



MANAGEMENT'S DISCUSSION AND
ANALYSIS (FY05) AND FINANCIAL STATEMENTS

CONTENTS

MANAGEMENT'S DISCUSSION AND ANALYSIS (FY05)

Overview
Development Activities
Outlook and Challenges
Funding Sources
Liquidity and Investment Management
Risk Management
Critical Accounting Policy
Results of Operations
Corporate Governance
Management's Assertion Regarding COSO
COSO Assertion of Independent Accountants

FINANCIAL STATEMENTS

Report of Independent Accountants
Balance Sheet
Statement of Income
Statement of Comprehensive Income
Statement of Changes in Shareholders' Equity
Statement of Cash Flows
Statement of Subscriptions to Capital Stock and Voting Power
Statement of Guarantees Outstanding
Notes to Financial Statements

MANAGEMENT'S DISCUSSION & ANALYSIS (FY05)

OVERVIEW

Established in 1988, the Multilateral Investment Guarantee Agency (MIGA) is an international organization and a member of the World Bank Group, which also includes the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the International Finance Corporation (IFC) and the International Centre for Settlement of Investment Disputes (ICSID). MIGA is a legal entity separate and distinct from IBRD, IDA, IFC and ICSID, with its own charter (the "Convention"), share capital, financial structure, management, and staff. Its membership, which currently stands at 165, is open to all countries that are members of the IBRD.

MIGA's mission is to promote foreign direct investment (FDI) into developing countries, to support economic growth, reduce poverty and improve people's lives. To this end, the agency's vision is to be a multilateral risk mitigator, providing products and services that encourage potential investors into developing countries and provide the necessary comfort to alleviate concerns over political (non-commercial) risks. The agency's core business is the provision of political risk insurance. In addition, MIGA has a mandate to carry out complementary activities—including technical assistance activities, mediation, and online services—to support productive FDI.

MIGA is committed to promoting projects that promise a strong development impact, and that are economically, environmentally, and socially sustainable. The agency is also dedicated to working with governments that are committed to policies and actions that improve their countries' investment climates. By providing political risk insurance for foreign direct investment, technical assistance, and other activities, MIGA is able to play a critical role in supporting the World Bank Group's broad strategic priorities.

Since its creation through the end of fiscal year 2005 (FY05), MIGA has issued \$14.7 billion in guarantee coverage, in support of more than 486 projects in 91 developing member countries. The agency has also conducted hundreds of technical assistance activities in member countries, as well as multiple programs that have operated at regional and global levels.

MIGA is financially self-sustaining, and its activities are supported by a robust capital base. MIGA is able to fund its administrative budget, while maintaining the strength of its balance sheet, through a combination of premium income and investment income.

MIGA prepares its financial statements in accordance with accounting principles generally accepted in the United States of America (US GAAP) and International Financial Reporting Standards (IFRS).

DEVELOPMENT ACTIVITIES

Summary of Business Segments

MIGA's mission is to promote FDI into developing countries, to support economic growth, reduce poverty and improve people's lives. MIGA seeks to fulfill this mandate in member countries by offering political risk insurance, technical assistance, online dissemination of information and investment dispute mediation.

Political Risk Insurance (PRI)

MIGA provides investment guarantees against certain noncommercial risks (i.e., political risk insurance) to eligible foreign investors for qualified investments in developing member countries. Coverage is offered against the risks of transfer restriction and inconvertibility; expropriation; breach of contract; and war and civil disturbance, and investors may choose any combination of these coverages. MIGA insures new cross-border investments originating in any MIGA member country, destined for any developing member country. Types of investment that can be covered include equity, shareholder loans, and shareholder loan guarantees, provided the loans have a minimum maturity of three years. Other forms of investment, such as technical assistance and management contracts, or franchising and licensing agreements, may also be eligible.

From its establishment through June 30, 2005, MIGA has issued guarantees totaling \$14.7 billion to investors in 91 countries.

A summary of cumulative guarantees issued in member countries is contained in Table 1.

Box 1 Coverages of MIGA's Guarantees

MIGA provides four types of political risk insurance to eligible investors and lenders against noncommercial risk such as:

- **Transfer restriction and inconvertibility** – risk of inconvertibility of local currency into foreign exchange for transfer outside the host country. Currency depreciation is not covered.
- **Expropriation** – risk of partial or total loss of the insured investment as a result of acts by the host government that may reduce or eliminate ownership of, control over, or rights to the insured investment.
- **War and civil disturbance** – risk of damage to, or the destruction or disappearance of, tangible covered assets caused by politically motivated acts of war or civil disturbance in the host country including revolution, insurrection, coup d'état, sabotage and terrorism.
- **Breach of contract** – risk of being unable to obtain or enforce an arbitral or judicial decision recognizing the breach of an obligation by the host government.

Table 1 Cumulative Guarantees Issued in Member Countries

	FY05	FY04	FY03
Cumulative Guarantees Issued (\$ B) ^a	14.7	13.5	12.4
Host Countries ^b	91	85	85

^a Includes Cooperative Underwriting Program (CUP) contracts.

^b FY05 includes six new host countries: Belarus, Burkina Faso, Democratic Republic of Congo, Laos People's Democratic Republic, Latvia, and Thailand.

During FY05, MIGA supported 20 projects in IDA-eligible countries and 8 projects in sub-Saharan Africa, which are special areas of focus for the agency. In terms of exposure, IDA-eligible countries accounted for 42 percent of the gross portfolio, while coverage for projects in sub-Saharan Africa accounted for 16.5 percent. Table 2 details the regional distributions of MIGA's gross and net guarantee exposures over the past three years. The total gross and net exposures at June 30, 2005 amounted to \$5.1 billion and \$3.1 billion compared to \$5.2 billion and \$3.3 billion respectively at the end of FY04.

Table 2 Regional Distribution of Gross and Net Exposure

	Gross (\$ M)			Net (\$ M)			Total Net Exposure (%)		
	FY05	FY04	FY03	FY05	FY04	FY03	FY05	FY04	FY03
Africa	840	692	953	606	433	693	19.3	13.3	21.6
Asia	670	672	611	471	486	449	15.0	14.9	14.0
Europe and Central Asia	2,303	1,973	1,334	1,225	1,201	837	39.0	36.9	26.1
Latin America and Caribbean	1,257	1,736	2,197	757	989	1,168	24.1	30.3	36.5
Middle East and North Africa	154	243	167	144	215	146	4.6	6.6	4.6
Adjustment for Master Agreement	-130	-130	-179	-65	-65	-89	-2.0	-2.0	-2.8
Total	5,094	5,186	5,083	3,138	3,259	3,204	100.0	100.0	100.0

MIGA cooperates with national and private investment insurance schemes, through coinsurance and reinsurance arrangements to provide investors with broader investment insurance coverage and for the purpose of enhancing capacity and effectiveness. Under the Cooperative Underwriting Program, MIGA does not assume the credit risk of the private or public insurer.

