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Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.

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Table Of Contents

Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.

Major Rating Factors

Issuer Credit Rating
AAA/Stable/A-1+

Strengths:

- Explicit government support, demonstrated by state's maintenance obligation and guarantee of FMO's financial commitments
- Strong financial profile and prudent financial management and policies

Weaknesses:

- Significant volatility in the income stream and high risk profile of its lending

Rationale

The ratings on Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (Netherlands Development Finance Co.; FMO) reflect strong sovereign support for the company, based on the operating maintenance obligation and the solvency commitment, which support the ratings at the same level as the State of The Netherlands (AAA/Stable/A-1+). FMO fulfils a strong public policy role as one of the government's vehicles for promoting private sector growth in developing countries. The state is the majority shareholder, with 51% of FMO's share capital.

Sovereign support was formally codified in the 1998 agreement between FMO and the state. Under Article 8 of the agreement, the state is legally required to enable FMO to meet its obligations on time. The duration of the agreement is indefinite and its termination requires 12 years' notice by either party. The Netherlands' long-term commitment to, and support of, FMO is also demonstrated by the sovereign's obligation in most circumstances to safeguard the company's solvency (Article 7 of the agreement).

FMO is a leading European development finance institution, with total assets of €2.7 billion in 2007 (for comparable data on similar institutions see commentary titled "Financial Data For Rated National Development Banks And Export Credit Agencies," published Aug. 20, 2008, on RatingsDirect). The company supports businesses and financial institutions in developing countries with capital and skills. It does so by arranging loans, equity investments, guarantees, and other investment promotion activities. It also manages several development funds on behalf and at the risk of the Dutch government.

Profitability in 2007 was high, with net income as a percentage of total average assets at 4.2% by year-end, This performance largely results from equity participations.

As FMO moves more into equity and mezzanine financing, financial results are likely to become more volatile, but FMO's more commercial approach and wider experience of managing emerging market risks will support long-term profitability. Overall, FMO continues to maintain adequate capitalization relative to its business, and its asset-liability management is conservative.

Outlook

The outlook on FMO mirrors that on The Netherlands and reflects Standard & Poor's Ratings Services' expectation that the 1998 agreement with the state will remain in force for the foreseeable future. Given that FMO already has a very strong capital base relative to its business, we do not expect the state to resume making capital contributions. The Dutch state, however, is in principle committed to future capital contributions if FMO's loan portfolio expansion requires it. FMO's prospects as a majority state-owned company with a strong public mandate and continued support from the state are considered secure.

Profile

FMO was established in 1970 by the state, several Dutch companies, and trade unions as a joint-stock company under the "Law of May 1, 1970, on Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V." Under FMO's Articles of Association, the company is mandated to promote the economic and social progress of developing countries by funding private sector investments in those countries in line with the Dutch government's policy goals on development cooperation. The state holds 51% of FMO and private Dutch banks hold 42%. The remaining shares are with private investors. FMO pays a moderate dividend to shareholders.

Until 1991, FMO was the government arm that financed investments in developing countries, mostly in the private sector. The agreement between the state and FMO signed in 1991 clearly defined FMO's more commercial approach and its focus on private sector operations, and conferred on the company a large degree of management and operational independence. The agreement was last amended in 1998, mainly to reassert its validity in the longer term and to extend and comprehensively define the government's financial support of, and obligations to, FMO.

The company's core business is to provide long-term funding to private companies and financial institutions in developing countries, primarily through long-term loans and equity investments. FMO also provides guarantees for third-party investments in developing economies and plays an active role in trade financing and syndicated loans. In addition, FMO manages several development funds and their associated risks on behalf of the government.

