# FINANCIAL REPORT 2012

European Bank
for Reconstruction and Development

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The *Financial Report 2012* includes the approved and audited financial statements required to be submitted under Article 27 of the Agreement Establishing the European Bank for Reconstruction and Development and Section 13 of its By-Laws.

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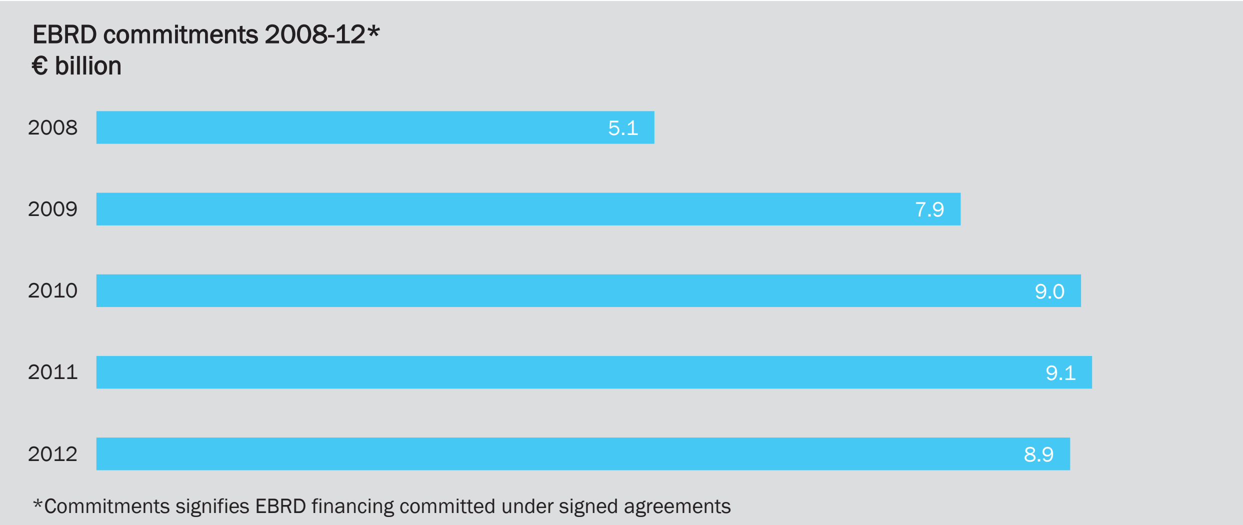
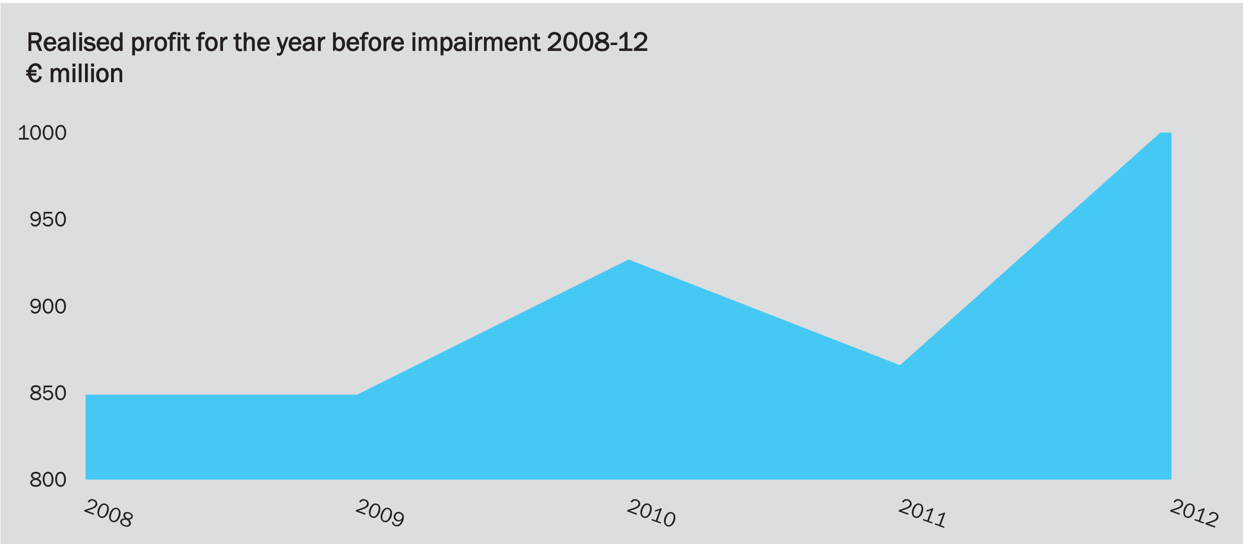
# Highlights