Technical Assistance (TA)

MIGA provides technical assistance to help governments and government agencies involved in promoting foreign direct investment improve their ability to respond effectively to investors' needs. MIGA works with investment promotion intermediaries to develop their capacity to provide investors with information, advice, and other services, thereby helping to reduce the transaction costs associated with site selection, and subsequently, with establishing investments. MIGA has also developed and operates a suite of online investor information services to disseminate information on investment opportunities, business operating conditions, and potential business partners in emerging markets worldwide. In addition, MIGA's online FDI Promotion Center extends the reach of MIGA's capacity-building services by offering practical guidance to investment promotion intermediaries worldwide.

The scale and scope of MIGA's technical assistance activities have increased substantially over the years, with 30-40 projects ongoing at any given time. There has been a special focus on IDA countries, which represent around 40 percent of the TA portfolio, with Africa the primary regional beneficiary. The relative mix of activities and the nature of the interventions have also evolved, with a shift from one-off interventions to multi-year engagements. This has helped improve coordination and integration with other private sector development programs in the World Bank Group (WBG). In FY05, MIGA invested approximately \$5 million of its own budget in its TA programs (in staff, travel and other costs) while also mobilizing donor resources through trust funds.

Online Dissemination of Information

MIGA offers online dissemination of information on investment opportunities through four online products: FDI Xchange, IPAnet, Privatization Link and FDI Promotion Center. The online services team also supports technical assistance efforts by providing face-to-face and/or remote training in online investment promotion to more than 50 partners. During FY05, both average monthly user sessions and total number of registrants for all online services increased substantially from FY04. Meanwhile, MIGA enhanced the online services, e.g., by adding new resources to IPAnet and by expanding the available pool of “promotional tools” in the FDI Promotion Center. In FY05, MIGA invested approximately \$600,000, excluding regular staff costs, in its various online services.

Investment Dispute Mediation

Article 23 of the MIGA Convention mandates the agency to seek to remove impediments to the flow of investment to developing member countries and to encourage the settlement of disputes between investors and host governments. Pursuant to these mandates, the Agency has selectively offered mediation services to help resolve disputes between investors (not guaranteed by MIGA) and host countries which inhibit the flow of additional investment to the host country.

In general, MIGA seeks reimbursement for its out-of-pocket expenses and utilizes its own staff to mediate a small number of investment disputes annually. The amicable resolution of these disputes is the primary performance indicator and is evidenced by acknowledgement letters from the parties involved; the resolution of these disputes should subsequently facilitate the flow of investment to host countries.

OUTLOOK AND CHALLENGES

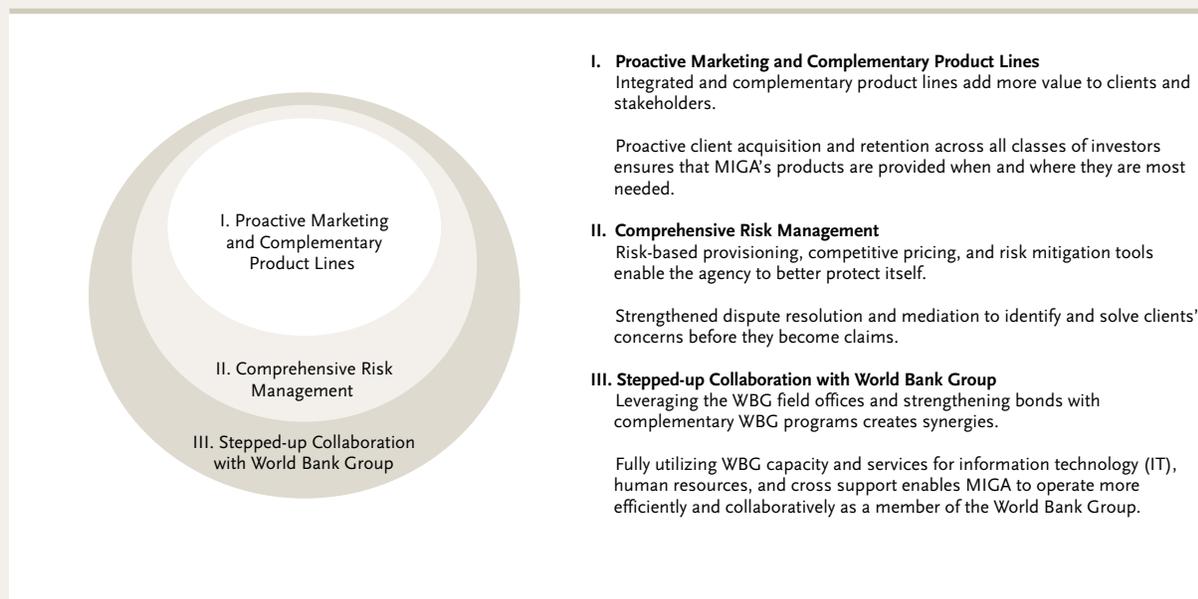
Market Positioning

MIGA has a well-established position and reputation as the “insurer of choice” for investors looking for a business partner that will help them mitigate risks in frontier markets. A recent survey of MIGA’s PRI clients indicates that when investors care primarily about the PRI provider’s ability to manage difficult political situations, the choice is generally MIGA. The survey also suggests that, going forward, investors see an increasing number of risky environments, where the management of risk is key in investment decisions.

New Business Model

At the end of FY04, MIGA management launched a business model that builds on its comparative advantages and strengthens its financial and operational sustainability over the long-term. It centers on MIGA’s unique role as a multilateral risk mitigator, drawing on its governance structure to support development in ways that add value and complement the activities of others. This implies a focus on areas that public and private entities cannot serve as well, such as higher-risk markets, and other areas where MIGA has a unique comparative advantage. MIGA’s new business model consists of three principal elements which leverage the agency’s comparative advantages and reinforce each other to form an integrated strategy: proactive marketing and complementary products; a comprehensive risk management framework; and stepped-up collaboration with the World Bank Group (WBG).