Table 1

FMO Balance Sheet

(Mil. €)	2007	2006	2005	2004	2003	2002	2001
Total assets	2,685.0	2,306.0	2,329.0	1,844.9	1,748.3	1,457.5	1,497.7
Loans (net)	1,276.0	1,098.5	991.8	885.3	847.9	829.1	961.6
Equity investment	337.5	215.9	127.9	93.4	81.9	79.2	103.5
Cash and interbank holdings	184.1	114.8	373.2	148.5	439.5	349.4	234.8
Marketable securities	585.6	633.9	626.5	569.4	147.8	115.5	132.2
Other assets	301.9	242.8	209.5	148.3	231.2	84.3	65.6
Total liabilities	1,502.9	1,222.8	1,378.8	1,060.5	1,015.4	782.2	864.3
Debt securities	1,117.9	1,004.0	1,139.4	895.2	913.7	647.9	777.2
Of which short-term	23.1	0.5	38.8	42.1	107.5	47.2	61.0
Banks	244.1	44.2	28.8	64.5	11.9	49.2	61.0
Customer deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other liabilities	140.9	174.6	210.6	100.8	89.8	85.1	26.0

Table 1

FMO Balance Sheet(cont.)							
Capital	1,182.2	1,083.1	950.2	784.3	732.9	675.3	633.4
Of which share capital (paid-in)	9.1	9.1	9.1	9.1	9.1	9.1	9.1
Of which reserves	1,143.8	1,044.8	911.8	746.0	694.6	636.9	595.1

Ownership And Legal Status: Bank Status Obtained

FMO obtained a banking license in March 2008 that will further ensure its processes are fully integrated and aligned with financial institution best practices. From 2008 onwards, FMO will thereby be supervised by the central bank. FMO still remains subject to The Netherland's Civil Code.

The Dutch government has retained 51% of FMO's shares since 1977, when it increased its stake from 50%. Major Dutch banks hold 42% and employer's associations, labor unions, private companies, and individuals own the remaining 7%. FMO's basic ownership structure is unlikely to change in the medium term. The 1998 agreement has an indefinite term and its termination requires 12 years' notice from either party. Moreover, FMO's authorized share capital comprises 49% 'B' shares, which may be held by the private sector, and 51% 'A' shares, which may only be issued to, and owned by, the state. Neither the state nor the private sector shareholders have shown any interest in altering the ownership structure.

Government Support Is Robust

The long-term commitment of the Dutch government to FMO and the importance of the company's public policy role are further reflected in the clear and robust state support of FMO's financial obligations and the state's commitment to continue funding FMO if necessary.

According to Article 8 of the 1998 agreement, "The state shall prevent situations arising in which FMO is unable to meet (its financial) commitments on time." The article comprehensively lists the types of obligations covered by this undertaking.

This obligation exists solely between the state and FMO. FMO's creditors do not have a direct claim against the state and Article 8 does not formally constitute a full, unconditional guarantee. Nevertheless, the pledge effectively ensures that FMO's obligations are fully supported by the state's credit standing. The Dutch central bank has allowed a 0% risk weighting to all the financial instruments and loans to FMO specified in Article 8. The robustness of the state's backing of FMO's obligations is further underpinned by the constitutionally binding nature of the 1998 agreement, which is an obligation for the state rather than the current government. Moreover, unlike other obligations that the state has toward FMO, Article 8 cannot be suspended under any circumstances while the agreement remains in force (Article 10).

Article 7 of the 1998 agreement also stipulates the state's "maintenance obligation" toward FMO, which, unlike the guarantee on the company's financial liabilities, can be suspended. Under this obligation, the state is committed to covering all FMO's losses from unforeseen and nonprovisioned operational risks that cannot be covered by the general reserve risk fund.

If FMO's financial situation were to deteriorate to the extent that it could be expected to invoke the state's obligations, the Ministry of Finance would be entitled to direct the company's financial and economic policies. Under such a scenario, FMO's failure to comply with the minister's directions could result in the suspension of the maintenance obligation, although the likelihood of such a suspension seems remote, as cooperation between the state and FMO has always been good. If FMO were liquidated, its capital reserves would fall due to the state after settlement of the contractual return to shareholders.

