As of end-May 2007, shortfalls of scheduled contributions by LACMCs totaled US\$20.9 million, of which \$13.6 million was owed by one of the largest regional shareholders. In addition, the U.S. was delinquent on US\$35.7 million. A number of countries have expressed interest in acquiring additional shares, and IIC's management expects eventually to receive all of the subscribed capital 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 had been improving in recent years. IIC's ratio of shareholders' equity to assets increased monotonically to 82% at year-end 2004 from 58% at year-end 2000 before declining to 69% at year-end 2005 and 62% at year-end 2006. 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 marginally to 103% at year-end 2005 and 91% at year-end 2006. However, this latter ratio continues to be one of the highest among MDFIs.

IIC's capital position thus continues to be very strong. However, this is largely the result of the receipt of installments under the 1999 capital increase, supplemented by the slow growth of DRE, at least until the last two years. Once the final payments under the 1999 capital increase have been received and in the absence of another capital increase, changes in IIC's risk-bearing capacity will be driven by the amount of its net income that is added to its retained earnings.

Net Income

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

As is true of other MDFIs, the drivers of IIC's net income are interest rate levels (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, as shown in Table 8, historically has been volatile, and the corporation suffered large losses in 1999, 2001, and 2002 due to 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.

Table 8**IIC Net Income**

(Mil. US\$, unless otherwise indicated)	--Year ended Dec. 31--				
	2006	2005	2004	2003	2002
Income from investment securities	10	5	1	1	2
Income from loan investments, of which:	42	24	19	13	14
Interest income from loans	40	22	17	12	12
Other loan-related income	2	2	2	2	2
Release of provisions for (provisions for) loan losses	2	(4)	6	5	(30)
Total loan income	43	21	25	18	(16)
Income from mortgage-backed securities	0	0	0	(0)	1
Income from equity investments, of which:	16	6	(5)	(2)	(12)
Gain from sale of equity investments	8	0	2	1	1
Change in the carrying value of equity investments	6	3	0	0	0
Dividends, distributions, and other equity investmetn income	2	2	3	2	2
Provision for losses on equity investments	0	0	(9)	(4)	(14)
Advisory service, cofinancing, and other income	4	4	3	3	2
Borrowing and long-term debt expense	(14)	(5)	(3)	(3)	(2)
Operating expenses, of which:	(20)	(19)	(17)	(15)	(16)
Administrative expenses	(19)	(19)	(17)	(15)	(16)
Operating income	40	12	4	2	(41)
(Loss)/gain on nontrading derivatives instruments	(0)	2	0	0	0
Net income	39	14	4	2	(41)
Memo items:					
Operating return on average assets and guarantees (%)	4.9	2.1	0.8	0.5	(10.7)
Operating return on average shareholders' equity (%)	7.5	2.8	1.0	0.7	(14.9)

IIC's profitability in absolute terms and relative to average assets plus guarantees (ROAG) and average shareholders' equity (ROE) has steadily improved over the past four years. Its 2006 operating income of US\$40 million represented a 4.9% ROAG and a 7.5% ROE, up from 2.1% and 2.8%, respectively, one year earlier, which are very high returns for an MDFI.

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

- Interest income from loans increased to US\$40 million from US\$22 million one year earlier, the consequence of sharply higher loans outstanding and higher interest rates;
- Interest income from investment securities increased to US\$10 million from US\$5 million, due principally to higher interest rates;
- Income from IIC's equity investments ballooned to US\$16 million from US\$6 million one year earlier, principally as the result of a realized gain of US\$8 million on the sale of equity investments;
- IIC released US\$2 million in provisions for losses, in contrast to the US\$4 million in provisions made one year earlier; and
- Administrative expenses increased by less than 2.2%.

The outlook for IIC's profitability during 2007 is also promising by historical standards, although its ROAG and ROE seem unlikely to match those of 2006.

Borrowing And Liquidity

IIC's extremely strong capital position of recent years has resulted in little need to borrow. At year-end 2006, IIC's cash and marketable securities totaled US\$260 million, nearly 28% of total assets, against borrowings of US\$342 million. The receipt of the last installments of paid-in capital during 2007 means that IIC's need to borrow during 2007 will be limited, even if loan and equity disbursements are strong.

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 to some degree) IIC's historically strong liquidity position.

IIC's policies require liquidity to cover the greater of either 100% of undisbursed commitments or 65% of projected three-year net cash flows, and cash and marketable securities must cover at least 30% of those requirements. At year-end 2006, IIC's undisbursed commitments were less than US\$38 million.

For the purpose of calculating its liquidity, IIC includes the undrawn balances under committed credit facilities from financial institutions rated 'AA' or higher. While not all of them are 'AA' institutions, at year-end 2006 IIC had in place credit facilities from six different commercial financial institutions. These facilities totaled US\$475 million, up from US\$230 million one year earlier, of which US\$275 million was drawn; US\$455 million of the facilities had expiration dates beyond June 2009.

In addition to these facilities, however, is a US\$300 million facility from IADB, which expires in November 2010 and was completely undrawn at year-end 2006. Including this facility, IIC's liquidity position is among the strongest of rated MDFIs.

Comparative Data

Comparative data for IIC and 14 other multilateral lending institutions rated by Standard & Poor's may be found on pages 58 through 62 of Standard & Poor's Supranationals Special Edition 2006, which is available on RatingsDirect and at www.standardandpoors.com. Enter "Supranationals Special Edition 2006" in the search box and click on the title under "Credit Ratings" in the center of the screen. The 2006 edition will be updated by end-October 2007.

Ratings Detail (As Of 22-Jun-2007)*

Inter-American Investment Corporation

Issuer Credit Rating

Foreign Currency

AA-/Stable/A-1+

Issuer Credit Ratings History

17-May-2005

Foreign Currency

AA-/Stable/A-1+

22-Aug-2002

AA/Negative/A-1+

18-Dec-2000

AA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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