

Inter-American Development Bank

Ordinary Capital



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

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MANAGEMENT'S DISCUSSION AND ANALYSIS

September 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 nine months of 2012, the Bank approved 89 loans totaling \$5,929 million compared to 66 loans that totaled \$4,030 million during the same period in 2011. There were three non-trade-related guarantees approved without sovereign counter-guarantee for \$22 million (2011 – three for \$45 million) and 222 trade-related

guarantees were issued for a total of \$559 million (2011 – 191 guarantees issued for a total of \$430 million).

The portfolio of non-sovereign-guaranteed loans increased to a level of \$3,722 million compared to \$3,316 million at December 31, 2011. The non-sovereign guarantees exposure decreased \$175 million to \$672 million compared to \$847 million at the end of the previous year. As of September 30, 2012, 6.5% 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 \$194 million at September 30, 2012 compared to \$175 million at December 31, 2011. The Bank had non-sovereign-guaranteed loans with outstanding balances of \$263 million classified as impaired at September 30, 2012 compared to \$129 million at the end of the prior year. All impaired loans have specific allowances for loan losses amounting to \$57 million at September 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. During the first nine months of 2012, loan approvals under the FFF totaled \$3,247 million.

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 nine months of the year, the Bank issued bonds for a total face amount of \$10,710 million (2011 – \$2,634 million) that generated proceeds of \$9,897 million (2011 – \$2,603 million), representing increases of \$8,076 million and \$7,294 million, respectively, compared to the same period last year. The average life of new issues was 6 years (2011 – 5.3 years). The higher level of borrowing operations during the first nine months of 2012 was mainly due to a larger funding program, in part based on a higher anticipated level of debt redemptions. In addition, last year's lower borrowings reflected the positive impact on the

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.

Bank's liquidity levels of the conversion of \$3,225 million of non-borrowing member currency holdings subject to maintenance of value.

FINANCIAL RESULTS: Operating Income during the first nine months of 2012 was \$695 million, compared to \$772 million for the same period last year, a decrease of \$77 million. This decrease was mainly due to a decrease in net interest income of \$136 million, an increase in net non-interest expense of \$28 million and an increase in the provision for loan and guarantee losses of \$38 million, partially offset by an increase in net investment gains of \$116 million.

During the nine months ended September 30, 2012, the trading investments portfolio experienced net mark-to-market gains of \$211 million, compared to \$95 million experienced during the nine months ended September 30, 2011. The trading investments portfolio's net interest income, which excludes realized and unrealized investment gains and losses, added income of \$26 million during the first nine months of the year compared to \$43 million during the same period in 2011.

The provision (credit) for loan and guarantee losses increased by \$38 million, from \$(19) million in the first nine months of 2011 to \$19 million in 2012, as a result of an increase in impaired loans in the non-sovereign-guaranteed portfolio.

In 2008, the Bank elected the fair value option for a substantial number of its borrowings so that the changes in fair value of the borrowing swaps would be significantly offset by the changes in fair value of the associated borrowings. In addition, 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, in 2011 the Bank modified its borrowing fair value option policy to address income volatility on a financial instruments portfolio basis rather than on an instrument-by-instrument basis. Notwithstanding, 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. Net fair value adjustments on non-trading portfolios for the nine months ended September 30, 2012 amounted to a gain of \$116 million, compared to a loss of \$966 million for the same period last year, mainly resulting from gains associated with changes in the Bank's credit spreads on the borrowing portfolio (approximately \$142 million), which were partially offset by losses from changes in swap basis spreads (approximately \$56 million). Fair value losses on lending swaps (\$227 million), net of gains from equity duration swaps (\$109 million), were offset by gains on swaps where the associated bond was not elected for fair value treatment (\$146 million), following the new fair value option accounting policy established in 2011.

(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. See Other Developments for additional information related to IDB-9 occurring after September 30, 2012.

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 Bank's capital adequacy framework provides rules that support the determination of capital requirements for credit and market risk, as well as operational risk. Under this framework, the Bank's capital adequacy position remains strong.

The Bank's equity base plays a critical role in securing its financial objectives. The Total Equity-to-Loans Ratio (TELR) at September 30, 2012 was 32.3% 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)			
	Nine months ended		Year ended
	September 30,		December 31,
	2012	2011	2011
Lending Summary			
Loans and guarantees approved ⁽¹⁾	\$ 5,951	\$ 4,075	\$ 10,400
Undisbursed portion of approved loans	26,395	21,912	23,994
Gross loan disbursements	3,356	3,915	7,898
Net loan disbursements ⁽²⁾	(64)	578	3,297
Income Statement Data			
Operating Income ⁽³⁾	\$ 695	\$ 772	\$ 836
Net fair value adjustments on non-trading portfolios ⁽⁴⁾	116	(966)	(919)
Board of Governors approved transfers	(200)	(200)	(200)
Net income (loss)	611	(394)	(283)
Returns and Costs, after swaps			
Return on average loans outstanding	2.53%	2.76%	2.75%
Return on average liquid investments ⁽⁵⁾	2.17%	1.40%	0.65%
Average cost of borrowings outstanding during the period	0.91%	0.80%	0.81%
Balance Sheet Data			
	September 30,	2011	December 31,
	2012	2011	2011
Cash and investments-net ⁽⁶⁾ , after swaps	\$ 19,776	\$ 14,357	\$ 13,882
Loans outstanding ⁽⁷⁾	66,378	63,418	66,130
Borrowings outstanding ⁽⁸⁾ , after swaps	63,112	56,157	58,015
Equity	20,725	20,558	19,794
Total Equity ⁽⁹⁾ -to- Loans ⁽¹⁰⁾ Ratio	32.3%	33.9%	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 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 \$1,971 million as of September 30, 2012 (2011 - \$1,536 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 policy 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 enables 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.