Figure 1 MIGA’s New Business Model



Organizational Realignment

In order to implement the new business model, MIGA was realigned so as to achieve a simpler and flatter organizational structure, which aimed at creating a more flexible and responsive organization. Under the realignment, the operational departments—guarantees and technical assistance—were brought together to form a new Operations Group. The move recognized that addressing the challenges of attracting and retaining FDI requires more than just political risk insurance. It requires that MIGA provide client countries an integrated package of products to address risk and related factors affecting an investment or a site selection decision. Integrating the two departments has allowed for the more efficient delivery of MIGA's products and services.

Operational Priorities

In May 2005, MIGA received the endorsement of its Board of Directors for the operational strategy outlined in the *Strategic Directions 2006-2008* paper. The strategy highlights four operational priorities that will guide decision-making going forward:

- **Supporting investment between developing countries (South-South investment).** Companies from developing countries are contributing a greater proportion of FDI flows into other developing countries. For these investors, political risk insurance can make a difference in the decision to go ahead or not, and MIGA has thus targeted these South-South investments under the MIGA 2005 strategic plan.
- **Supporting investment in infrastructure expansion and rehabilitation.** Ongoing and near-term efforts are focused on growing the pipeline of business in the infrastructure sector to increase the proportion of new business in infrastructure to 30-35 percent.
- **Increasing FDI in conflict-affected environments.** MIGA is planning to establish a new PRI facility for Africa in order to accelerate the recovery of the private sector and increase FDI flows to conflict-affected countries in the region. The facility will be financed through a combination of donor contributions and concessional lending from multilateral institutions.
- **Supporting growth in other frontier markets.** The near-term emphasis is in growing the business in the Middle East and North Africa, diversifying the base of guarantee business in Europe and Central Asia, supporting investors from key countries like China, India, Brazil, Turkey, and supporting client countries' ability to seize investment opportunities created by regional trade liberalization efforts in Latin America and the Caribbean.

MIGA's corporate strategy also calls for an aggressive program of marketing and outreach, targeting not just traditional investors in Europe and the US, but also investors in South Africa, Mauritius, and some investors in the Middle East and North Africa.

FUNDING SOURCES

Equity

Total shareholders' equity as reported in MIGA's balance sheet at June 30, 2005 was \$710 million compared with \$576 million at June 30, 2004. The increase from June 30, 2004 of \$134 million reflects primarily the increase in retained earnings of \$131 million resulting from a significant release of provision in FY05 of \$107 million and operating income of \$24 million.

MIGA's equity base ensures the financial sustainability of the agency, over both the short term and longer term. The subscribed capital and retained earnings determine the agency's statutory underwriting capacity, and the Council of Governors and the Board of Directors have set the maximum amount of contingent liability that may be assumed by MIGA at 350 percent of the sum of MIGA's unimpaired subscribed capital and its retained earnings plus 90 percent of reinsurance ceded by MIGA with private insurers and 100 percent of reinsurance ceded with public insurers. At June 30, 2005, MIGA's underwriting capacity was \$9,837 million, as follows:

Table 3 Current Underwriting Capacity (\$ M)

Subscribed Capital	\$1,827
Retained Earnings	357
Accumulated Other Comprehensive Income	3
Insurance Portfolio Reserve—Net	120
Total	2,307
350 Percent of Subscribed Capital, Retained Earnings, Other Comprehensive Income and Reserve	8,075
90 Percent of Reinsurance Ceded with Private Insurers	1,749
100 Percent of Reinsurance Ceded with Public Insurers	13
Statutory Underwriting Capacity—June 30, 2005	\$9,837

At June 30, 2005, MIGA's gross exposure of \$5,094 million represented 52 percent of MIGA's statutory underwriting capacity.

For purposes of measuring its risk-bearing capacity, MIGA uses the ratio of operating capital over net exposure. Operating capital includes paid-in-capital, retained earnings, and the insurance portfolio reserve, net of the corresponding reinsurance recoverable. MIGA management's objective is to have sufficient operating capital to sustain losses associated with claims and to support the ongoing business without facing a significant risk of having to call on the callable capital. Table 4 shows the ratio of operating capital to net exposure over the past three years. This ratio, which increased from 24.9 percent in FY04 to 26.4 percent in FY05, remains satisfactory.

Table 4 Risk-Bearing Capacity (FY03-05, \$ M)

	FY05	FY04	FY03
Net Exposure	\$ 3,138	\$ 3,259	\$ 3,204
Insurance Portfolio Reserve—Net ^a	120	235	286
Retained Earnings and Accumulated Other Comprehensive Income	361	228	141
Paid-in Capital	349	348	339
Operating Capital	830	811	766
Operating Capital/Net Exposure	26.4%	24.9%	23.9%

^a In FY03 and FY04, these were shown as general claims reserves.

Capital

MIGA derives its financial strength primarily from the capital it receives from its shareholders. In FY05, the Maldives completed its membership requirements, bringing the total number of member countries to 165.

The MIGA Convention established MIGA's authorized capital stock (membership shares) at 100,000 shares equivalent to \$1,082 million with a provision that the authorized capital stock shall automatically increase on the admission of a new member to the extent that the then authorized shares are insufficient to provide the shares to be subscribed by such member. At June 30, 2005, the authorized membership shares increased to 104,987 shares, equivalent to \$1,136 million, which have all been subscribed by the 165 member countries. Of the membership shares subscribed, 20 percent or \$227.2 million had been paid-in and the remaining eighty percent or \$908.8 million was subject to call when needed by MIGA to meet its obligations. Of the paid-in capital, \$108.9 million was in promissory notes. The notes are denominated in freely convertible currencies and are due on demand to meet MIGA's obligations. Since inception, MIGA has not encashed any of the promissory notes.

On March 29, 1999, MIGA's Council of Governors approved a General Capital Increase (GCI) of 78,559 shares, equivalent to \$850 million. The subscription period ended on March 28, 2003. On March 17, 2003, the Council of Governors approved an amendment to the GCI resolution allowing eligible countries to reserve the GCI shares allocated to them by submitting an instrument of contribution before the end of the GCI subscription period, and requesting such countries to subscribe to their GCI shares as soon as possible. The reserved shares are issued and corresponding voting power accrues when the subscription process reaches completion, i.e., when the required payment has been received. No time limit has been set for the payment of the reserved shares. As of June 30, 2005, cumulative subscriptions to the GCI totaled 63,821 shares, equivalent to \$690.5 million, and GCI shares reserved through instruments of contribution totaled 12,441 shares, equivalent to \$134.6 million. Of the GCI shares subscribed, \$121.9 million has been paid-in and \$568.6 million is callable.

