European Bank
for Reconstruction and Development

The Italian Investment Special Fund

Annual Financial Report
31 December 2013

The Italian Investment Special Fund

Contents

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Statement of comprehensive income

For the year ended 31 December 2013	Note	Year to 31 December 2013 € 000	Year to 31 December 2012 € 000
Interest and similar income			
From loans	3	**481**	415
From credit institutions		**-**	3
Dividend income		**25**	10
Net (losses)/gains from share investments	4	**(467)**	406
Net gains/(losses) from loans at fair value through profit or loss	9	**162**	(3)
Financial guarantees movement	5	**453**	(332)
Foreign exchange movement		**(245)**	(25)
Other operating expenses	6	**(7)**	(8)
Impairment charge on loan investments	7	**(657)**	(104)
Net (loss)/profit and comprehensive (expense)/income for the year		**(255)**	362
Attributable to:			
Contributor		**(255)**	362

Balance sheet

At 31 December 2013	Note	31 December 2013 € 000	31 December 2013 € 000	31 December 2012 € 000	31 December 2012 € 000
Assets					
Placements with credit institutions			**8,044**		7,960
Other financial assets					
Derivative financial instruments		**81**		726	
Interest receivable on loans		**88**		76	
			169		802
Loan investments					
Loans at amortised cost	8	**5,975**		6,169	
Less: Provisions for impairment	7	**(1,177)**		(526)	
Loans at fair value through profit or loss	9	**2,302**		2,681	
			7,100		8,324
Share investments	10		**2,392**		2,592
Total assets			**17,705**		19,678
Liabilities and contributor's resources					
Other financial liabilities	11				
Derivative financial instruments		**2,203**		2,427	
Other financial liabilities		**7**		1,006	
			2,210		3,433
Financial guarantee liabilities	12		**2,005**		2,500
Total liabilities			**4,215**		5,933
Contributions			**19,524**		19,524
Reserves and accumulated loss			**(6,034)**		(5,779)
Total contributor's resources			**13,490**		13,745
Total liabilities and contributor's resources			**17,705**		19,678
Memorandum items					
Undrawn loan commitments and guarantees	13		**12,012**		13,418

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Statement of changes in contributor's resources

For the year ended 31 December 2013	Contributions	Accumulated loss	Total
	€ 000	€ 000	€ 000
At 31 December 2011	21,024	(6,141)	14,883
Distribution of funds to contributor	(1,500)	-	(1,500)
Total comprehensive income for the year	-	362	362
At 31 December 2012	19,524	(5,779)	13,745
Total comprehensive expense for the year	-	(255)	(255)
At 31 December 2013	**19,524**	**(6,034)**	**13,490**

Statement of cash flows

For the year ended 31 December 2013		Year to 31 December 2013		Year to 31 December 2012
	€ 000	€ 000	€ 000	€ 000
Cash flows from/(used in) operating activities				
Net (loss)/profit for the year	(255)		362	
Adjustment for:				
Interest income	(481)		(418)	
Net gains/(losses) from share investments	467		(406)	
Net (gains)/losses from loans at fair value through profit or loss	(162)		3	
Foreign exchange movement	245		26	
Financial guarantees movement	(453)		(161)	
Impairment charge on loan investments	657		597	
	18		3	
Interest income received	367		320	
(Increase)/decrease in operating assets:				
Proceeds from repayment of loan investments	2,611		826	
Funds advanced for loans investments	(1,975)		(2,168)	
Proceeds from sale of share investments	154		1,193	
Funds advanced for share investments	-		(1,000)	
Decrease in operating liabilities				
Audit fees payable	1		1	
Net cash from/(used in) operating activities		1,176		(825)
Cash flows from financing activities				
Distribution of funds to contributor	(1,000)		(500)	
Net cash used in financing activities		(1,000)		(500)
Net decrease in cash and cash equivalents		176		(1,325)
Cash and cash equivalents at the beginning of the year		7,960		9,285
Effect of foreign exchange rate changes		(92)		-
Cash and cash equivalents at 31 December		8,044		7,960

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Accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

A. Basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and financial liabilities held at fair value through profit or loss. The financial statements have been prepared on a going concern basis.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Italian Investment Special Fund's ("the Fund") policies. The areas involving a higher degree of judgement or complexity, or areas where judgements and estimates are significant to the financial statements, are disclosed in "Critical accounting estimates and judgements" within the section for accounting policies.

Amendments to published standards

The following new and amended standards are effective for the current reporting period:

Pronouncement	Nature of change	Impact
IFRS 7 (Amendment) Financial Instruments: Disclosures – Offsetting of Financial Assets and Liabilities	Requires disclosure of information that will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position.	No changes of presentation required
IFRS 10: Consolidated Financial Statements	Establishes the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.	No change to the Fund's accounting for its equity investments
IFRS 11: Joint Arrangements	Establishes the principles for financial reporting by parties to a joint arrangement.	No changes of presentation required
IFRS 12: Disclosure of Interests in Other Entities	Consolidates the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities.	No changes of presentation required
IFRS 13: Fair Value Measurement	Defines fair value, establishes a single framework for measuring fair value and requires disclosures about fair value measurements.	No change to Fund's fair value procedures
IAS 1 (Amendment): Presentation of Financial Statements	Requires entities to group items presented in other comprehensive income ("OCI") on the basis of whether they are potentially re-classifiable to profit or loss.	No changes of presentation required
IAS 19 (Amendment): Employee Benefits	Various amendments to the standard including: elimination of the option to defer the recognition of gains and losses through the use of the corridor method; streamlining the presentation of changes in assets and liabilities arising from defined benefit plans; enhancing disclosure requirements for defined benefit plans	Not applicable
IAS 27 (Reissued): Separate Financial Statements	Requires an entity preparing separate financial statements to account for investments in subsidiaries, joint ventures and associates at cost or in accordance with IFRS 9: Financial Instruments.	Not applicable