The Bank's equity base plays a critical role in securing its financial objectives. Table 1 presents the composition of the TELR as of September 30, 2012 and December 31, 2011. It shows that the TELR increased from 31.3% to 32.3% mainly due to an increase in Total Equity.

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

	<u>September 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>(23)</u>	<u>-</u>
	4,617	4,339
Retained earnings:		
General reserve ⁽¹⁾	13,543	12,890
Special reserve ⁽¹⁾	<u>2,565</u>	<u>2,565</u>
	20,725	19,794
Plus:		
Allowances for loan and guarantee losses.....	194	175
Minus:		
Borrowing countries' local currency cash balances.....	155	173
Net receivable from members.....	213	76
Cumulative net fair value adjustments on non-trading portfolios.....	<u>(1,125)</u>	<u>(1,241)</u>
Total Equity	\$ 21,676	\$ 20,961
Loans outstanding and net guarantee exposure	\$ 67,102	\$ 67,030
Total Equity-to-Loans Ratio	<u><u>32.3%</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, the Bank may make loans and guarantees to any private or public sector entity that does not benefit from a sovereign guarantee and for the purpose of financing a project in a borrowing member country in any economic sector, subject to an exclusion list and other criteria. The Bank also lends to other development institutions without a 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 September 30, 2012, 94% was sovereign-guaranteed. At September 30, 2012, the total volume of outstanding loans was \$66,378 million, compared with \$66,130 million as of December 31, 2011. The slight increase in the loan portfolio was mostly due to a higher level of disbursements (\$3,356 million) than loan collections (\$3,292 million), and positive currency translation adjustments (\$184 million).

As of September 30, 2012, 6.5% 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 \$3,722 million, compared to \$3,316 million at December 31, 2011.

² As of June 30, 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 5.3% of Total Equity (\$1,148 million and 5%, respectively as of 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 \$5,996 million during the first nine months of 2012, mainly resulting from net cash inflows from borrowings (\$5,151 million), collection of capital subscriptions under the IDB-9 (\$278 million), net cash inflows from operating activities (\$584 million), and mark-to-market gains (\$211 million), partially offset by payments of maintenance of value to members (\$153 million), net loan disbursements (\$64 million) and negative currency translation adjustments (\$13 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 \$5,097 million compared with December 31, 2011, primarily due to a larger amount of new borrowings than maturities (\$5,151 million), the accretion of discount on borrowings (\$329 million), and collection of the accretion of discount on borrowing swaps (\$105 million), partially offset by a net decrease in the fair value of borrowings and related swaps (\$461 million), and negative currency translation adjustments (\$29 million).

EQUITY: Equity at September 30, 2012 was \$20,725 million, an increase of \$931 million from December 31, 2011, reflecting paid-in capital received under the IDB-9 of \$278 million, net income of \$611 million, and the reclassification of unrecognized pension actuarial losses and prior service cost to net income of \$36 million and \$6 million, respectively.

RESULTS OF OPERATIONS

Table 2 shows a breakdown of Operating Income. For the nine months ended September 30, 2012, Operating Income was \$695 million compared to \$772 million for the same period last year, a decrease of \$77 million. This decrease was mainly due to a decrease in net interest income and increases in net non-interest expense and in the provision for loan and guarantee losses, partially offset by higher net investment gains.

The Bank had net interest income of \$940 million during the first nine months of 2012, compared to \$1,076 million for the same period last year, a decrease of \$136 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 \$211 million during the period, compared to \$95 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 \$87 million (relative to purchased price) were realized, compared to \$33 million in 2011.

Net non-interest expense increased \$28 million mainly due to higher net periodic pension costs of \$42 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, reduced by a lower amortization of prior service cost, partially offset by a decrease in special programs of \$15 million.

The provision (credit) for loan and guarantee losses increased by \$38 million, from (\$19) million during the first nine months of 2011 to \$19 million in the first nine months of 2012, mostly due to an increase in non-sovereign-guaranteed impaired loans.

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

	Nine months ended September 30,	
	2012	2011
Loan interest income	\$ 1,205	\$ 1,259
Investment interest income	72	73
Other interest income	81	83
	<u>1,358</u>	<u>1,415</u>
Less:		
Borrowing expenses	<u>418</u>	<u>339</u>
Net interest income	940	1,076
Other loan income	48	39
Net investment gains	211	95
Other expenses:		
Provision (credit) for loan and guarantee losses	19	(19)
Net non-interest expense	<u>485</u>	<u>457</u>
Total	<u>504</u>	<u>438</u>
Operating Income	<u>\$ 695</u>	<u>\$ 772</u>

The average interest-earning asset and interest-bearing liability portfolios, after swaps, and the respective financial returns and costs for the nine months ended September 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)

	Nine months ended September 30, 2012		Nine months ended September 30, 2011		Year ended December 31, 2011	
	Average balance	Return/Cost %	Average balance	Return/Cost %	Average balance	Return/Cost %
Loans ⁽¹⁾	\$ 66,107	2.43	\$ 63,002	2.67	\$ 63,420	2.65
Liquid investments ⁽²⁾⁽³⁾	17,643	2.17	14,886	1.40	15,110	0.65
Total earning assets	<u>\$ 83,750</u>	<u>2.38</u>	<u>\$ 77,888</u>	<u>2.43</u>	<u>\$ 78,530</u>	<u>2.27</u>
Borrowings	<u>\$ 61,265</u>	<u>0.91</u>	<u>\$ 56,505</u>	<u>0.80</u>	<u>\$ 56,794</u>	<u>0.81</u>
Net interest margin ⁽⁴⁾		<u>1.50</u>		<u>1.85</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 nine months ended September 30, 2012, there were three non-trade-related guarantees approved without sovereign counter-guarantee for \$22 million (2011 – three for \$45 million). Also, the Bank issued 222 trade-related guarantees for a total of \$559 million (2011 – 191 guarantees issued for a total of \$430 million).