Table 5 Summary of General Capital Increase (as of June 30, 2005)

	Category One		Category Two		All Countries	
	Number	\$ M	Number	\$ M	Number	\$ M
Fully Subscribed	19	\$284.5	82	\$244.0	101	\$528.5
Partly Subscribed	2	159.2	1	2.8	3	162.0
Total Subscribed	21	443.7	83	246.8	104	690.5
Reserved through						
Instrument of Contribution		50.1	30	84.5	30	134.6
Total Subscribed and Reserved	21	493.8	113	331.3	134	825.2
Allocated	21	493.8	140	356.2	161	850.0
Subscribed (percent)		89.9		69.3		81.2
Subscribed and Reserved (percent)		100		93.0		97.1

As of June 30, 2005, MIGA's total subscribed capital amounted to \$1,826.5 million, of which \$349.1 million was paid-in and \$1,477.4 million was callable. Since its inception, no call has been made on MIGA's callable capital. Any calls on unpaid subscriptions shall be uniform on all shares. If the amount received by MIGA on a call is insufficient to meet the obligations which necessitated the call, MIGA may make further successive calls until the amounts received are sufficient to meet such obligations. The liability of a member on a call or calls shall be limited to the unpaid balance of its capital subscription.

During FY05, the Council of Governors approved the solution proposed by MIGA management for reaching voting parity between Category One and Category Two countries. This solution involves the introduction of a parity factor that allocates the same number of parity votes to every member country and can be easily adjusted when there are changes in membership.

LIQUIDITY AND INVESTMENT MANAGEMENT

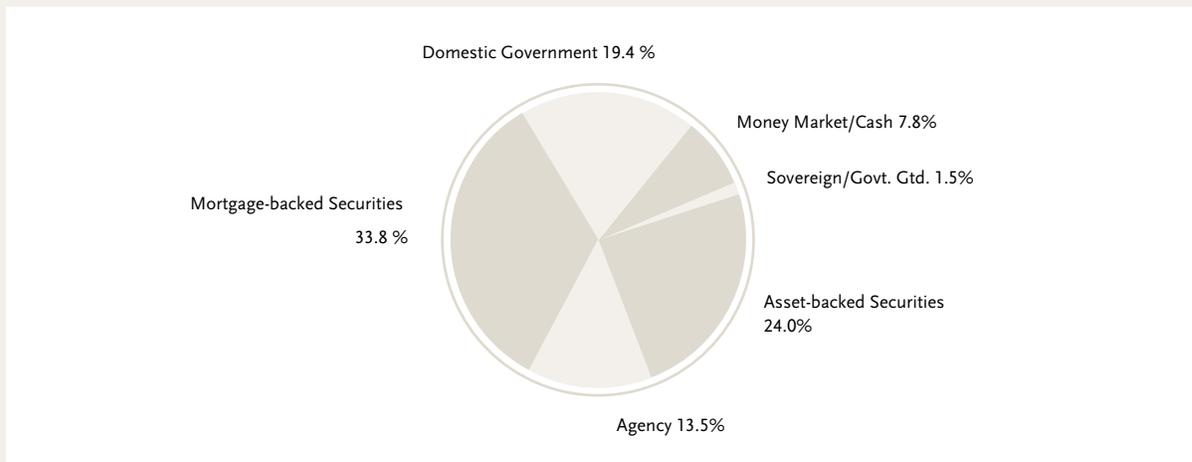
The investment of MIGA's liquid assets plays an important role in supporting risk-taking in underwriting. Although substantial drawdowns of the investment portfolio have not occurred in the past, they should be expected to happen from time to time, given the nature of MIGA's underwriting business. As a result, management deems the following three main rationales as appropriate for MIGA's investment strategy.

- **Providing liquidity for identified claims.** MIGA must be able to draw on the investment portfolio to pay for claims and potential claims that it has already identified. MIGA keeps track of projects where the investor is experiencing problems or is involved in a dispute with government authorities, and the investment portfolio must allow for payment of claims on a pre-recovery basis.
- **Providing liquidity for unidentified claims.** MIGA also needs to be prepared to pay for claims that have not yet been identified at the contract level. Even though the precise amount of such claims is unknown, it is possible to construct portfolio models to estimate the most likely aggregate size of such claims, as well as to estimate their maximum size at a given confidence level. The agency recently developed an economic capital model that provides for the structuring of the investment portfolio to cover claims that are not yet identified at the contract level but can be estimated statistically.
- **Providing capital growth.** While the investment portfolio at any given time must be managed to ensure MIGA's ability to pay identified and unidentified claims, the rate of return on the portfolio also plays a crucial role in enhancing MIGA's future financial strength.

MIGA's investment portfolio is managed in two tranches under the Investment Authorization approved by the Board in June 2004, with the above three objectives in mind. Tranche 1 is managed with a risk tolerance of 1% probability of annual capital loss over a one-year horizon and Tranche 2 is managed with a 1% probability of annual capital loss over a three-year horizon. MIGA management sets the investment policy, including risk tolerance and asset allocation with the analytical support of IBRD's Treasury. Portfolio management activities, including trading, risk analytics and reporting, are executed by IBRD's Treasury under an Investment Management Agreement (IMA) between MIGA and IBRD and the associated Investment Management Guidelines.

The bulk of MIGA's portfolio is in US dollars (USD) and the composition of the USD holdings is detailed in Figure 2. During FY05, the USD investment portfolio consisted of cash and securities including Treasury securities, agency securities, mortgage-backed securities (MBS) and asset-backed securities (ABS). In addition, the portfolio included cash and government securities denominated in other currencies. Overall, the management of the portfolio generated a return of 2.7% in FY05 on an economic basis and 2.3% on an accounting basis, after taking into consideration a one-time mark-to-market of unrealized losses on account of a change in the accounting treatment of the investment portfolio from "available-for-sale" to "trading securities".

Figure 2 Portfolio Composition of MIGA's US Dollar Holdings



In addition, MIGA maintains several credit facilities for the purpose of managing liquidity. As of June 30, 2005, these credit facilities totaled \$125 million. MIGA would draw on these credit lines to cover a portion of a high percentile insurance loss. Some of these credit facilities will expire in FY06. The agency is currently reviewing its liquidity needs and will decide early in FY06 which credit facilities it should renew and carry forward.

RISK MANAGEMENT

Controlled acceptance of political risks in developing countries is MIGA's primary business and the underwriting of those risks requires a strong and comprehensive risk management framework that analyzes, measures, mitigates and controls the risk exposures. It is also essential to understand the risk exposures on an enterprise-wide perspective.