IAS 28 (Reissued): Investments in Associates and Joint Ventures	Prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.	No change as Fund accounts for such investments on a fair value basis

IFRS not yet effective but adopted early

IFRS 9: Financial Instruments is the IASB's replacement project for IAS 39 which is being completed in a number of distinct stages. At this time there is no mandatory application date for the standard although entities are allowed to adopt early all completed phases. The Fund adopted the first stage 'recognition and measurement of financial assets' (November 2009) in its 2010 financial statements.

See the accounting policy for financial assets for more details.

IFRS not yet effective and not adopted early

The following standards are not yet effective and have not been adopted early.

Pronouncement	**Nature of change**	**Potential Impact**
IFRS 9 Financial Instruments	Classification and measurement of financial liabilities (October 2010) Hedge accounting (November 2013) There is currently no mandatory effective date for application of this standard.	The Fund is yet to assess the potential impact of adopting this standard
IAS 32 (Amendment) Financial Instruments: Presentation – Offsetting of Financial Assets and Financial Liabilities	The amendment updates the application guidance and basis of conclusions in relation to the offsetting of financial assets and financial liabilities. Effective for accounting periods beginning on or after 1 January 2014.	The Fund does not consider this standard will have a material impact as it considers that gross presentation of derivative assets and liabilities, to which this amendment predominantly relates, will continue to be appropriate
Investment entities – amendments to IFRS 10, IFRS 12 and IAS 27	The amendments introduce an exception to consolidating particular subsidiaries for "investment entities", requiring instead such subsidiaries to be measured at fair value through profit or loss in accordance with IFRS 9 Financial Instruments. New disclosure requirements are also introduced. Effective for accounting periods beginning on or after 1 January 2014.	Not applicable
IAS 19 Amendment: Employee contributions to defined benefit plans	Simplifies the accounting for contributions to defined benefit plans from employees and other third parties. Effective for accounting periods beginning on or after 1 July 2014.	Not applicable

A number of existing standards were reviewed by the IASB in December 2013 as part of the IFRS annual improvements cycle. It is the Fund's opinion that none of these amendments, effective for accounting periods beginning on or after 1 July 2014, will have a material impact on the Fund's financial statements.

B. Significant accounting policies

Financial assets - Classification and measurement

The Fund early adopted the first instalment of IFRS 9: Financial Instruments, concerning the classification and measurement of financial assets, with effect from 1 January 2010. Pursuant to that adoption, the Fund classifies its financial assets in the following categories: those measured at amortised cost and those measured at fair value. This classification depends on both the contractual characteristics of the assets and the business model adopted for their management.

Financial assets at amortised cost
An investment is classified as 'amortised cost' only if both of the following criteria are met: the objective of the Fund's business model is to hold the asset to collect the contractual cash flow; and the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding, interest being consideration for the time value of money and the credit risk associated with the principal amount outstanding.

Investments meeting these criteria are measured initially at fair value plus transaction costs that are directly attributable to the acquisition of the financial assets. They are subsequently measured at amortised cost using the effective interest method less any impairment. The Fund's financial assets at amortised cost are recognised at settlement date.

Financial assets at fair value
If either of the two criteria above is not met, the debt instrument is classified as 'fair value through profit or loss'. The presence of an embedded derivative, which could potentially change the cash flows arising on a debt instrument so that they no longer represent solely payments of principal and interest, requires that instrument to be classified at fair value through profit or loss, an example being a convertible loan.

All share investments held by the Fund are measured at fair value through profit or loss.

When an instrument which is required to be measured at fair value through profit or loss has characteristics of both a debt and equity instrument, the Fund determines its classification as a debt or an equity instrument on the basis of how the investment was internally appraised and presented at the Operations Committee of the Bank for approval.

The basis of fair value for share investments that are unlisted is determined using valuation techniques appropriate to the market and industry of each investment. The primary valuation techniques used are multiples applied to net asset value and earnings, the multiples based on those drawn from a range of comparative listed companies, and discounted cash flows.

The Fund's share investments are recognised on a trade date basis.

At initial recognition, the Fund measures these assets at their fair value. Transaction costs of financial assets carried at fair value through profit or loss are expensed in the income statement. Such assets are carried at fair value on the balance sheet with changes in fair value included in the income statement in the period in which they occur.

Financial liabilities

The Fund has not adopted early that part of IFRS 9 which relates to financial liabilities and therefore still applies IAS 39: Financial Instruments.

All financial liabilities are measured at amortised cost, except for derivative instruments which must be measured at fair value and financial guarantees which are measured in accordance with IAS 39, as described under "Financial guarantees" within the accounting policies section of the report.

Impairment of financial assets

Financial assets at amortised cost
Where there is objective evidence that an identified loan asset is impaired, specific provisions for impairment are recognised in the income statement. Impairment is quantified as the difference between the carrying amount of the asset and the net present value of expected future cash flows discounted at the asset's original effective interest rate where applicable. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement. The carrying amount of the asset is reduced directly only upon write-off. Resulting adjustments include the unwinding of the discount in the income statement over the life of the asset, and any adjustments required in respect of a reassessment of the initial impairment.