CONTRACTUAL OBLIGATIONS: The Bank's most significant contractual obligations relate to undisbursed loans and the repayment of borrowings. At September 30, 2012, undisbursed loans amounted to \$26,395 million and the average maturity of the medium- and long-term borrowing portfolio, after swaps, was 4.6 years with contractual maturity dates through 2042³.

LIQUIDITY MANAGEMENT

Credit markets improved in the third quarter of 2012, despite mixed to weak economic figures, as more optimistic sentiment prevailed in the markets thanks to further stimuli by major central banks, sound corporate earnings reports, and diminished concerns in Europe. In this environment, rates in various markets continued to trend lower.

The Bank's exposure to structured assets continued to be reduced through repayments at par of \$351 million during the first nine months of the year (2011—\$810 million) and selected asset sales. Valuations 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 nine months ended September 30, 2012, the Bank recognized \$211 million of mark-to-market gains in its trading investments portfolio (2011 – \$95 million). These investment gains, to a major extent, relate to gains recognized in the \$1,650 million asset-backed and mortgage-backed securities portion of the portfolio and, the general recovery in credit assets. As of September 30, 2012, 33.6% of this portfolio is still rated AAA and AA, and 70.8% is rated investment

grade compared to 48.2% and 72.9%, respectively, at December 31, 2011.

Table 4 shows a breakdown of the trading investments portfolio and related swaps at September 30, 2012 and December 31, 2011, by major security class, together with unrealized gains and losses included in Income from Investments – Net gains (losses) on securities held at the end of the respective period.

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

	September 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	\$ 6,480	\$ -	\$ 1,974	\$ -
U.S. Government-sponsored enterprises	463	-	841	-
Obligations of non-U.S. governments and agencies	7,389	64	5,586	(7)
Bank obligations	4,486	4	3,323	(6)
Corporate securities	11	-	-	-
Mortgage-backed securities	1,036	69	1,269	(41)
U.S. residential	363	41	444	(7)
Non-U.S. residential	352	22	419	(54)
U.S. commercial	115	1	167	13
Non-U.S. commercial	206	5	239	7
Asset-backed securities	614	26	750	27
Collateralized loan obligations	383	25	470	22
Other collateralized debt obligations	113	(1)	125	4
Other asset-backed securities	118	2	155	1
Total investments-trading	20,479	163	13,743	(27)
Currency and interest rate swaps	(136)	(12)	(96)	(41)
Total	\$ 20,343	\$ 151	\$ 13,647	\$ (68)

⁽¹⁾ Includes accrued interest of \$58 million (2011 - \$40 million) for trading investments and \$(31) 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 (losses) 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 September 30, 2012, the credit exposure amounted to \$20,679 million, compared to \$14,121 million as of December 31, 2011. The credit quality of the portfolios continues to be high, as 88.3% of the counterparties are rated AAA and AA, 7.7% are rated A, 1.1% are rated BBB, and 2.9% are rated below BBB, compared to 88.8%, 4.8%, 2.5% and 3.9%, respectively, at December 31, 2011.

As of September 30, 2012, out of the Bank's total current credit exposure in Europe of \$7,372 million (\$6,718 million at December 31, 2011) the direct exposure to three Eurozone countries rated BBB+ or lower (Italy, Portugal, and Spain) was \$19 million (\$147 million at December 31, 2011). The exposure was entirely composed of government agencies. In addition, in the countries specified, the Bank had \$302 million (\$401 million at December 31, 2011) of exposure in asset-backed and mortgage-backed securities, generally rated higher than the sovereigns, and no exposure on swaps (\$24 million at December 31, 2011). All the remaining European current exposure of \$7,051 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)

Counterparty rating	September 30, 2012					Total Exposure on Investments and Swaps	% of Total
	Governments and Agencies	Investments			Net Swap Exposure		
		Banks	ABS and MBS	Corporates			
AAA ⁽¹⁾	\$ 5,286	\$ 335	\$ 103	\$ -	\$ -	\$ 5,724	27.7
AA	8,278	3,598	451	11	192	12,530	60.6
A	626	553	403	-	8	1,590	7.7
BBB	19	-	211	-	-	230	1.1
BB	124	-	63	-	-	187	0.9
B	-	-	131	-	-	131	0.6
CCC	-	-	159	-	-	159	0.8
CC and below	-	-	128	-	-	128	0.6
Total	<u>\$ 14,333</u>	<u>\$ 4,486</u>	<u>\$ 1,649</u>	<u>\$ 11</u>	<u>\$ 200</u>	<u>\$ 20,679</u>	<u>100.0</u>

⁽¹⁾ Includes \$1,151 million of Governments and agencies rated A1+, the highest short-term rating.

Counterparty rating	December 31, 2011					Total Exposure on Investments and Swaps	% of Total
	Governments and Agencies	Investments			Net Swap Exposure		
		Banks	ABS and MBS	Corporates			
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>\$ -</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 have been required to pay an amount in connection with such litigation equivalent to approximately \$40 million. The litigation has since been dismissed with prejudice and the Bank was not required to make any payment.

STANDARD & POOR'S RATINGS SERVICES (S&P)

METHODOLOGY REVISIONS: S&P is in the process of updating the methodology for rating multilateral lending institutions, which is expected to be adopted later this year. Such proposed changes could affect the rating for some multilateral institutions.

NEW LOAN PRODUCTS: In September 2012, the Board of Executive Directors approved the Development Sustainability Credit Line (DSL) product that will replace the current Emergency Lending Facility. The DSL is designed as a contingent credit line upon the occurrence of certain systemic or country specific triggers, to respond to exogenous economic crisis and establishes a new set of criteria that can better respond to the types of crisis that may affect the region. The DSL will be limited to a maximum of \$300 million per country, or two percent of a country's gross domestic product (GDP), whichever is less, and will have available resources of \$2 billion each year from 2012 to 2014, cumulative during the following years, if not used. The Board also approved the Contingent Credit Line for Natural Disasters, that will complement the current Contingent Credit Facility for Natural Disaster Emergencies, providing additional resources in the event of natural disasters.