Risk Management Organization

The responsibility for approving MIGA's risk management policies lies with the Board of Directors. The committee of the Board that deals with risk management issues is the Audit Committee.

While the Executive Vice President assumes the responsibility for overall risk management with the support of the senior management team, the responsibility for the design and operational implementation of the risk management framework lies with the Finance and Risk Management Group under the leadership of the Director and Chief Financial Officer, in coordination with colleagues across the agency.

In particular, the Legal Affairs and Claims Group handles claims and dispute situations. The Policy and Economics Group analyzes country risks and maintains MIGA's internal country ratings. The Insurance Operations Support Team within the Operations Group monitors reinsurer creditworthiness.

Risk Landscape and Risk Management per Category

MIGA broadly distinguishes three types of risks: insurance risks, investment risks, and operational and other risks.

Insurance risks can be divided into two categories:

1. Claims risk, the largest risk for MIGA, is the risk of incurring a financial loss as a result of a claimable political risk event in developing countries.
2. Reinsurance non-performance risk is the risk that reinsurers fail to pay their share of risk-taking in case of a claim.

Investment risks include the following risks:

1. Market risk is exposure to the risk that MIGA's invested assets are being negatively impacted by changes in financial markets risk factors, such as movements in interest rates and foreign exchange rates.
2. Prepayment risk for MBS holdings is the uncertainty related to unscheduled prepayment in excess of scheduled principal repayment.
3. Spread risk is related to differences in the relative price of corporate bonds, MBS, ABS and Treasury bonds.
4. Credit risk is the risk of incurring a financial loss due to adverse changes in the creditworthiness of issuers of fixed income assets.

Operational and other risks are risks that are inherent in MIGA's business undertaking.

1. Operational risk is the potential for loss resulting from inadequate or failed internal processes or systems, human factors, or external events, and includes business interruption and system failure, transaction processing failures and failures in execution of legal, fiduciary and agency responsibilities.
2. Other risks comprise legal risk, human resource risk, and reputational risk.

Management of major risks is described below:

■ *Claims risk management*

Claims risk arises from the underwriting activities of the agency. Political risk assessment forms an integral part of MIGA's underwriting process, and includes the analysis of both country-related and project-related risks.

Country risk assessment is a combination of quantitative and qualitative analysis, assessing the probability of a claimable event taking place as captured in a comparative rating scale. Ratings are assigned individually to each risk for which MIGA provides insurance coverage in a country. Country ratings are reviewed and updated every quarter. Country risk analysis forms the basis of the underwriting of political risk guarantees, setting of premium levels, and provisioning for claims.

The project-specific risk assessment process is performed by a cross-functional team from MIGA's Operations, Policy and Economics, and Legal Affairs and Claims Groups. Based on the analysis of project-specific risk factors within the country context, the final project risk ratings can be higher or lower than the country ratings per coverage. The decision to issue a guarantee is subject to approval by MIGA's senior management, followed by endorsement by the Board of Directors.

In order to prevent excessive risk concentration, MIGA sets exposure limits per country and per project. In addition, MIGA's reinsurance program, including treaty and facultative reinsurance, helps manage the risk profile of the portfolio. Finally, MIGA's risk-based pricing framework provides the basis to ensure ex ante that sufficient premium income can be expected to provide appropriate compensation for both standalone and concentration risks of guarantee contracts that MIGA underwrites.

- **Reinsurer non-performance risk management**

Non-performance risk exposure arises from MIGA's reinsurance program. MIGA requires that reinsurers be rated by at least two of the four major rating agencies (Standard & Poor's, A.M. Best, Moody's and Fitch), and that the ratings be above a minimum threshold. In addition, MIGA may also place reinsurance with public insurers of member countries that operate under and benefit from the full faith and credit of their governments, therefore representing a negligible counterparty risk to MIGA.

MIGA has established limits, at both the project and portfolio levels, which restrict the amount of reinsurance. The project limit states that MIGA may reinsure no more than 90 percent of any individual project. The portfolio limit states that MIGA may not reinsure more than 50 percent of its aggregate gross exposure (excluding reinsurance placed with public insurers that benefit the full faith and credit of the relevant member country).
- **Investment risk management**

MIGA's investment portfolio is exposed to the risk of loss of portfolio value resulting from adverse fluctuations in interest rates and foreign currency exchange rates, spreads, convexity, and prepayment. Because the portfolio is invested in fixed income securities, the primary investment risk for MIGA is interest rate risk. Other risks are small, although prepayment risk may become more important due to the gradual increase in MIGA's MBS holdings. To manage investment risks in the investment portfolio, MIGA has defined investment guidelines for portfolio managers, which includes a series of constraints and limits.

MIGA's investment portfolio does not have any significant credit risk exposure. MIGA invests only in fixed-income securities with high-credit quality. The Investment Authorization stipulates that government or agency sponsored debt securities need to be AA-rated or above, time deposits need to be A-rated or above, and corporate debt securities have to be AAA-rated.
- **Operational risk management**

Operational risk is intrinsic to financial institutions and is an important component of the agency-wide risk management framework. The most important types of operational risk involve breakdowns in internal controls and corporate governance.

MIGA attempts to mitigate key operational risks by maintaining a system of internal control. Since 2000, MIGA, in line with IBRD/IDA and IFC, has used a COSO-based integrated internal control framework.

In FY04, MIGA adopted the same operational risk management system (Horizon) as IBRD and uses it to strengthen the annual review process and to enhance the management's ability to monitor the operational risks with a higher degree of detail and consistency. Key risks and controls in financial reporting were assessed and documented in Horizon, and the results were examined through the internal quality assurance review process. It was found that, overall, controls are both in place and effective. Opportunity for further improvements exist in processing and governance, for which action plans were established. The results of the review supported the annual management assertion on the effectiveness of internal control over external financial statements, which in turn was examined by the external auditors and a formal acknowledgment ("attestation") was provided.

With regard to information technology infrastructure, MIGA has taken steps over the past year to leverage IBRD's systems infrastructure and services. From an IT risk management perspective, in particular, all mission critical databases have been migrated to the IBRD's server infrastructure and secure facilities. As a result, all mission critical applications in MIGA are now replicated at headquarters and at the World Bank Group's Business Continuity Center, resulting in a significant reduction of the risk of interruption of service.
- **Legal risk management**

Legal risks arise primarily from changes in the legal parameters of MIGA's member countries as a result of legislation or court decisions that may affect MIGA's activities. There are also legal risks associated with MIGA being involved in legal disputes and arbitration proceedings, especially in the context of claim resolution or settlement.