State support for FMO is also demonstrated by the funding the company has received in the past. Given that FMO already has a very strong capital base relative to its business, the state's capital contributions are not expected to resume in the next few years. The Dutch state, however, is in principle committed to future capital contributions if FMO's expansion of its loan portfolio requires it. FMO also benefits from advantageous bilateral tax treaties and de facto preferred credit status in certain of FMO's countries of operation.

Organization And Operations: A Burgeoning Portfolio

Growth in FMO's portfolio of loans, equity investments, and guarantees was substantial in 2007, with a 24% increase to €3.4 billion (including government funds). Portfolio growth was financed by an increase in both long- and short-term liabilities. There was a slight increase in the share of investment in low-income countries with a particular focus on housing finance, while the general distribution across the regions FMO works in remained unchanged. The proportion of government funds in the portfolio remained constant, while there was an increase in local currency financing and in equity and mezzanine investments.

In 2006 and the first half of 2007, FMO's activities were significantly affected by the excess liquidity in global financial markets, which meant that commercial investors were investing in areas where FMO used to be involved and that early repayments were in abundance in all the regions FMO works in. FMO has in turn sought out new higher-risk market niches and focused its activities in segments that were still too high risk for commercial players, such as mortgage banks providing housing finance to low-income families, entrepreneurs looking for custom made financing solutions, and also financial institutions serving small and medium-sized businesses. It has done this through its own financial products and those managed on behalf of the Dutch government, through which FMO earns fee income. In 2008, given the tight liquidity in the global markets, demand for FMO funding is high and early repayments will be a characteristic of the past.

Instead of setting up offices around the world, FMO's strategy relies on well-established partner networks. It collaborates closely with well-established multilateral financial institutions, including the European Bank for Reconstruction and Development (AAA/Stable/A-1+), and with development banks, local financial institutions, and commercial investors. FMO has also recently formed the first formal global partnership between a European development finance institution and a leading commercial bank, Citigroup Inc. (AA-/Negative/A-1+), and the two have together launched a risk-sharing facility, with the aim of providing loans to small and midsize enterprises in developing countries.

FMO's core investment activities are aimed at the financial sector (comprising bank and nonbank financial institutions, housing finance, and capital markets). In 2007, in addition to increasing its investments in financial institutions, FMO also increased investments in the construction, energy, telecom and transport sectors, while reducing its investments in the areas of agriculture, industry, mining, and trade and tourism.

FMO's overall investment decisions must observe the principles stated in the Criteria Memorandum (an appendix to the 1998 agreement). In addition to promoting economic development in emerging economies, environmental and social factors are key for FMO when it considers investment projects. In addition to these investment criteria, FMO's management has established exposure limits by country, client, sector, and guarantor, in order to diversify risk.

The focus on fostering sustainable growth and maximizing the developmental impact of individual investment projects has recently been institutionalized in the form of a "Scorecard." This scorecard measures the economic, environmental, and social risks, as well as the impact and corporate governance aspects of completed projects. In addition, a development impact indicator (DII) is now used to estimate the expected effects on the host country's economic development resulting from new investments and projects.

Policies governing lending decisions

FMO's main activity is to provide loans. FMO's gross loans (including activities on behalf of the state) represented 58% of its managed portfolio at the end of 2007. Lending and guarantee operations include project finance, corporate loans, and lines of credit to financial institutions, which in turn onlend to local companies. In line with its mandate to operate commercially, the company provides funding on similar terms and conditions to those found in global financial markets.

FMO calculates what interest rate to charge by adding a spread over its own basic rate for fixed-rate loans, or over LIBOR, or over an equivalent benchmark for floating-rate loans. The spread generally varies between 200 basis points (bps) and 500 bps, reflecting borrower and country risks, the maturity of the loan, and the current situation in the financial markets. FMO also mobilizes funds from commercial banks through nonrecourse loan syndication. The company provides part of the funds for the loan and serves as the lender of record for the entire loan.