NEW EFFECTIVE DATES FOR IDB-9 INSTALLMENTS: On October 19, 2012, the Board of Executive Directors determined that February 28, 2013 would be the effective date for the second installment of the increase in the Ordinary Capital

paid-in and callable capital stock and that, moreover, the third and fourth installments would become effective on February 28, 2014 and February 28, 2015, respectively, and that the fifth installment would become effective on February 29, 2016, or such later dates as the Board of Executive Directors shall determine.

MANAGEMENT CHANGES DURING THE QUARTER: 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.

**Condensed Quarterly Financial Statements
(Unaudited)**

ORDINARY CAPITAL
INTER-AMERICAN DEVELOPMENT BANK

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

	September 30,		December 31,	
	2012		2011	
	(Unaudited)		(Unaudited)	
ASSETS				
Cash and investments				
Cash- Note P.....	\$ 1,645		\$ 1,189	
Investments - Trading - Notes C, G, H and P.....	<u>20,421</u>	\$ 22,066	<u>13,703</u>	\$ 14,892
Loans outstanding - Notes D, E and P.....	66,378		66,130	
Allowance for loan losses.....	<u>(171)</u>	<u>66,207</u>	<u>(150)</u>	65,980
Accrued interest and other charges.....		938		851
Receivable from members.....		279		295
Currency and interest rate swaps - Notes G, H, I and P				
Investments - trading.....	18		11	
Loans.....	15		112	
Borrowings.....	7,508		6,702	
Other.....	<u>323</u>	<u>7,864</u>	<u>215</u>	7,040
Other assets.....		400		374
Total assets.....		\$ 97,754		\$ 89,432
LIABILITIES AND EQUITY				
Liabilities				
Borrowings - Notes F, G, H, I and P				
Short-term.....	\$ 611		\$ 898	
Medium- and long-term:				
Measured at fair value.....	50,753		48,901	
Measured at amortized cost.....	<u>18,618</u>	\$ 69,982	<u>14,124</u>	\$ 63,923
Currency and interest rate swaps - Notes G, H, I and P				
Investments - trading.....	123		80	
Loans.....	1,986		1,658	
Borrowings.....	<u>638</u>	<u>2,747</u>	<u>794</u>	2,532
Payable for investment securities purchased and cash collateral received....		<u>2,185</u>		943
Amounts payable to maintain value of currency holdings.....		66		219
Due to IDB Grant Facility - Note J.....		363		272
Accrued interest on borrowings.....		503		538
Liabilities under retirement benefit plans.....		806		796
Other liabilities.....		<u>377</u>		<u>415</u>
Total liabilities.....		77,029		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.....	(23)		-	
Retained earnings.....	16,099		15,488	
Accumulated other comprehensive income (loss).....	<u>9</u>	<u>20,725</u>	<u>(33)</u>	19,794
Total liabilities and equity.....		\$ 97,754		\$ 89,432

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		Nine months ended	
	September 30,		September 30,	
	2012	2011	2012	2011
	(Unaudited)		(Unaudited)	
Income				
Loans, after swaps - Notes D and G.....	\$ 416	\$ 426	\$ 1,253	\$ 1,298
Investments - Notes C and G:				
Interest.....	23	25	72	73
Net gains (losses).....	96	(64)	211	95
Other interest income.....	29	32	81	83
Other.....	8	4	30	14
Total income.....	<u>572</u>	<u>423</u>	<u>1,647</u>	<u>1,563</u>
Expenses				
Borrowing expenses, after swaps - Notes F and G.....	141	105	418	339
Provision (credit) for loan and guarantee losses - Note E.....	(21)	4	19	(19)
Administrative expenses.....	167	146	480	421
Special programs.....	15	24	35	50
Total expenses.....	<u>302</u>	<u>279</u>	<u>952</u>	<u>791</u>
Income before Net fair value adjustments on non-trading				
portfolios and Board of Governors approved transfers.....	270	144	695	772
Net fair value adjustments on non-trading portfolios - Notes F, G and L.....	204	(778)	116	(966)
Board of Governors approved transfers - Note J.....	-	-	(200)	(200)
Net income (loss).....	474	(634)	611	(394)
Retained earnings, beginning of period.....	15,625	16,011	15,488	15,771
Retained earnings, end of period.....	\$ 16,099	\$ 15,377	\$ 16,099	\$ 15,377

CONDENSED STATEMENT OF COMPREHENSIVE INCOME*(Expressed in millions of United States dollars)*

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2012	2011	2012	2011
	(Unaudited)		(Unaudited)	
Net income (loss).....	\$ 474	\$ (634)	\$ 611	\$ (394)
Other comprehensive income (loss)				
Translation adjustments.....	5	(8)	-	(9)
Reclassification to income - amortization of net unrecognized actuarial losses and prior service cost on retirement benefits plans.....	14	-	42	-
Total other comprehensive income (loss).....	<u>19</u>	<u>(8)</u>	<u>42</u>	<u>(9)</u>
Comprehensive income (loss).....	\$ 493	\$ (642)	\$ 653	\$ (403)

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)