The criteria that the Fund uses to determine that there is objective evidence of an impairment loss include:
- delinquency in contractual payments of principal or interest;
- cash flow difficulties experienced by the borrower;
- breach of loan covenants or conditions;
- initiation of bankruptcy proceedings;
- deterioration in the borrower's competitive position; and
- deterioration in the value of collateral.

Provisions for impairment of classes of similar assets that are not individually identified as impaired are calculated on a portfolio basis. The methodology used for assessing such impairment is based on a risk-rated approach for non-sovereign assets. The Fund's methodology calculates impairment on an incurred loss basis. Impairment is deducted from the asset categories on the balance sheet.

Impairment, less any amounts reversed during the year, is charged to the income statement. When a loan is deemed uncollectible the principal is written off against the related impairment provision. Such loans are written off only after all necessary procedures have been completed and the amount of the loss has been determined. Recoveries are credited to the income statement if previously written off.

Loans and advances are generally renegotiated in response to an adverse change in the circumstances of the borrower. Depending upon the degree to which the original loan is amended, it may continue to be recognised or will be derecognised and replaced with a new loan. To the extent the original loan is retained, it will continue to be shown as overdue if appropriate and individually impaired where the renegotiated payments of interest and principal will not recover the original carrying amount of the asset.

Derivative financial instruments

The Fund makes use of derivatives for two purposes: (i) to provide potential exit strategies for its unlisted equity investments through negotiated put options and (ii) to guarantee a minimum return to the European Bank for Reconstruction and Development ("the Bank") in respect of share investments in which the Fund makes a parallel investment. In the latter case, the Fund's liability to make up the minimum return is limited to the recoverable amount of its own parallel investment.

All derivatives are measured at fair value through the income statement. Fair values are derived from option-pricing models. Derivatives are carried as assets when their fair value is positive and as liabilities when their fair value is negative.

Financial guarantees

The Fund provides guarantees to cover the principal losses of the Bank's parallel loan investments, limited to the debt proceeds recovered on the Fund's loan investment. When a guarantee is issued a financial guarantee liability is initially recognised at fair value, which is estimated using the risk margin, principal and tenor of the guaranteed loan as a proxy for the fees which may have been received if the transaction had been at arm's length. Subsequently the guarantee is measured at the higher of the initial fair value less cumulative amortisation or, if appropriate, the expenditure required to settle the commitment at the balance sheet date.

Contributor's resources

The Fund recognises contributions received from the Italian Government ("the contributor") as equity on the basis that the termination of the contribution agreement would lead to the winding up of the Fund and the distribution of the residual assets to the contributor.

Statement of cash flows

The statement of cash flows is prepared using the indirect method. Cash and cash equivalents comprise balances with less than three months maturity from the date of the transaction, which are available for use at short notice and that are subject to insignificant risk of changes in value.

Foreign currencies

The Fund's reporting currency for the presentation of its financial statements is the euro (€).

Foreign currency transactions are initially translated into euro using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions, and from the translation at the year-end exchange rate of monetary assets and liabilities denominated in foreign currencies, are included in the income statement.

Interest and dividends

Interest is recorded on an accruals basis using the effective interest method. All interest income is recognised within 'interest and similar income' in the income statement.

Dividends relating to share investments are recognised in accordance with IAS 18 when the Bank's right to receive payments has been established, and when it is probable that the economic benefits will flow to the Bank and the amount can be reliably measured.

Taxation

In accordance with Article 53 of the Agreement Establishing the Bank ("the AEB"), within the scope of its official activities, the Bank, its assets, property and income are exempt from all direct taxes and all taxes and duties levied upon goods and services acquired or imported, except for those parts of taxes or duties that represent charges for public utility services. As described in note 1, this exemption is extended to the Fund.

C. Critical accounting estimates and judgements

Preparing financial statements in conformity with IFRS requires the Fund to make estimates and judgements that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts included in the income statement during the reporting period. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The Fund's critical accounting estimates and judgements are as follows:

Fair value of derivative financial instruments
The fair values of the Fund's derivative financial instruments are determined by using discounted cash flow models. These cash flow models are based on underlying market prices for currencies, interest rates and option volatilities. Where market data is not available for all elements of a derivative's valuation, extrapolation and interpolation of existing data has been used. Where unobservable market data has been used, a sensitivity analysis has been included within the risk management section of the report.

Fair value of loans at fair value through profit or loss
The fair values of the Fund's loans at fair value through profit or loss are determined by using a combination of discounted cash flow models and option pricing models. These models incorporate market data pertaining to interest rates, borrower's credit spreads, underlying equity prices and dividend cash flows. Where relevant market data is not available extrapolation and interpolation of existing data has been used. Where unobservable market data has been used, a sensitivity analysis has been included within the risk management section of the report.

Fair value of share investments
The Fund's method for determining the fair value of share investments is described under "Financial assets" within the accounting policies section of the report and an analysis of the share investment portfolio is provided in note 10. Where relevant market data is not available extrapolation and interpolation of existing data has been used. Where unobservable market data has been used, a sensitivity analysis has been included within the risk management section of the report.