EBRD commitments 2008-12*
€ billion
2008
5.1
2009
7.9
2010
9.0
2011
9.1
2012
8.9
*Commitments signifies EBRD financing committed under signed agreements

Realised profit for the year before impairment 2008-12
€ million
1000
950
900
850
800
2008
2009
2010
2011
2012

## Financial results 2008-12

| € million | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Realised profit before impairment[1] | 1,006 | 866 | 927 | 849 | 849 |
| Net profit/(loss) before transfers of net income | 1,020 | 173 | 1,377 | (746) | (602) |
| Transfers of net income approved by the Board of Governors | (190) | - | (150) | (165) | (115) |
| Net profit/(loss) after transfers of net income | 830 | 173 | 1,227 | (911) | (717) |
| Paid-in capital | 6,202 | 6,199 | 6,197 | 5,198 | 5,198 |
| Reserves and retained earnings[2] | 7,808 | 6,974 | 6,780 | 6,317 | 6,552 |
| Total members' equity | 14,010 | 13,173 | 12,977 | 11,515 | 11,750 |

## Operational results 2008-12

| | 2012 | 2011 | 2010 | 2009 | 2008 | Cumulative 1991 - 2012 |
|---|---|---|---|---|---|---|
| Number of projects | 393 | 380 | 386 | 311 | 302 | 3,644 |
| Annual business volume (€ million) | 8,920 | 9,051 | 9,009 | 7,861 | 5,087 | 78,916 |
| Non-EBRD finance (€ million) | 17,372 | 20,802 | 13,174 | 10,353 | 8,372 | 155,644 |
| Total project value[3] (€ million) | 24,871 | 29,479 | 22,039 | 18,087 | 12,889 | 235,387 |

[1] Realised profit is before unrealised fair value adjustments to share investments, provisions, other unrealised amounts and transfers of net income.
[2] The movement in reserves and retained earnings reflects the net profit after transfers of net income, the movement in other comprehensive income and the retention of internal tax.
[3] Total project value is the total amount of finance provided to a project, including both EBRD and non-EBRD finance, and is reported in the year in which the project first signs. EBRD financing may be committed over more than one year with "annual business volume" reflecting EBRD finance by year of commitment. The amount of finance to be provided by non-EBRD parties is reported in the year the project first signs.

# Financial results

The European Bank for Reconstruction and Development (the Bank) recorded a net realised profit of €1.0 billion before provisions, unrealised losses on share investments and other unrealised amounts (2011: €866 million). Including provisions and unrealised amounts, net profit before transfers approved by the Board of Governors was also €1.0 billion for 2012 compared with a net profit of €173 million for 2011. The higher profit compared with 2011 reflects the change in unrealised equity fair values which registered a gain of €57 million in 2012 compared with a loss of €586 million in 2011. This portfolio is valued at €0.4 billion above cost (this includes the valuation of associated derivatives).

The Bank's reserves were €7.8 billion at the end of 2012 (2011: €7.0 billion), primarily reflecting the net profit for the year after transfers approved by the Board of Governors.

The Bank continues to be rated AAA or equivalent, with a stable outlook, by all three major rating agencies. It maintains a strong capital position, high levels of liquidity and enjoys the strong support of its shareholders.