	Nine months ended September 30,	
	2012	2011
	(Unaudited)	
Cash flows from lending and investing activities		
Lending:		
Loan disbursements (net of participations).....	\$ (3,356)	\$ (3,915)
Loan collections (net of participations).....	3,292	3,337
Net cash used in lending activities.....	(64)	(578)
Miscellaneous assets and liabilities.....	(41)	(72)
Net cash used in lending and investing activities.....	(105)	(650)
Cash flows from financing activities		
Medium- and long-term borrowings:		
Proceeds from issuance.....	9,891	2,616
Repayments.....	(4,453)	(6,388)
Short-term borrowings, net.....	(287)	1,619
Cash collateral received.....	557	357
Collection of capital subscriptions.....	278	-
Collection of receivable from members.....	16	19
Payments of maintenance of value to members.....	(153)	(296)
Net cash provided by (used in) financing activities.....	5,849	(2,073)
Cash flows from operating activities		
Gross purchases of trading investments.....	(20,089)	(14,383)
Gross proceeds from sale or maturity of trading investments.....	14,356	16,853
Loan income collections, after swaps.....	1,155	1,202
Interest and other costs of borrowings, after swaps.....	(216)	(204)
Income from investments.....	(7)	26
Other interest income.....	74	84
Other income.....	30	14
Administrative expenses.....	(431)	(418)
Special programs.....	(50)	(46)
Transfers to the IDB Grant Facility.....	(109)	-
Net cash (used in) provided by operating activities.....	(5,287)	3,128
Effect of exchange rate fluctuations on cash.....	(1)	-
Net increase in cash.....	456	405
Cash, beginning of year.....	1,189	242
Cash, end of period.....	\$ 1,645	\$ 647

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 nine 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

The Financial Accounting Standards Board (FASB) has 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 required disclosures should be provided retrospectively for all comparative periods presented. The applicable new disclosure will be incorporated in the condensed quarterly financial statements as of March 31, 2013. Otherwise, ASU No. 2011-11 will not have an impact on the Bank's financial condition or result of operations.

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 \$151 million on trading portfolio instruments held at September 30, 2012 compared to \$34 million at September 30 2011, were included in Income from Investments-Net gains (losses). Unrealized gains recognized are to a large extent related to the asset-backed and mortgage-backed securities portion of the portfolio, which at September 30, 2012 amounted to \$1,650 million (\$2,234 million at September 30, 2011) and, the general recovery in credit assets.

In the third quarter of 2012, the investments portfolio continued its recovery from the financial crisis as positive market sentiment was fueled by further stimuli by major central banks, sound corporate earnings reports, and diminished concerns in Europe. 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 September 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 nine months ended September 30, 2012, there were three non-trade-related guarantees approved without sovereign counter-guarantee for \$22 million (2011 – three for \$45 million). As of September 30, 2012, the Bank had approved, net of cancellations and maturities, non-trade-related guarantees without sovereign counter-guarantees of \$709 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 nine months of the year, the Bank issued 222 guarantees for a total of \$559 million under this program (2011 – 191 guarantees for a total of \$430 million).

At September 30, 2012, guarantees of \$793 million (\$980 million at December 31, 2011), including \$399 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 \$34 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 September 30, 2012 and December 31, 2011, the Bank's exposure on guarantees without sovereign counter-guarantee, net of reinsurance, amounted to \$672 million and \$847 million, respectively, and was classified as follows (in millions):

Internal Credit Risk Classification	September 30,	December 31,
	2012	2011
Excellent.....	\$ 111	\$ 140
Very Strong.....	209	159
Strong.....	216	146
Satisfactory.....	38	253
Fair.....	-	27
Weak.....	91	106
Possible loss.....	7	16
Total	<u>\$ 672</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 94 % 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 September 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	September 30,	December 31,
	2012	2011
A+ to A-.....	\$ 1,194	\$ 1,266
BBB+ to BBB-.....	37,368	35,864
BB+ to BB.....	5,538	6,995
B+ to B.....	18,202	18,478
CCC+ to CCC-.....	239	211
SD.....	115	-
Total	<u>\$ 62,656</u>	<u>\$ 62,814</u>

The ratings presented above have been updated as of September 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 collateralizing 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 September 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
	September 30, 2012	December 31, 2011	
Excellent.....	\$ 217	\$ 117	BBB / Baa3 or higher
Very Strong.....	593	494	BB+ / Ba1
Strong.....	1,140	1,270	BB / Ba2
Satisfactory.....	629	517	BB- / Ba3
Fair.....	399	319	B+ / B1
Weak.....	286	114	B / B2
Possible Loss.....	32	183	B- / B3
Impaired.....	263	129	CCC-D / Caa-D
Total	<u>\$ 3,559</u>	<u>\$ 3,143</u>	

In addition, as of September 30, 2012, the Bank has loans to other development institutions of \$163 million (2011 – \$173 million), which are rated AAA, A+ and A-.

Past due and Non-accrual loans

As of September 30, 2012, there were no loans considered past due. Non-sovereign-guaranteed loans with an outstanding balance of \$263 million were in non-accrual status (\$129 million at December 31, 2011), including \$88 million whose maturity has been accelerated.

Impaired loans

The Bank has non-sovereign-guaranteed loans with outstanding balances of \$263 million classified as impaired at September 30, 2012. Impaired loans have specific allowances for loan losses amounting to \$57 million (\$41 million at December 31, 2011).

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

	September 30, 2012	December 31, 2011
Recorded investment at end of period.....	\$ 263	\$ 129
Average recorded investment during the period.....	197	126

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

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

	Nine months ended September 30,	
	2012	2011
Loan income recognized.....	\$ 6	\$ 4
Loan income that would have been recognized on an accrual basis during the period.....	10	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, and the Bank is not compensated.

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 and it is accomplished in two steps: (i) Obtain the probabilities of default to be used for individual loans and guarantees. Since the Bank's internal credit ratings are mapped to the credit ratings used by external credit rating agencies, the probabilities of default are obtained from the probabilities of default associated by external credit agencies to each of the Bank's credit rating categories. 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 level; (ii) An estimated loss (loss given default) rate is generally determined based upon the Bank's specific experience gained in the assessment of the losses stemming from impairments in the Bank's portfolio; or by the loss given default ratios calculated by external credit agencies for similar type of exposures in areas where the Bank has limited specific experience. Based upon (i) the probability of default rate for each risk category, (ii) the amount of credit exposure in each of these categories and (iii) the applicable loss given default ratio, the required level of the collective loss allowance is determined.