Provisions for the impairment of loan investments
The Fund's method for determining the level of impairment of loan investments is described within the accounting policies section of the report and further explained under credit risk within the risk management section of the report. As described in the risk management section the Fund participates in investments jointly with the Bank and credit risk is jointly managed. Accordingly, the risk management disclosures are based on the Bank's risk processes and procedures.

Portfolio provisions for the unidentified impairment of loan investments at 31 December 2013 were €259,000 (2012: €222,000). The sensitivity of portfolio provisions to key variables used in determining the level of impairment is provided below.

Risk ratings
- If all loan investments were upgraded by three 'notches' or detailed ratings within the Bank's probability of default rating scale, this would result in a reduction of €223,000 in portfolio provisions on loan investments.
- Conversely, if all loan investments were downgraded by three 'notches' or detailed risk ratings within the Bank's probability of default rating scale, this would result in a charge to the income statement of €515,000 in relation to portfolio provisions for loans.
- With respect to specific provisions, an increase or decrease of ten per cent on the level of impaired loans would have a +/- €169,000 impact.

Loss emergence period
- Provisions for unidentified impairment are made to reflect losses arising from events existing but not identified at the balance sheet date and which will emerge within a 12 month period from that date. If the loss emergence period was reduced to three months it is broadly estimated that this would result in a decrease in portfolio provisions charged to the income statement of €188,000.

Probability of default rates
- In determining the probabilities of default for each risk rating, the relative weighting applied to external data and the Bank's own experience is reviewed annually. The 2013 general provisioning methodology applies a 50 per cent weighting to the Bank's own experience and a 50 per cent weighting to external data, which is consistent with the methodology approved in the previous year. A decrease in the weighting assigned to the Bank's own experience to 40 per cent (60 per cent external default data) would lead to an increase in portfolio provisions of €28,000, increasing provisions for unidentified impairment of loan investments to €287,000. Similarly, an increase in the weighting assigned to the Bank's own experience to 60 per cent (40 per cent external default data) would lead to a decrease in portfolio provisions of €28,000, decreasing provisions for unidentified impairment of loan investments to €231,000.

Loss given default rates

- A decrease in loss given default rates by ten percentage points would lead to a decrease in portfolio provisions of €43,000, reducing provisions for unidentified impairment of loans to €216,000.
- An increase in loss given default rates by ten percentage points would lead to a corresponding increase in portfolio provisions for unidentified impairment of loans by €43,000, to a total of €302,000.

The methodology and judgements used for estimating provisions for the impairment of loan investments are reviewed annually to reduce any differences between loss estimates and actual experience.

Financial guarantee liability

The Fund's method for determining the fair value of financial guarantees is described under "Financial guarantees" within the accounting policies section of the report and further explained within credit risk within the risk management section of the report.

Risk management

The Fund was established to assist the modernisation, restructuring, expansion and development of small and medium size enterprises (SMEs) in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Egypt, FYR Macedonia, Jordan, Kosovo, Montenegro, Morocco, Romania, Serbia, Tunisia and Turkey. To achieve this, the Fund has participated, alongside the Bank, in providing equity investments and loans to such businesses. The Fund's resources are also used to mitigate the Bank's risk exposure by providing guarantees on the Bank's investments in which the Fund also has a parallel investment.

As the primary purpose of the Fund is to assist the development of SMEs rather than to generate a return on its net assets, most financial risks are not actively managed by the Fund. As the Fund participates in investments jointly with the Bank, credit risk is jointly managed; however the Fund does not hedge against market risk and is hence exposed to interest rate, foreign exchange and equity price risk.

A. Credit risk

Credit risk is the potential loss to a portfolio that could result from the default of a counterparty or the deterioration of its creditworthiness. The Fund may also be exposed to concentration risk, which is the risk arising from too high a proportion of the portfolio being allocated to a specific country, industry sector or obligor, or to a particular type of instrument or individual transaction.

The Fund is exposed to credit risk as borrowers and counterparties could default on their contractual obligations, or the value of the Fund's investments could be impaired.

The carrying amounts of financial assets presented on the balance sheet, together with the undrawn loan commitments and guarantees as shown under memorandum items, best represents the Fund's maximum exposure to credit risk at 31 December 2013 and 31 December 2012, without taking account of any collateral held or other credit enhancements.

Credit risk management and measurement

As previously stated, the Fund participates jointly with the Bank in the financing of investments in the Bank's countries of operations. It therefore benefits from the same governance process employed by the Bank in the measurement and management of credit exposures, which is described below.

The Board of Directors ("the Board") approves a credit process document that defines the procedures for the approval, management and review of Banking exposures by the Operations Committee. The Audit Committee reviews the credit process annually and its review is submitted to the Board of Directors ("the Board") for approval.

Banking projects are reviewed by the Operations Committee which is chaired by the First Vice President Banking and whose membership comprises senior managers of the Bank. The Operations Committee is responsible for reviewing all Banking operations prior to their submission for Board approval. This includes a number of frameworks for smaller projects which are then each considered by the Small Business Investment Committee. Both committees review projects to ensure they meet the Bank's criteria for sound banking, transition impact and additionality. The Operations Committee operates within the authority delegated by the Board, via the Executive Committee, to approve projects within Board-approved framework operations. The Operations Committee is also responsible for approving significant changes to existing operations.

The responsibility for oversight of the Banking portfolio resides with the Risk Committee. The Risk Committee is chaired by the Vice President Risk, comprises senior managers of the Bank and operates within the authority delegated by the Board via the Executive Committee. Risk Management is responsible for recommending provisions for the impairment of Banking loans and reports these quarterly to the Risk Committee.