Policies governing equity investments

FMO's equity investments are growing each year as FMO works to diversify its product mix and meet the needs of its clients. In 2007, including activities on behalf of the state, these investments represented 42% of FMO's portfolio, up from 35% in 2006. FMO's equity investments comprise common and preference shares, subordinated loans with equity options and other quasi-equity instruments. FMO never takes more than a minority equity investment and is never the largest shareholder, although in some cases it is willing to take seats on company boards.

The bank's equity investments have an average duration of five years. In addition, exit arrangements, preferably through stock markets, are agreed at the outset. FMO also provides management support and participates in private equity funds, which in turn take stakes in local firms not listed on the stock exchange. FMO's equity investment policies were tightened in 2001. Investment criteria are now stricter, portfolio management is more important, and more attention is paid to generating cash flow, collaborating with partners, and improving the structure and completion of exits.

Local currency financing and new products

FMO is increasingly involved in local currency financing because foreign banks are often not in a position to offer local currency on longer tenors or to manage the currency risk involved in loans or financing denominated in foreign currencies. Local currency products have always been available to clients through government funds, but more recently FMO has started introducing its own products.

Local currency products are likely to become increasingly important in the future and FMO envisions that 20% of its balance sheet will be made up of local currency positions by 2010. In 2007, local currency financing, which is mostly hedged for currency risk, already represented 17% (2006: 13%) of the total portfolio.

Asset Quality Matches That Of Peers

FMO's asset quality is broadly comparable with that of multilateral lenders operating in high-risk emerging markets.

Since 2002, the benign economic climate and a continued focus on strong risk management led to a sharp reduction in new value added adjustments, while past value adjustments could often be released. After three years of net releases, a historically low infected portfolio resulted in 2007. Further significant releases are not expected in the near future.

A specific loan provisions policy was introduced in 2003, linking the provision ratio (15%-100%) to internal ratings and the duration of arrears. A new value-adjustment policy has introduced the concept of incurred but not reported (IBNR) provisions, in accordance with IFRS. IBNR provision relates to risks that are present but not yet identified, calculated with an advanced model that depends on factors such as country ratings, portfolio breakdowns, default risks, and recovery rates. By year-end 2007, specific value adjustments and IBNR provisions on loans to the private sector and at the risk of FMO amounted to 11% of gross disbursed loans while gross non-performing loans (those provisioned or experiencing payment arrears for three months or more) decreased to under 3% of FMO's outstanding loan portfolio, from 13% in 2003. Value adjustments for loans guaranteed by the state amount to 20% of gross disbursed loans with nonperforming loans significantly higher than among loans managed at the risk of FMO, reflecting the less commercial nature of this side of the business.

Profitability Boosted By Strong Performance In Equity Portfolio

FMO's profitability is significant given the risk profile of its lending. That said, the volatility of the company's annual results remains a salient feature, especially as equity and mezzanine financing increases. FMO can, however, partially manage annual profits through the spreads it charges its customers for its financial products.

As recently as 2001 and 2002, profitability was low, as provisioning soared in response to a more challenging operational environment and lower-than-expected equity sales. The trend reversed in 2003 as global economic conditions recovered. Return on average assets was 4.2% in 2007, a slight decline compared to 2006, but significantly above the 1.3% in 2003, while ROE was up to 9.3% in 2007 from about 2.9% in 2003. Maintaining these high profitability ratios will become more challenging in the coming years.

Total income remained high in 2007, with a significant result from the sale of equity participations as in 2006. Divestment of or exit from equity participations amounted to €73 million in 2007, with an additional €6 million from dividend income.

FMO's main source of income is still the net interest on its loan portfolio, which represented 51% of total revenues in 2007 on the back of growth in the portfolio as well as an increase in interest revenues of the treasury portfolio. Remuneration for services rendered in managing programs on behalf of the state was stable at €23 million.