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

	September 30, 2012	December 31, 2011
Balance, beginning of year	\$ 175	\$ 172
Provision for loan and guarantee losses	19	3
Balance, end of period	<u>\$ 194</u>	<u>\$ 175</u>
Composed of:		
Allowance for loan losses	\$ 171	\$ 150
Allowance for guarantee losses ⁽¹⁾	23	25
Total	<u>\$ 194</u>	<u>\$ 175</u>

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

As of September 30, 2012, the total allowance for loan and guarantee losses is composed of \$10 million related to the sovereign-guaranteed portfolio and \$184 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 \$2 million and \$1 million related to sovereign-guaranteed loans in 2012 and 2011, respectively.

During the first nine 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 September 30, 2012 amounted to \$137 million (2011 - \$134 million), including \$127 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 restructuring agreement or management still has doubts about the collectibility of the loan.

During the quarter ended September 30, 2012, there was a troubled debt restructuring of a non-sovereign-guaranteed loan classified as impaired, with an outstanding balance of \$47 million. The restructuring was implemented pursuant to a plan that was approved by a qualified majority of the borrower's creditors in the context of a court-supervised restructuring proceeding. As a result, the principal modifications to the Bank's loan agreement consisted of an additional grace peri-

od, an extension of the repayment date, and a reduction in the interest rate below market for a loan with a similar risk profile. The effects of the restructuring reduced the specific loan loss allowance by approximately \$10 million.

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 nine months ended September 30, 2012 and 2011, as follows (in millions):

	Three months ended September 30,	
	2012	2011
Borrowing expenses, after swaps	\$ (486)	\$ (515)
Net fair value adjustments on non-trading portfolios	(339)	333
Total changes in fair value included in Net income (loss)	<u>\$ (825)</u>	<u>\$ (182)</u>
	Nine months ended September 30,	
	2012	2011
Borrowing expenses, after swaps	\$ (1,463)	\$ (1,584)
Net fair value adjustments on non-trading portfolios	(364)	(630)
Total changes in fair value included in Net income (loss)	<u>\$ (1,827)</u>	<u>\$ (2,214)</u>

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

	September 30, 2012	December 31, 2011
Fair value.....	\$ 51,176 ⁽¹⁾	\$ 49,335 ⁽¹⁾
Unpaid principal outstanding.....	47,282	45,571
Fair value over unpaid principal outstanding.....	\$ 3,894	\$ 3,764

⁽¹⁾ Includes accrued interest of \$423 million at September 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, 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 (losses) 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 September 30, 2012 and December 31, 2011, and their related gains and losses for the three and nine months ended September 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	September 30, 2012 ⁽¹⁾		December 31, 2011 ⁽¹⁾	
		Assets	Liabilities	Assets	Liabilities
Currency Swaps	Currency and interest rate swaps				
	Investments - Trading	\$ 18	\$ 70	\$ 11	\$ 45
	Loans	12	324	109	186
	Borrowings	5,349	508	4,785	703
	Accrued interest and other charges	191	(35)	113	(69)
Interest Rate Swaps	Currency and interest rate swaps				
	Investments - Trading	-	53	-	35
	Loans	3	1,662	3	1,472
	Borrowings	2,159	130	1,917	91
	Other	323	-	215	-
	Accrued interest and other charges	171	75	252	89
		<u>\$ 8,226</u>	<u>\$ 2,787</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 September 30,		Nine months ended September 30,	
		2012	2011	2012	2011
Currency Swaps					
Investments - Trading	Income from investments:				
	Interest	\$ (5)	\$ (6)	\$ (14)	\$ (19)
	Net gains (losses)	5	(23)	16	(10)
Loans	Income from loans, after swaps	(23)	(24)	(66)	(72)
	Net fair value adjustments on non-trading portfolios	(75)	297	(220)	193
Borrowings	Borrowing expenses, after swaps	264	290	795	886
	Net fair value adjustments on non-trading portfolios	473	(1,152)	448	(294)
	Other comprehensive income (loss) - Translation adjustments	5	9	37	3
Interest Rate Swaps					
Investments - Trading	Income from investments:				
	Interest	(5)	(8)	(17)	(21)
	Net gains (losses)	(8)	(24)	(11)	(26)
	Other comprehensive income (loss) - Translation adjustments	(54)	51	(22)	(33)
Loans	Income from loans, after swaps	(90)	(105)	(277)	(310)
	Net fair value adjustments on non-trading portfolios	(54)	(948)	(190)	(1,064)
Borrowings	Borrowing expenses, after swaps	205	207	598	632
	Net fair value adjustments on non-trading portfolios	89	754	185	767
	Other comprehensive income (loss) - Translation adjustments	2	(9)	-	-
Other	Other interest income	30	32	81	83
	Net fair value adjustments on non-trading portfolios	58	251	109	292
Futures	Income from investments:	-	-	-	-
	Net gains (losses)	-	(1)	-	(2)
		<u>\$ 817</u>	<u>\$ (409)</u>	<u>\$ 1,452</u>	<u>\$ 1,005</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 September 30, 2012 is \$286 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 \$47 million at September 30, 2012 (\$0 million at December 31, 2011).