The Equity Committee acts as governance committee for the equity portfolio and reports to the Operations Committee.

The Bank conducts reviews of exposures within the Banking portfolio. At each review, Risk Management assesses whether there has been any change in the risk profile of the exposure, recommends actions to mitigate risk and reconfirms or adjusts the risk rating. For share investments it also reviews the fair value. At the recommendation of Risk Management, investments considered to be in jeopardy may be transferred from Banking teams to the Corporate Recovery Unit – which reports jointly to Risk Management and Banking – in order to manage the restructuring work-out and recovery process.

The table below shows the Bank's internal probability of default rating scale from 1.0 (lowest risk) to 8.0 (highest risk) and how this maps to the external ratings of Standard & Poor's (S&P). References to risk rating through this text relate to probability of default ratings unless otherwise specified.

EBRD risk category	EBRD risk rating[1]	External rating equivalent	Category name	Broader category
1	1.0	AAA	Excellent	Investment Grade
2	1.7 2.0 2.3/2.5	AA+ AA AA-	Very Strong	
3	2.7 3.0 3.3	A+ A A-	Strong	
4	3.7 4.0 4.3	BBB+ BBB BBB-	Good	
5	4.7 5.0 5.3	BB+ BB BB-	Fair	
6	5.7 6.0 6.3	B+ B B-	Weak	
7	6.7 7.0 7.3	CCC+ CCC CCC-	Special Attention	Classified
8	8.0	CC/CD	Expected Loss/Impaired	

Disbursements are managed by the Operations Administration Department (OAD) within the Office of the General Counsel (OGC). The OAD is responsible for checking compliance with loan and other project agreements and ensuring that correct procedures are followed in line with approved policy. Waivers, consents and amendments of loan covenants and conditionality are prepared by the OAD and are approved by Banking, Risk Management and, where required, by the OGC, the Office of the Chief Economist and the Environment and Sustainability Department.

The Bank assigns its internal risk ratings to all counterparties in the portfolio. Counterparty risk ratings reflect the financial strength of the risk counterparty as well as consideration of any implicit support, for example from a major shareholder. For non-sovereign operations, probability of default ratings are normally capped by the local sovereign rating, except where the Bank has recourse to a guarantor from outside the country of operations which may have a better rating than the local sovereign rating. The Bank also assigns loss given default ratings on a scale of 0 per cent to 100 per cent determined by seniority, jurisdiction and sector of the transaction.

The Bank's general portfolio provisions are based on an assumed value for the probability of default rating assigned to each transaction by Risk Management and loss given default parameters based on product seniority and legal jurisdiction. Both the assumed probability of default value and the loss given default assumptions remain more conservative than the Bank's own default and recovery experience.

Risk Management reports on the development of the portfolio as a whole on a quarterly basis to the Audit Committee. The report includes a summary of key factors affecting the portfolio and provides analysis and commentary on trends within the portfolio and within various sub-portfolios. It also includes reporting on compliance with all portfolio risk limits including explanation of any limit breaches.

[1] Probability of default

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Credit risk in the loan portfolio

Distressed restructured loans[2] represent €2.3 million of disbursed loan investments at year-end 2013.

Placements with credit institutions

The Fund's placements with credit institutions were all internally risk rated between 2 and 6 (approximately AA+ to B- in terms of S&P equivalent).

Derivative financial assets

Derivative financial assets represent option contracts to provide potential exit routes for the Fund on its unlisted equity investments. The counterparties to these option contracts are all internally risk rated at 7.

Other financial assets

Other financial assets represent interest receivable from the Fund's loans.

Loan investments at amortised cost

Set out below is an analysis of the Fund's loan investments at amortised cost and the associated impairment provisions for each of the Bank's relevant internal risk rating categories.

Risk category	Neither past due nor impaired € 000	Impaired € 000	Total € 000	Total %	Portfolio provisions for unidentified impairment € 000	Specific provisions for identified impairment € 000	Total net of impairment € 000	Impairment provisions %
6: Weak	2,849	-	2,849	47.7	(105)	-	2,744	3.7
7: Special attention	1,500	-	1,500	25.1	(154)	-	1,346	10.3
8: Expected loss/impaired	-	1,626	1,626	27.2	-	(918)	708	56.5
At 31 December 2013	**4,349**	**1,626**	**5,975**	**100.0**	**(259)**	**(918)**	**4,798**	**19.7**

Risk category	Neither past due nor impaired € 000	Impaired € 000	Total € 000	Total %	Portfolio provisions for unidentified impairment € 000	Specific provisions for identified impairment € 000	Total net of impairment € 000	Impairment provisions %
6: Weak	3,942	-	3,942	63.9	(124)	-	3,818	3.1
7: Special attention	484	-	484	7.8	(98)	-	386	20.2
8: Expected loss/impaired	-	1,743	1,743	28.3	-	(304)	1,439	17.4
At 31 December 2012	4,426	1,743	6,169	100.0	(222)	(304)	5,643	8.5

At 31 December 2013 the Fund had security arrangements in place for €4.1 million of its disbursed loan investments.

Loans investments at fair value through profit or loss

Set out below is an analysis of the Fund's loans at fair value through profit or loss for each of the Bank's relevant internal risk rating categories.