Typically, FMO's biggest expense is its provisioning (including equity value adjustments). In 2005-2006, however, reversals of old provisions and the low number of new provisions meant that value adjustments were positive at

3%-6% of revenues and resulted in an increase in income. In 2007, the trend has once again reversed and provisions were negative at 18% of revenues and more in line with what can be expected in the coming years. This still compares positively with an average of 62% between 1998 and 2003. Operating expense increases slowed down in 2007 due to improvements in operational efficiency and no one-off costs, such as the write-down on software and additional pension plans, which drove expenditures in 2006. Instead, growth was primarily driven by growth in production and the portfolio.

According to the 1998 agreement, FMO's net profits must first be allocated to cover any losses incurred in previous years, after which the company makes the required transfer to the contractual reserve. The management and the supervisory board then decide how to appropriate the remaining net profit. The distributable profit component in 2007 was €5.3 million and a cash dividend of €5.55 per share was proposed, with the remaining €3.1 million to be added to other reserves.

Since only a small percentage of the net result of €105 million was paid out to shareholders, and the balance qualified as retained earnings, FMO's capital is now almost €1.2 billion. Because its business is highly cyclical, it cannot guarantee to repeat the strong financial performance it has shown in the past few years, especially given the current tight liquidity environment. If there is a crisis, however, FMO's strong capitalization should enable it to continue to provide access to finance to its clients.

Table 2

FMO Profit and Loss Account

(Mil. €)	2007	2006	2005	2004	2003	2002	2001
Income	199.0	202.1	134.1	126.5	104.6	94.6	91.9
Net interest income	102.4	91.5	79.5	80.0	75.6	76.1	76.5
Income on equity investments	72.5	73.9	9.4	13.7	6.6	2.6	2.0
Remuneration for services rendered*	23.5	23.3	22.7	19.1	18.6	14.1	10.8
Other income	(8.5)	4.6	20.0	11.1	3.8	1.7	2.6
Expenses	86.7	41.1	33.2	71.2	75.4	84.9	93.9
Operating expenses	51.2	47.3	41.1	36.0	33.2	30.5	25.4
Value adjustments	35.4	(6.2)	(7.9)	35.3	42.2	54.4	68.5
Of which to loans	26.2	(8.7)	(13.0)	32.9	20.3	27.4	61.7
Of which to equity	9.2	2.4	5.0	2.4	2.8	8.3	20.4
Of which general value adjustment	0.0	0.0	0.0	0.0	19.1	18.8	(13.6)
Profit before tax	116.3	164.6	101.0	55.4	29.3	9.1	(2.0)
Taxes	11.3	30.6	27.6	18.0	8.7	4.6	(6.2)
Net profit	105.0	134.1	73.4	37.3	20.6	4.6	4.3

*Mostly services rendered to the state plus syndication fees.

Asset And Liability Management Benefits From Good Market Access

FMO's principal source of funds is domestic and international financial markets, to which the company has good access. Access to domestic markets has been facilitated by the 0% risk weighting of FMO's obligations in the balance sheet of Dutch financial institutions. In 2007, eight new notes were issued totaling €267 million, while €124 million was redeemed, all of which came under the auspices of the institution's €3 billion global MTN program. The program was launched in 2000, and was increased from €1.0 billion to €1.5 billion on October 2004, and further to €3 billion in May 2008. The remaining term of debt securities of less than one year was minimal as a percentage of debt securities, debentures and notes at year-end 2007. The funding focus has been shifting from funding in U.S. dollars and Japanese yen to larger local currency issues.

FMO mainly operates in a dollar environment, and so about 60% of its portfolio transactions consist of dollar-denominated lending. The EMTN borrowings are therefore predominantly swapped into variable-rate U.S. dollar funding. Additionally, derivatives are taken to control interest rate and currency risk.

Capital Levels Are High

Because of its activities in high-risk countries, FMO has a much higher risk profile than commercial banks. On average, FMO's level of risk weighting assets is two to three times higher than that of commercial banks. Even so, FMO is well capitalized relative to the high-risk profile of its operations and maintains a higher internal BIS II capital adequacy ratio of between 20%-25%, rather than the regulatory minimum of 8% set by the Bank for International Settlements. The standardized BIS ratio is approximately 43% (compared with around 30% in 2006).