The following tables provide information on the contract value/notional amounts of derivative instruments as of September 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	September 30, 2012			
	Currency swaps		Interest Rate swaps	
	Receivable	Payable	Receivable	Payable
Investments - trading				
Fixed	\$ -	\$ 2,139	\$ -	\$ 2,271
Adjustable	2,118	-	2,271	-
Loans				
Fixed	-	1,052	115	11,487
Adjustable	2,304	1,314	11,487	115
Borrowings				
Fixed	21,510	209	38,216	349
Adjustable	3,730	21,249	5,107	41,527
Other				
Fixed	-	-	8,610	-
Adjustable	-	-	-	8,610

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 September 30, 2012 and December 31, 2011 by level within the fair value hierarchy (in millions):

Financial assets:

Assets	Fair Value Measurements			
	September 30, 2012⁽¹⁾	Level 1	Level 2	Level 3
Investments - Trading:				
Obligations of the United States Government and its corporations and agencies.....	\$ 6,480	\$ 6,480	\$ -	\$ -
U.S. Government-sponsored enterprises.....	463	-	463	-
Obligations of non-U.S. governments and agencies.....	7,389	449	6,940	-
Bank obligations.....	4,486	-	4,486	-
Corporate securities.....	11	-	11	-
Mortgage-backed securities.....	1,036	-	1,030	6
U.S. residential.....	363	-	363	-
Non-U.S. residential.....	352	-	346	6
U.S. commercial.....	115	-	115	-
Non-U.S. commercial.....	206	-	206	-
Asset-backed securities.....	614	-	546	68
Collateralized loan obligations.....	383	-	383	-
Other collateralized debt obligations.....	113	-	45	68
Other asset-backed securities.....	118	-	118	-
Total Investments - Trading.....	<u>20,479</u>	<u>6,929</u>	<u>13,476</u>	<u>74</u>
Currency and interest rate swaps.....	8,226	-	8,226	-
Total.....	<u>\$ 28,705</u>	<u>\$ 6,929</u>	<u>\$ 21,702</u>	<u>\$ 74</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 \$58 million for trading investments and \$362 million for currency and interest rate swaps.

Assets	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.....	<u>13,743</u>	<u>2,117</u>	<u>11,551</u>	<u>75</u>
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:

Liabilities	Fair Value Measurements			
	September 30, 2012 ⁽¹⁾	Level 1	Level 2	Level 3
Borrowings measured at fair value.....	\$ 51,176	\$ -	\$ 51,176	\$ -
Currency and interest rate swaps	2,787	-	2,787	-
Total.....	<u>\$ 53,963</u>	<u>\$ -</u>	<u>\$ 53,963</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 \$423 million for borrowings and under Accrued interest and other charges of \$40 million for currency and interest rate swaps.

Liabilities	Fair Value Measurements			
	December 31, 2011 ⁽¹⁾	Level 1	Level 2	Level 3
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 nine months ended September 30, 2012 and 2011 (in millions). There were no financial liabilities measured at fair value using significant unobservable inputs for the three and nine months ended September 30, 2012 and 2011. In addition, the tables show the total gains

and losses included in Net income (loss) 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 September 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:

	Three months ended September 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 period	\$ 73	\$ -	\$ 73	\$ 95	\$ -	\$ 95
Total gains (losses) included in:						
Net income (loss).....	4	-	4	(3)	-	(3)
Other comprehensive income (loss).....	1	-	1	(4)	-	(4)
Settlements.....	(4)	-	(4)	(7)	-	(7)
Transfers out of Level 3	-	-	-	-	-	-
Balance, end of period.....	<u>\$ 74</u>	<u>\$ -</u>	<u>\$ 74</u>	<u>\$ 81</u>	<u>\$ -</u>	<u>\$ 81</u>
Total gains (losses) for the period included in:						
Net income (loss) attributable to the change in unrealized gains or losses related to assets still held at the end of the period.....	<u>\$ 4</u>	<u>\$ -</u>	<u>\$ 4</u>	<u>\$ (4)</u>	<u>\$ -</u>	<u>\$ (4)</u>

	Nine months ended September 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 (loss).....	17	-	17	11	-	11
Other comprehensive income (loss).....	(1)	-	(1)	-	-	-
Settlements.....	(17)	-	(17)	(23)	-	(23)
Transfers out of Level 3	-	-	-	(7)	-	(7)
Balance, end of period.....	<u>\$ 74</u>	<u>\$ -</u>	<u>\$ 74</u>	<u>\$ 81</u>	<u>\$ -</u>	<u>\$ 81</u>
Total gains (losses) for the period included in:						
Net income (loss) attributable to the change in unrealized gains or losses related to assets still held at the end of the period.....	<u>\$ 16</u>	<u>\$ -</u>	<u>\$ 16</u>	<u>\$ 9</u>	<u>\$ -</u>	<u>\$ 9</u>

As of September 30, 2012, the investment portfolio includes \$74 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 September 30,			
	2012		2011	
	Total Gains (Losses) included in Net Income (Loss) for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period	Total Gains (Losses) included in Net Income (Loss) for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period
Income from investments.....	\$ 4	\$ 4	\$ (4)	\$ (4)
Total	<u>\$ 4</u>	<u>\$ 4</u>	<u>\$ (4)</u>	<u>\$ (4)</u>

	Nine months ended September 30,			
	2012		2011	
	Total Gains (Losses) included in Net Income (Loss) for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period	Total Gains (Losses) included in Net Income (Loss) for the Period	Change in Unrealized Gains (Losses) related to Assets Still Held at End of Period
Income from investments	\$ 17	\$ 16	\$ 10	\$ 9
Total	\$ 17	\$ 16	\$ 10	\$ 9

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 \$71,578 million as of September 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 \$20,008 million as of September 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 nine months ended September 30, 2012 and 2011 comprise the following (in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Change in fair value of derivative instruments due to movements in:				
Exchange rates	\$ 346	\$ (1,596)	\$ 148	\$ (870)
Interest rates	121	798	161	764
Other	24	-	23	-
Total change in fair value of derivatives	491	(798)	332	(106)
Change in fair value of borrowings due to movements in:				
Exchange rates	(396)	1,908	(293)	1,094
Interest rates	57	(1,575)	(71)	(1,724)
Total change in fair value of borrowings	(339)	333	(364)	(630)
Currency transaction gains (losses) on borrowings and loans at amortized cost	52	(313)	148	(230)
Total	\$ 204	\$ (778)	\$ 116	\$ (966)

Net fair value gains on non-trading derivatives resulting from changes in interest rates were \$161 million for the first nine months of 2012. These gains were partially offset by fair value losses on borrowings of \$71 million. The income volatility related to movements in interest rates, which amounted to a gain of \$90 million for the nine months period ended September 30, 2012, compared to a loss of \$960 million for the same period last year, was primarily due to gains associated with changes in the Bank's credit spreads on the borrowing portfolio (approximately \$142 million), partially offset by losses from changes in swap basis spreads (approximately \$56 million). Fair value losses on lending swaps (\$227 million), net of gains from equity duration swaps (\$109 million), were offset by gains on swaps where the associated bond was not elected for fair value treatment (\$146 million), following the new fair value option accounting policy established in 2011.