Risk rating	**Fair value 2013 € 000**	Fair value 2012 € 000
6: Weak	**119**	400
7: Special attention	**2,183**	2,281
At 31 December	**2,302**	2,681

Guarantees and derivative financial instrument liabilities

At 31 December 2013, the Fund's resources may be used to guarantee future default losses incurred on the Bank's outstanding loan operating assets and share investment portfolio of €64.4 million (2012: €57.9 million). At 31 December 2013, the Fund's maximum exposure under such guarantees was €11.0 million

[2] Defined as a loan in which any of the key terms and conditions have been amended due to the financial stress of the borrower, and without such amendment(s) would like have become an impaired loan.

(2012: €12.3 million), of which €2.1 million (2012: €0.7 million) is recognised as "Derivative financial instrument liabilities" and €2.0 million (2012: €2.5 million) is recognised as "Financial guarantee liabilities" on the balance sheet.

Undrawn loan commitments and guarantees
Set out below is an analysis of the Fund's undrawn commitments for loan investments and maximum exposure for guarantees for each of the Bank's relevant internal risk rating categories.

Risk category	Undrawn loan commitments 2013 € 000	Guarantees 2013 € 000	Undrawn loan commitments 2012 € 000	Guarantees 2012 € 000
6: Weak	1,007	2,972	325	5,226
7: Special attention	-	6,291	800	6,542
8: Expected loss/impaired	-	1,742	-	525
31 December	1,007	11,005	1,125	12,293

Concentration of credit risk exposure

The following table breaks down the main credit risk exposures at their carrying amounts by geographic region.

	Undrawn loan commitments and guarantees 2013 € 000	Loans 2013 € 000	Undrawn loan commitments and guarantees 2012 € 000	Loans 2012 € 000
Albania	1,293	1,242	1,752	901
Bosnia and Herzegovina	593	529	1,370	1,361
Bulgaria	550	550	550	-
FYR Macedonia	200	200	362	-
Jordan	218	-	-	-
Kosovo	2,084	904	1,894	1,148
Montenegro	736	704	1,485	909
Serbia	4,602	3,276	4,234	3,138
Turkey	1,736	872	1,771	1,393
At 31 December	12,012	8,277	13,418	8,850

The following table breaks down the main credit risk exposures at their carrying amounts by industry sector of the counterparty.

	Undrawn loan commitments and guarantees 2013 € 000	Loans 2013 € 000	Undrawn loan commitments and guarantees 2012 € 000	Loans 2012 € 000
Agribusiness	2,328	1,589	4,367	3,641
Depository Credit (banks)	1,244	696	450	-
Information and Communication Technologies	2,735	2,200	1,894	1,395
Manufacturing and Services	4,385	2,622	4,322	2,847
Non-depository Credit (non-bank)	1,320	1,170	2,385	967
At 31 December	12,012	8,277	13,418	8,850

B. Market risk

Market risk is the potential loss that could result from adverse market movements. The drivers of market risk for the Fund are interest rate, foreign exchange and equity risk.

Market risk management and measurement

As discussed at the beginning of the risk management section, the Fund does not actively monitor or hedge against market risk.

Interest rate risk
Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates. The length of time for which the rate of interest is fixed on a financial instrument indicates to what extent it is exposed to interest rate risk.

The Fund's placements and loan investments are repriced to market interest rates within one month and six months respectively, therefore the exposure to interest rate risk is considered to be minimal.

Foreign exchange risk
Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The Fund's net exposure to foreign exchange risk is outlined in the table below.

	Albanian lek 2013 € 000	Euro 2013 € 000	Macedonian denar 2013 € 000	Serbian dinar 2013 € 000	Turkish lira 2013 € 000	United States dollar 2013 € 000	Total € 000
Total assets	525	15,353	-	226	1,605	(4)	17,705
Total liabilities	(78)	(3,291)	-	(145)	(687)	(14)	(4,215)
Net currency position at 31 December 2013	447	12,062	-	81	918	(18)	13,490

	Albanian lek 2012 € 000	Euro 2012 € 000	Macedonian denar 2012 € 000	Serbian dinar 2012 € 000	Turkish lira 2012 € 000	United States dollar 2012 € 000	Total € 000
Total assets	-	17,380	115	581	1,602	-	19,678
Total liabilities	-	(5,058)	(152)	(150)	(573)	-	(5,933)
Net currency position at 31 December 2012	-	12,322	(37)	431	1,029	-	13,745

Based on the five year rolling average of absolute movements in the Turkish lira to euro exchange rates, the potential impact on the Fund's net profit from a 10 per cent strengthening or weakening is €84,000 (2012: €94,000). The potential impact of movements in other foreign currencies is considered minimal.

Equity price risk
Equity price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.

The Fund expects the effect of equity price risk on net profit will bear a linear relationship to the movement in equity indices.

Based on the five year rolling average movement in the Stoxx EU Enlarged TMI index, the potential impact on the Fund's net profit from a 20 per cent movement (2012: 31 per cent) in equity prices is €474,000 (2012: €1,010,000).

C. Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The Fund's Rules and Regulations require that loan investments, equity investments and guarantees are financed from the resources of the Fund, which comprise contributions received and investment income. Accordingly, the Fund cannot commit more than the available resources and cannot borrow funds to finance operations. The Fund's guarantees are limited to the proceeds recoverable on the Fund's parallel investment. The Fund also recognises contributions received as equity, which may be returned to the contributor to the extent that there are sufficient contributions remaining in the Fund to meet existing commitments. As a result, the Fund's exposure to liquidity risk is considered to be minimal.