The company's authorized share capital doubled to €45 million in December 2000. Paid-in capital, which amounted to €9.1 million at year-end 2007, has remained unchanged since 1995, and there are no plans to increase it.

The company's equity also includes the share premium reserve, the development fund, the contractual reserve, and other reserves. The share premium reserve contains funds that were transferred by the government during FMO's financial restructuring in 1991. The development fund includes the annual budgetary allocations made by the state. The annual contributions, which ended in 2005, increased the balance of the fund to €658 million. The contractual reserve includes the share of the annual profit that FMO is obliged to allocate under the terms of the 1998 agreement. The remainder of FMO's net profit, after deductions for the proposed dividend, is added to other reserves.

At year-end 2007, total shareholder equity was €1.2 billion, up from €1.1 billion at year-end 2006. The reserve allocation policy followed by the company has so far ensured that adjusted common equity to total assets has been maintained at above 40%, even at times of below-average performance. It has also ensured an appropriate capitalization level, given the high credit risk profile.

Table 3

FMO Financial Ratios

	2007	2006	2005	2004	2003	2002	2001
Profitability (%)							
Revenues/average assets	8.0	8.7	6.4	7.0	6.5	6.4	6.3
Net interest income/average assets	4.1	3.9	3.8	4.5	4.7	5.2	5.3
Non-interest expense/average assets	2.1	2.0	2.0	2.0	2.1	2.1	1.7
Pretax profits/average assets	4.7	7.1	4.8	3.1	1.8	0.6	(0.1)
Net profit/average assets (ROA)	4.2	5.8	3.5	2.1	1.3	0.3	0.3
Return on equity (ROE)	9.3	13.2	8.5	4.9	2.9	0.7	0.7
Net interest income/revenues	51.4	45.3	59.3	63.2	72.3	80.5	83.2
Non-interest expense/revenues	25.7	23.4	30.7	28.4	31.7	32.3	27.6

Table 3

FMO Financial Ratios(cont.)							
Provisions/revenues	17.8	(3.1)	(5.9)	27.9	40.3	57.6	74.6
Pretax profits/revenues	58.5	81.4	75.3	43.7	28.0	9.6	(2.2)
Revenue/employee (000 €)*	843.3	902.4	660.6	642.3	533.7	492.6	560.4
Net profit/employee (000 €)*	445.1	598.6	361.5	189.6	105.1	23.8	26.0
Liquidity (% of assets)							
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net loans	47.5	47.6	42.6	48.0	48.5	56.9	64.2
Capital (%)							
Capital/assets	44.0	47.0	40.8	42.5	41.9	46.3	42.3
Capital/loans	92.6	98.6	95.8	88.6	86.4	81.4	65.9
Capital adequcy ratio¶	21.0	22.0	23.0	51.5	46.9	45.1	40.0
Dividend payout ratio	2.1	1.0	0.3	0.6	1.1	5.0	5.4
Asset quality (%)							
Loan write-offs/average loans	0.0	0.9	1.4	3.6	3.4	2.7	0.4
Provisioning for loans/average loans (gross)	2.0	(0.7)	(1.2)	3.1	1.9	2.3	5.1
Provisioning for equity/average equity investments	3.3	1.4	4.5	2.8	3.5	9.1	19.3
General provisioning/average assets	0.0	0.0	0.0	0.0	1.2	1.3	(0.9)
Employees	236.0	224.0	203.0	197.0	196.0	192.0	164.0

*Assuming constant headcount throughout years. ¶BASEL II Ratio for 2006, BASEL I Ratio for 2005, BIS Ratio for 2001-2004.

Ratings Detail (As Of September 10, 2008)*	
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured (112 Issues)	AAA
Issuer Credit Ratings History	
18-Jul-2000	AAA/Stable/A-1+
Default History	
None	

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

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