MIGA manages these risks by monitoring current and prospective future developments by way of ongoing discussions with member countries' representatives on the Board of Directors and Council of Governors. MIGA also shares information and analysis with other members of the World Bank Group, the IMF and the United Nations. In addition, MIGA actively participates as a member of the Berne Union in discussions and analyses of the changes in the operating investment environment in its member countries.

Enterprise-wide Risk Modeling

During FY05, MIGA completed a project to develop an economic capital model, which is now used to quantify its insurance and investment risks in an integrated manner. The model can be used to estimate the amount of capital required to support the agency's guarantee business to a specified solvency standard. In FY06, management plans to formalize the use of this model to determine MIGA's overall capital adequacy and to make allocation of economic capital to particular regions, countries, or individual contracts, according to the risk contribution of those components.

MIGA's economic capital is based on the latent factor model of the Merton framework in credit risk modeling. Risk is measured on an enterprise-wide basis, taking into consideration the correlation effects between the claims risk, the reinsurance non-performance risk, and the investment risk. Key parameters, such as frequency of claim, severity, and expected recovery, have been quantitatively derived from the PRI industry's historical data, augmented by econometric scoring models. Those parameters are consistently used in MIGA's insurance pricing and reserving models.

In addition, the economic capital model incorporates various correlation parameters in order to quantify the diversification effects between MIGA's risk exposures. The most important correlations are those that describe the extent to which multiple claims are likely to occur simultaneously, either within the same country, within the same region, or across countries and regions. The model also uses correlations between reinsurer credit worthiness and insurance risk, and between the insurance risks and the investment risk based on quantitative analysis of relevant data.

CRITICAL ACCOUNTING POLICY

Reserve for Claims

The footnotes to MIGA's financial statements contain a summary of MIGA's significant accounting policies. Described below are those significant policies where MIGA management is required to make certain estimates and parameters when preparing its financial statements and accompanying notes to conform with both IFRS and US GAAP. Accounting estimates generally involve the development of parameters by management based on judgments about the outcome of future conditions, transactions or events. Because the outcome of future events is not known, actual results could differ from those estimates in a variety of areas. The area that management views as most critical with respect to the application of estimates and parameters is the establishment of its loss reserves.

During the first quarter of FY05, MIGA implemented a new provisioning methodology. The methodology builds on portfolio risk quantification models that use both individually assessed loss probabilities for projects at risk and rating-based loss probabilities that are applied to the entire guarantee portfolio. Under this new methodology, for the purpose of presentation in the financial statements, MIGA's reserve consists of two primary components: the **Specific Reserve** and the **Insurance Portfolio Reserve**. These components are defined based on the degree of probability and the basis of estimation.

Reserves are shown on a gross basis on the liability side of the balance sheet, and reinsurance assets on the asset side. On MIGA's balance sheet, the gross amounts of Specific Reserve and Insurance Portfolio Reserve are \$59.8 million and \$120.0 million respectively as of June 30, 2005. Due to the reinsurance arrangements, MIGA also recorded a Reinsurance Recoverable as part of assets and are \$24.3 million. On the income statement, MIGA recorded a release of provisioning of \$106.8 million. The majority of this release (\$101 million) represents a one-time adjustment as a result of the implementation of the new methodology. The remaining release of provision extends the trend over the last three fiscal years, and reflects a stable amount of net exposure together with improvements in country ratings and other risk parameters underlying MIGA's net guarantee portfolio.

Accounting Classification of Invested Assets

Another area where application of assumptions is involved is the method of determining impairments of investment portfolio. At the beginning of FY05, MIGA changed the accounting treatment of invested assets from "securities available for sale" (AFS) to "trading securities" (TS). TS classification is applicable when "trading generally reflects active and frequent buying and selling and trading securities are generally used with the objective of generating profits on short-term differences in price." TS classification is therefore more appropriate to MIGA's portfolio where return maximization plays a prominent role under the new investment policy given the fact that the portfolio managers are constantly monitoring performance vis-à-vis their assigned benchmarks, and may engage in short-term active trading when market opportunities arise, to attempt to out-perform benchmarks. As a result of the change in its classification, MIGA recorded a one-time \$3.2 million unrealized loss during the first quarter of FY05.

Pension and Other Postretirement Benefits

MIGA participates along with IBRD and IFC in a number of pension and postretirement benefit plans that cover substantially all of their staff members. All costs and assets and liabilities associated with plans are allocated between IBRD, IFC and MIGA based upon their employees' respective participation in the plans. The underlying actuarial assumptions, fair value of plan assets and funded status associated with these plans are based on financial market interest rates, past experience, and management's best estimate of future benefit changes and economic conditions. For further details, please refer to Notes to Financial Statements—Note G.

RESULTS OF OPERATIONS

Operating Income and Net Income

In FY05, the operating income declined to \$24.1 million compared to \$25.5 million in FY04 due to (1) a decline in net premium income and (2) an increase in administrative expenses. The increase in administrative expense was offset in large part by an increase in investment income which reached \$16.8 million in FY05 compared to \$14.2 million in FY04, despite recording a \$3.2 million unrealized loss following the change in accounting basis of the investment portfolio from "available for sale" to "trading." Net income amounted to \$131.0 million in FY05, an increase of \$43.0 million compared to FY04, due to a substantial release of provision for claims of \$106.8 million. The table below shows the breakdown of MIGA's net income.

Table 6 Analysis of Operating Income and Net Income (\$ M)

	FY05	FY04	FY03
Total Guarantees Issued	\$1,226	\$1,076	\$1,372
Gross Exposure	5,094	5,186	5,083
Net Exposure	3,138	3,259	3,204
Premium Income	57.1	57.9	53.9
Premium Ceded	(23.9)	(23.2)	(21.4)
Fees and Commissions	6.4	6.2	7.0
Net Premium Income	39.6	40.9	39.5
Income from Investments	16.8	14.2	25.3
Administrative and Other Expenses	(32.3)	(29.6)	(26.7)
Operating Income	24.1	25.6	38.1
Release of Provision for Claims	106.8	62.4	20.7
Net Income	131.0	88.0	58.8
Operating Capital	830	811	766
ROOC* (before provisions)	2.9%	3.2%	5.0%
ROOC (after provisions)	15.7%	10.9%	7.7%

* Return on operating capital.

Note: numbers may not add up due to rounding.