D. Fair value of financial assets and liabilities

IFRS 7 specifies classification of fair values on the basis of a three-level hierarchy of valuation methodologies. The classifications are determined based on whether the inputs used in the measurement of fair values are observable or unobservable. These inputs have created the following fair value hierarchy:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability.
- Level 3 - Inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes share investments, derivative financial instruments and loans at fair value through profit or loss for which not all market data is observable.

The fair values of the Fund's share investments, derivative financial instruments and loans at fair value have been classified as Level 3, that is, those which have fair values determined by inputs not based on observable market data.

At 31 December 2013, the Fund's balance sheet approximates to the fair value of all financial assets and liabilities.

Level 3 - sensitivity analysis
The table below presents the Level 3 financial instruments carried at fair value at 31 December 2013, main valuation models/techniques used in the valuation of these financial instruments and reasonably possible increases or decreases in fair value based on reasonably possible alternative assumptions.

		Impact on net profit in 2013	
	Carrying amount	**Favourable change**	**Unfavourable change**
Assets	**€ 000**	**€ 000**	**€ 000**
Loan investments	**2,302**	**89**	**(254)**
Share investments and associated derivatives[3]	**270**	**200**	**(52)**
At 31 December	**2,572**	**289**	**(306)**

		Impact on net profit in 2012	
	Carrying amount	Favourable change	Unfavourable change
Assets	€ 000	€ 000	€ 000
Loan investments	2,681	85	(219)
Share investments and associated derivatives	891	72	(50)
At 31 December	3,572	157	(269)

Level 3 financial liabilities relate to derivatives attached to share investments which have been analysed together in the table above.

[3] Share investments typically have an attached put and/or call option derivative. As such, any change in the underlying of the equity may be offset by the change in the value of the derivative. For this reason, share investments and the associated derivatives have been combined for the sensitivity analysis.

Loan investments

Loans at fair value through profit or loss mainly comprise convertible loans or loans with an element of performance-based return. The valuation models used to fair value these financial instruments are discounted cash flow (DCF) models and option pricing models. The inputs into the models include interest rates, the borrower's credit spreads and underlying equity prices. Reasonable possible alternative valuations have been determined based on the borrower's probability of default.

Share investments and associated derivatives

The Fund's unlisted equity portfolio comprises direct share investments, equity derivatives and equity funds. The valuation techniques/models used to fair value these financial instruments are net asset value (NAV) multiples, earnings before interest, tax, depreciation and amortisation (EBITDA) multiples, book cost and DCF cash flow models. Reasonable possible alternative valuations have been determined based on the NAV and EBITDA multiple ranges used in the valuations.

A valuation model is used to fair value the guarantee of a minimum rate of return on the Bank's parallel share investments. The inputs into the model include the euro yield curve, the valuation of the underlying parallel investments, future dividend yields, equity volatility, the subscription price and an equity valuation additional amount. Reasonable possible alternative valuations have been determined based on the favourable and unfavourable change in the underlying direct share investments.

The Italian Investment Special Fund

Notes to the financial statements

1. Creation of the Special Fund

The creation of the Fund was approved by the Board of the Bank at its meeting of 15/16 September 1998 and is administered, *inter alia,* in accordance with the AEB and under the terms of the Rules and Regulations of the Fund. The Fund became operational on 19 January 1999 following the receipt of the first contribution.

The Fund's principal office is located in London at One Exchange Square, EC2A 2JN.

The Fund was established in accordance with Article 18 of the AEB. The Fund is not part of the ordinary capital resources of the Bank, but any privileges and immunities available to the Bank are extended to the Fund.

2. President's responsibilities

The President is responsible for preparing the financial statements in accordance with IFRS issued by the IASB.

3. Interest income from loans

	2013	2012
	€ 000	€ 000
Loans at amortised cost	**328**	229
Loans at fair value through profit or loss	**153**	186
Interest income from loans	**481**	415

4. Net (losses)/gains from share investments

	2013	2012
	€ 000	€ 000
Net unrealised (losses)/gains from share investments and equity related derivatives	**(471)**	315
Net realised gains from share investments	**4**	91
Net gains from share investments	**(467)**	406

5. Financial guarantees movement

	2013	2012
	€ 000	€ 000
Financial guarantees issued	**404**	913
Amortisation of day one fair value	**(639)**	(1,074)
(Release)/charge for estimated settlement of impaired guaranteed loans	**(218)**	493
Financial guarantees movement	**(453)**	332

6. Other operating expenses

Other operating expenses represent external auditor's remuneration of €6,500 (2012: €7,700). At 31 December 2013 €6,500 (2012: €6,500) is payable to the Bank in relation to the 2013 external audit. The external auditor is appointed for a four-year term with Deloitte LLP (UK) serving as auditor for the period 2011-14. The external auditor may only serve a maximum of two consecutive terms.