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 nine months of 2012, exchange rate changes increased the value of borrowings and loans, resulting in a net loss of \$145 million (2011 – net gain of \$864 million), which was offset by a net gain from changes in the value of the borrowing and lending swaps of \$148 million (2011 – net loss of \$870 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 mil-

lion 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

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. See Note Q – Subsequent Events for additional IDB-9 related developments occurring after September 30, 2012.

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 nine months ended September 30, 2012 were as follows (in millions, except for share information):

	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				
September 30, 2012.	9,688,828	\$ 4,640	\$ 112,240	\$ 116,880

As of September 30, 2012, the Bank has collected \$278 million of the \$301 million IDB-9 paid-in subscribed capital. The remaining \$23 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 nine months of 2012 were \$65 million (2011 – \$69 million). As of September 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 nine months ended September 30, 2012 and 2011 (in millions):

	Pension Benefits			
	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Service cost.....	\$ 22	\$ 16	\$ 65	\$ 50
Interest cost.....	37	38	113	113
Expected return on plan assets.....	(46)	(47)	(138)	(142)
Amortization of:				
Prior service cost.....	-	-	-	1
Unrecognized net actuarial losses.....	8	-	23	-
Net periodic benefit cost.....	<u>\$ 21</u>	<u>\$ 7</u>	<u>\$ 63</u>	<u>\$ 22</u>
Of which:				
ORC's share.....	\$ 20	\$ 7	\$ 61	\$ 21
FSO's share.....	\$ 1	\$ -	\$ 2	\$ 1

	Postretirement Benefits			
	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Service cost.....	\$ 12	\$ 9	\$ 35	\$ 26
Interest cost.....	19	19	56	55
Expected return on plan assets.....	(19)	(19)	(56)	(56)
Amortization of:				
Prior service cost.....	2	9	6	28
Unrecognized net actuarial losses.....	4	-	13	-
Net periodic benefit cost.....	<u>\$ 18</u>	<u>\$ 18</u>	<u>\$ 54</u>	<u>\$ 53</u>
Of which:				
ORC's share.....	\$ 17	\$ 17	\$ 52	\$ 52
FSO's share.....	\$ 1	\$ 1	\$ 2	\$ 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 September 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 \$7,900 million at September 30, 2012 and \$2,967 at December 31, 2011. The Bank's total loans and guarantees outstanding to these VIEs were \$489 million and \$89 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 \$578 million at September 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 (LOSS) TO NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES

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

	Nine months ended September 30,	
	2012	2011
Net income (loss).....	\$ 611	\$ (394)
Difference between amounts accrued and amounts paid or collected for:		
Loan income.....	(98)	(96)
Investment income.....	(139)	(108)
Other interest income.....	(7)	-
Net unrealized gain on trading investments.....	(151)	(34)
Interest and other costs of borrowings, after swaps.....	202	135
Administrative expenses, including depreciation.....	49	3
Special programs.....	(15)	5
Net fair value adjustments on non-trading portfolios.....	(116)	966
Transfers to the IDB Grant Facility.....	91	200
Net (increase) decrease in trading investments.....	(5,733)	2,470
Provision (credit) for loan and guarantee losses.....	19	(19)
Net cash (used in) provided by operating activities.....	<u>\$ (5,287)</u>	<u>\$ 3,128</u>

Supplemental disclosure of noncash activities

	Increase (decrease) resulting from exchange rate fluctuations:	
Trading investments.....	\$ (13)	\$ 44
Loans outstanding.....	(15)	59
Borrowings.....	(29)	90
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 nine months ended September 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):

	Nine months ended	
	September 30,	
	2012	2011
Brazil.....	\$ 277	\$ 310
Mexico.....	286	289
Argentina.....	231	250

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 September 30, 2012 and December 31, 2011 (in millions):

	September 30,		December 31,	
	2012 ⁽¹⁾		2011 ⁽¹⁾	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash.....	\$ 1,645	\$ 1,645	\$ 1,189	\$ 1,189
Investments - trading.....	20,479	20,479	13,743	13,743
Loans outstanding, net.....	66,764	71,578	66,446	70,882
Currency and interest rate swaps receivable				
Investments - trading.....	10	10	5	5
Loans.....	11	11	103	103
Borrowings.....	7,871	7,871	7,077	7,077
Others.....	334	334	220	220
Borrowings				
Short-term.....	611	611	898	898
Medium- and long-term:				
Measured at fair value.....	51,176	51,176	49,335	49,335
Measured at amortized cost..	18,698	20,008	14,228	15,463
Currency and interest rate swaps payable				
Investments - trading.....	146	146	101	101
Loans.....	2,065	2,065	1,738	1,738
Borrowings.....	576	576	713	713

⁽¹⁾ Includes accrued interest.

NOTE Q – SUBSEQUENT EVENTS

Management has evaluated subsequent events through November 13, 2012, which is the date the financial statements were issued. As a result of this evaluation, except as disclosed below, there are no subsequent events that require recognition or disclosure in the Bank's Condensed Quarterly Financial Statements as of September 30, 2012.

On October 19, 2012, the Board of Executive Directors determined that February 28, 2013 would be the effective date for the second installment of the increase in the Ordinary Capital paid-in and callable capital stock, and that, moreover, the third and fourth installments would become effective on February 28, 2014 and February 28, 2015, respectively, and that the fifth installment would become effective on February 29, 2016, or such later dates as the Board of Executive Directors shall determine.