FY05 versus FY04

FY05 operating income was \$24.1 million, which was \$1.4 million lower compared to that of FY04. While MIGA issued \$1.23 billion in guarantees during FY05, \$150 million more than FY04, the premium income decreased by \$0.8 million. This was mainly due to a decrease in gross exposure resulting mostly from higher cancellations and reductions in FY05, which reached \$1.31 billion, compared to \$0.97 billion in FY04. In addition, the premium amount ceded to reinsurers increased by \$0.7 million in FY05 as the amount reinsured increased slightly between FY04 and FY05.

In FY05, administrative and other expenses increased by \$2.7 million compared to FY04 due to, for the large part, several one-time and step-up expenses associated with a corporate realignment, and the strengthening in IT systems to achieve closer integration with IBRD's system architecture, as well as an increase in World Bank Group charges as a result of MIGA's systematic efforts to leverage off the World Bank Group's infrastructure, experience and economies of scale with respect to corporate and support functions.

During FY05, MIGA implemented a new investment policy, and MIGA's investment portfolio generated \$16.8 million of investment income, including a one-adjustment related \$3.2 million unrealized loss. On an economic basis, the return reached 2.7% in FY05 compared to 0.99% in FY04. This significant increase in investment return was due to several factors, including a more favorable interest rate environment and changes in both the strategic asset allocation and the portfolio benchmarks associated with the implementation of the new investment policy.

In FY05, net income was significantly impacted by a substantial release of provision for claims of \$106.8 million, largely as a result of the adoption of a new provisioning methodology.

FY04 versus FY03

FY04 operating income amounted to \$25.5 million, \$12.6 million below FY03 despite a marginal increase in net premium income resulting from a increase in the average net exposure during FY04. The decrease in operating income was due to for the largest part a significant reduction in investment income of \$11.1 million compared to FY03. The unfavorable investment climate contributed to lower returns, thereby reducing the investment income despite an increase of the size of the investment portfolio from \$689 million in FY03 to \$729 million in FY04 associated with the implementation of GCI. Total administrative expenses in FY04 increased by \$2.9 million compared to FY03 mainly due to an increase in WBG charges of \$1.7 million.

In FY04, net income increased by \$29.1 million compared to \$58.8 million in FY03 due to a significant release of provision for claims. In FY04, the release of provision was \$62.4 million, as a result of several factors, including the cancellation of a large contract in the Dominican Republic, the reduction of the probability of claims for loan contracts in Argentina, continued improvement in geographical diversification and other portfolio changes.

CORPORATE GOVERNANCE

General Governance

Board Membership

In accordance with the Convention establishing the Multilateral Investment Guarantee Agency, members of MIGA's Board of Directors are appointed or elected by their member governments. Directors are neither officers nor staff of MIGA. The President is the only management member of the Board of Directors, serving as a non-voting member (except casting a deciding vote in case of an equal division) and as Chairman of the Board. The Directors have established several committees including:

- Committee on Development Effectiveness
- Audit Committee
- Budget Committee
- Personnel Committee
- Ethics Committee
- Committee on Governance and Administrative Matters

The Directors and their committees function in continuous session at the principal offices of MIGA, as business requires. Each committee's terms of reference establishes its respective roles and responsibilities. As committees do not vote on issues, their role is primarily to serve the full Board of Directors in discharging its responsibilities.

Audit Committee

Membership

The Audit Committee consists of eight members of the Board of Directors. Membership on the committee is determined by the Board of Directors, based upon nominations by the Chairman of the Board, following informal consultation with the Directors. In addition, membership of the committee is expected to reflect the economic and geographic diversity of MIGA's member countries. Other relevant selection criteria include seniority, continuity and relevant experience. Some or all of the responsibilities of individual committee members are performed by their alternates or advisors. Generally, committee members are appointed for a two-year term; reappointment to a second term, when possible, is desirable for continuity. Audit Committee meetings are generally open to any member of the Board who may wish to attend, and non-committee members of the Board may participate in the discussion. In addition, the Chairman of the Audit Committee may speak in that capacity at meetings of the Board of Directors, with respect to discussions held in the Audit Committee.

Key Responsibilities

The Audit Committee is appointed by the Board to assist it in the oversight and assessment of MIGA's finances and accounting, including the effectiveness of financial policies, the integrity of financial statements, the system of internal controls regarding finance, accounting and ethics (including fraud and corruption), and financial and operational risks. The Audit Committee also has the responsibility for reviewing the performance and recommending to the Board the appointment, of the external auditor, as well as monitoring the independence of the external auditor and meeting with it in executive session. The Audit Committee participates in oversight of the internal audit function, including reviewing the responsibilities, staffing and the effectiveness of internal audit. The committee also reviews the annual internal audit plan. In the execution of its role, the committee discusses with management, the external auditors, and the internal auditors, financial issues and policies which have a bearing on the institution's financial position and risk-bearing capacity. The Audit Committee monitors the evolution of developments in corporate governance and the role of audit committees on an ongoing basis and revised its terms of reference in FY04.

Communications

The Audit Committee communicates regularly with the full Board through distribution of the following:

- The minutes of its meetings.
- Reports of the Audit Committee prepared by the Chairman, which document discussions held. These Reports are distributed to the Directors, Alternates, World Bank Group senior management and the senior management of MIGA.
- "Statement(s) of the Chairman" and statements issued by other members of the committee.
- The Annual Report to the Board of Directors, which provides an overview of the main issues addressed by the committee over the year.

The Audit Committee's communications with the external auditor are described in the Auditor Independence section.

Executive Sessions

Members of the Audit Committee may convene in executive session at any time, without management present. Under the Audit Committee's terms of reference, it meets separately in executive session with the external and internal auditors.

Access to Resources and to Management

Throughout the year, the Audit Committee receives a large volume of information, which supports the preparation of the financial statements. The Audit Committee meets both formally and informally throughout the year to discuss financial and accounting matters. Directors have complete access to management. The Audit Committee reviews and discusses with management the quarterly and annual financial statements. The committee also reviews with the external auditor the financial statements prior to their publication and recommends them for approval to the Board of Directors.

The Audit Committee has the capacity, under exceptional circumstances, to obtain advice and assistance from outside legal, accounting or other advisors as deemed appropriate.

Code of Ethics

MIGA strives to foster and maintain a positive work environment that supports the ethical behavior of its staff. To facilitate this effort, the World Bank Group has in place a Code of Professional Ethics-Living our Values. MIGA has adopted the code which applies to all staff (including managing managers, consultants, and temporary employees) worldwide.

This code is available in nine languages on IBRD's website, www.worldbank.org. Staff relations, conflicts of interest, and operational issues, including the accuracy of books and records, are key elements of the code.