7. Provision for impairment of loan investments

	2013	2012
Charge/(release) for the year	**€ 000**	€ 000
Portfolio provisions for the unidentified impairment of loan investments	**43**	(200)
Specific provisions for the identified impairment of loan investments	**614**	304
Provisions for impairment of loan investments	**657**	104
Movement in provisions		
At 1 January	**526**	422
Charge for the year to the income statement	**657**	104
Foreign exchange adjustments	**(6)**	-
At 31 December	**1,177**	526
Analysed between		
Portfolio provisions for the unidentified impairment of loan investments	**259**	222
Specific provisions for the identified impairment of loan investments	**918**	304
At 31 December	**1,177**	526

8. Loan investments at amortised cost

	2013	2012
	€ 000	€ 000
At 1 January	**6,169**	5,102
Disbursements	**1,975**	1,918
Repayments	**(1,969)**	(826)
Foreign exchange movement	**(200)**	(25)
At 31 December	**5,975**	6,169
Impairment at 31 December	**(1,177)**	(526)
Total loan investments net of impairment at 31 December	**4,798**	5,643

9. Loan investments at fair value through profit or loss

	2013	2012
	€ 000	€ 000
At 1 January	**2,681**	2,663
Disbursements	**-**	371
Repayments	**(642)**	(350)
Capitalised interest	**101**	-
Movement in fair value revaluation	**162**	(3)
Fair value at 31 December	**2,302**	2,681

10. Share investments

	2013	2012
	€ 000	€ 000
Outstanding disbursements		
At 1 January	**5,720**	5,472
Disbursements	**-**	1,350
Disposals	**(150)**	(1,102)
At 31 December	**5,570**	5,720
Fair value adjustment		
At 1 January	**(3,128)**	(3,816)
Movement in fair value revaluation	**(50)**	688
At 31 December	**(3,178)**	(3,128)
Fair value at 31 December	**2,392**	2,592

11. Other financial liabilities

	2013	2012
	€ 000	€ 000
Fair value of equity related derivatives	**2,203**	2,427
Audit fees payable	**7**	6
Distribution payable to contributor	**-**	1,000
At 31 December	**2,210**	3,433

12. Financial guarantee liabilities

	2013	2012
	€ 000	€ 000
Unamortised balance of day one fair value	**1,698**	1,975
Estimated settlement of impaired guaranteed loans	**307**	525
At 31 December	**2,005**	2,500

13. Undrawn commitments and guarantees

	2013	2012
	€ 000	€ 000
Undrawn loan commitments	**1,007**	1,125
Guarantees	**11,005**	12,293
Memorandum items at 31 December	**12,012**	13,418
Undrawn share commitments	**500**	650
Undrawn commitments and guarantees at 31 December	**12,512**	14,068

14. Analysis of current and non-current assets and liabilities

The table below provides the classification of current and non-current assets and liabilities in the balance sheet.

	Current	Non-current	Total	Current	Non-current	Total
	2013	2013	2013	2012	2012	2012
Assets	€ 000	€ 000	€ 000	€ 000	€ 000	€ 000
Placements with credit institutions	8,044	-	8,044	7,960	-	7,960
Derivative financial instruments	-	81	81	-	726	726
Interest receivable on loans	88	-	88	76	-	76
Loan investments at amortised cost	968	5,007	5,975	-	6,169	6,169
Provisions for impairment	(58)	(1,119)	(1,177)	-	(526)	(526)
Loan investments at fair value through profit or loss	22	2,280	2,302	-	2,681	2,681
Share investments	-	2,392	2,392	-	2,592	2,592
Total assets	9,064	8,641	17,705	8,036	11,642	19,678
Liabilities						
Derivative financial instruments	-	2,203	2,203	-	(2,427)	(2,427)
Other financial liabilities	7	-	7	(1,006)	-	(1,006)
Financial guarantee liabilities	2,005	-	2,005	(2,500)		(2,500)
Total liabilities	2,012	2,203	4,215	(3,506)	(2,427)	(5,933)

15. Events after the reporting period

There have been no material post-reporting date events that would require disclosure or adjustment to these financial statements.

16. Related parties

The Fund's related parties are the Bank and the contributor.

The Bank is entitled to charge the Fund a management fee of an amount equal to 1.5 per cent of contributions received. As there were no contributions received in 2013, there were no management fees paid by the Fund to the Bank (2012: nil) and there was no accrued management fee payable by the Fund to the Bank at 31 December 2013 (2012: nil).

Audit fees payable to the Bank are outlined in note 6.

INDEPENDENT AUDITOR'S REPORT TO THE BOARD OF GOVERNORS OF THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT ("THE BANK")

Report on the financial statements

We have audited the financial statements of the Italian Investment Special Fund ("the Fund") for the year ended 31 December 2013 which comprise the statement of comprehensive income, the balance sheet, the statement of changes in contributor's resources, the statement of cash flows for the year then ended together with the accounting policies, the risk management section and the related notes 1 to 16. The financial reporting framework that has been applied in their preparation is International Financial Reporting Standards as issued by the International Accounting Standards Board.

President's responsibility for the financial statements

The President is responsible for the preparation and fair presentation of the Financial Statements in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board, and for such internal control as the President determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Financial Statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the Financial Statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Bank's preparation and fair presentation of the Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion the Financial Statements present fairly, in all material respects, the financial position of the Italian Investment Special Fund as at 31 December 2013 and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board.

Other reporting responsibilities

We also report to you if, in our opinion, the Financial Statements are not in agreement with the accounting records, if the proper accounting records have not been kept, or if we have not received all the information and explanations we require for our audit. We have nothing to report in connection with this duty.

Other Matters

The financial statements have been prepared for, and only for, the Bank in accordance with Article 24 of the Agreement Establishing the Bank dated 29 May 1990, and for the use of the contributor and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this Report is shown or into whose hands it may come, save where expressly agreed by our prior consent in writing.

Deloitte LLP

Deloitte LLP
Chartered Accountants
London, United Kingdom
9 April 2014