In addition to the code, an essential element of appropriate conduct is compliance with the obligations embodied in the Principles of Staff Employment, Staff Rules, and Administrative Rules, the violation of which may result in disciplinary actions. In accordance with the Staff Rules, senior managers must complete a confidential financial disclosure instrument with the Office of Ethics and Business Conduct.

Guidance for staff is also provided through programs, training materials, and other resources. Managers are responsible for ensuring that internal systems, policies, and procedures are consistently aligned with MIGA's ethical goals. In support of its efforts on ethics, MIGA offers a variety of methods for informing staff of these resources. Many of these efforts are headed by the following groups:

- The Office of Ethics and Business Conduct (OEBC) provides leadership, management and oversight for MIGA's ethics infrastructure including the Ethics HelpLine, a consolidated conflicts of interest disclosure/resolution system, financial disclosure, ongoing training to both internal and external audiences, and communication resources.
- The Department of Institutional Integrity (INT) is charged with investigating allegations of fraud and corruption in projects benefiting from World Bank Group funding or guarantees worldwide. The department also investigates allegations of misconduct by MIGA staff, and trains and educates staff and clients in detecting and reporting fraud and corruption in MIGA-guaranteed projects. The department reports directly to the President and is composed of professionals from a range of disciplines including financial analysts, researchers, investigators, lawyers, prosecutors, forensic accountants, and staff with operational experience across the World Bank Group.

MIGA has in place procedures for the receipt, retention and treatment of complaints received regarding accounting, internal control and auditing matters, including close collaboration with OEBC and INT.

Auditor Independence

In February 2003, the Board of Directors adopted a set of principles applicable to the appointment of the external auditor for the World Bank Group. Key features of those principles include:

- Prohibition of the external auditor from the provision of all non audit-related services.
- All audit-related services must be pre-approved on a case-by-case basis by the Board of Directors, upon recommendation of the Audit Committee.
- Mandatory rebidding of the external audit contract every five years.
- Prohibition of any firm serving as external auditors for more than two consecutive five-year terms.
- Mandatory rotation of the senior partner after five years.
- An evaluation of the performance of the external auditor at the mid-point of the five-year term.

In FY04, MIGA's external auditor, Deloitte and Touche, began a new five-year term and will have served 11 years as auditor upon completion of that term, pursuant to a one-time grandfathered exemption from the above-referenced ten-year limit. Even within a five-year term the service of the external auditors is subject to recommendation by the Audit Committee for annual reappointment and approval of a resolution by the Board of Directors.

As a standard practice, the external auditor is present as an observer at virtually all Audit Committee meetings and is frequently asked to present its perspective on issues. In addition, the Audit Committee meets periodically with the external auditor in private session without management present. Communication between the external auditor and the Audit Committee is ongoing, as frequently as is deemed necessary by either party. MIGA's auditors follow the communication requirements with audit committees set out under U.S. generally accepted auditing standards and International Standards on Auditing. In keeping with these standards, significant formal communications include:

- Quarterly and annual financial statement reporting.
- Annual appointment of the external auditors.
- Presentation of the external audit plan.
- Presentation of control recommendations and discussion of the COSO attestation and report.
- Presentation of a statement regarding independence.

In addition to committee meetings, individual members of the Audit Committee have independent access to the external auditor.



World Bank Group
Multilateral Investment Guarantee Agency

Management's Report Regarding Effectiveness of Internal Controls Over External Financial Reporting

7/28/2005

The management of the Multilateral Investment Guarantee Agency (MIGA) is responsible for the preparation, integrity, and fair presentation of its published financial statements and all other information presented in this annual report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and International Financial Reporting Standards and, as such, include amounts based on informed judgments and estimates made by management.

The financial statements have been audited by an independent accounting firm, which was given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Directors and committees of the Board. Management believes that all representations made to the independent auditors during their audit were valid and appropriate. The independent auditors' report accompanies the audited financial statements.

Management is responsible for establishing and maintaining effective internal control over external financial reporting for financial presentations in conformity with both accounting principles generally accepted in the United States of America and International Financial Reporting Standards. The system of internal control contains monitoring mechanisms, and actions are taken to correct deficiencies identified. Management believes that internal controls for external financial reporting, which are subject to scrutiny by management and the internal auditors, and are revised as considered necessary, support the integrity and reliability of the external financial statements.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

MIGA assessed its internal control over external financial reporting for financial presentations in conformity with both accounting principles generally accepted in the United States of America and International Financial Reporting Standards as of June 30, 2005. This assessment was based on the criteria for effective internal control over external financial reporting described in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this assessment, management believes that MIGA maintained effective internal control over external financial reporting presented in conformity

July 28, 2005

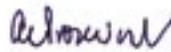
with both accounting principles generally accepted in the United States of America and International Financial Reporting Standards. The independent accounting firm that audited the financial statements has issued an attestation report on Management's assessment of MIGA's internal control over external financial reporting.

The Board of Directors of MIGA has appointed an Audit Committee responsible for monitoring the accounting practices and internal controls of MIGA. The Audit Committee is comprised entirely of Directors who are independent of MIGA's management. The Audit Committee is responsible for recommending to the Board of Directors the selection of independent auditors. It meets periodically with management, the independent auditors, and the internal auditors to ensure that they are carrying out their responsibilities.

The Audit Committee is responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of MIGA in addition to reviewing MIGA's reports. The independent auditors and the internal auditors have full and free access to the Audit Committee, with or without the presence of management, to discuss the adequacy of internal control over external financial reporting and any other matters which they believe should be brought to the attention of the Audit Committee.


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INDEPENDENT ACCOUNTANTS' REPORT

President and Board of Governors
Multilateral Investment Guarantee Agency

We have examined management's assertion, included in the accompanying *Management's Report Regarding Effectiveness of Internal Controls Over External Financial Reporting*, that the Multilateral Investment Guarantee Agency maintained effective internal control over external financial reporting presented in conformity with both accounting principles generally accepted in the United States of America and International Financial Reporting Standards as of June 30, 2005, based on the criteria established in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). Management is responsible for maintaining effective internal control over external financial reporting. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of the inherent limitations of internal control over external financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the effectiveness of the internal control over external financial reporting to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the Multilateral Investment Guarantee Agency maintained effective internal control over external financial reporting presented in conformity with both accounting principles generally accepted in the United States of America and International Financial Reporting Standards as of June 30, 2005, is fairly stated, in all material respects, based on the criteria established in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Deloitte & Touche LLP

July 28, 2005