In a historic year for the EBRD and its prospective countries of operations in Egypt, Jordan, Morocco and Tunisia, the Bank continued to lay the foundations for future growth in the southern and eastern Mediterranean (SEMED) region by creating the SEMED Investment Special Fund (SEMED ISF) to enable financing of projects within the region. Consequently, an amount of €1.0 billion was set aside from unrestricted general reserves to finance the SEMED ISF. For accounting purposes, these monies continue to be recognised as part of the Bank's financial statements and all the disclosures (with the exception of note 32) include the results from the Bank's ordinary operations and the SEMED operations.

## Banking operations

### Operational results

Annual business volume[4] amounted to €8.9 billion in 2012, comprising 393 projects and 72 outstanding balances under the 2012 trade facilitation programme (2011: €9.1 billion, 380 projects and 63 trade finance balances). This total included six commitments for €181 million funded through the SEMED ISF. The SEMED ISF was created following the shareholders' decision in 2012 to expand the Bank's region of operations to include the SEMED region, with Egypt, Jordan, Morocco and Tunisia applying to become recipient countries.

Projects in the Central Asia region accounted for 10 per cent of business volume in 2012, Eastern Europe and Caucasus 17 per cent, South-eastern Europe 17 per cent, Russia 29 per cent, Central Europe and Baltics 14 per cent, Turkey 12 per cent and the SEMED region 2 per cent.

The Bank continued to support key economic sectors in line with its operational strategy. Projects in the diversified corporate sectors accounted for 28 per cent of 2012 business volume, 32 per cent went to the financial sector, with priority given to the financing of SMEs, and the energy and infrastructure sectors accounted for the remaining 41 per cent.

The Bank's portfolio of investment operations increased to €37.5 billion[5] by the end of 2012, an 8 per cent increase on the 2011 year-end level of €34.8 billion. Reflows were 19 per cent higher than in 2011, reflecting both robust repayment levels from the Bank's loan portfolio and divestments of around €0.6 billion from the Bank's equity portfolio.

Gross disbursements reached €6.0 billion in 2012 compared with €6.7 billion in 2011, reflecting the high level of signings late in the year which will disburse in 2013. Reported operating assets increased to €26.5 billion at the end of 2012, up 7 per cent compared with the end-2011 level of €24.8 billion. These comprised €20.0 billion of disbursed outstanding loans (2011: €18.7 billion) and €6.6 billion of disbursed outstanding equity investments at historic cost (2011: €6.1 billion).

The Bank's projects attracted additional financing of €17.4 billion during 2012 (2011: €20.8 billion) with the Bank directly mobilising €1.2 billion of syndicated loans (2011: €1.0 billion). In addition the Bank's activities continued to be strongly supported by donor funding, including the Special Funds programme and Technical and Investment Cooperation Funds.

### Financial performance

Banking operations recorded a net profit of €749 million for 2012 compared with a net profit of €99 million in 2011. The difference reflected the change in unrealised equity fair values which registered a gain of €57 million in 2012 compared with a loss of €586 million in 2011.

[4] Commitments made by the Bank in the year to finance investment operations, including to restructured operations, less cancellation or sales of such commitments within the same year.
[5] This figure includes undrawn commitments of €11.0 billion and operating assets of €26.5 billion.

The Banking profit for the year is primarily due to net interest income of €742 million. Excluding unrealised fair value movements on the share investments portfolio and provisions charged against the loans portfolio, Banking operations returned a profit of €0.8 billion (2011: €0.7 billion).

The contribution from share investments to the Bank's income statement is expected to continue to show significant variability from year to year, given the volatility of equity markets and the timing of exits. Exits are mainly linked to the completion of the Bank's transition role in the specific operation and the opportunity, in the market or otherwise, to sell its holding.

## Treasury operations

### Portfolio

The value of assets under Treasury management at 31 December 2012 was €20.5 billion compared with €17.6 billion at the end of 2011. This comprised debt securities of €12.4 billion (2011: €11.5 billion), €7.5 billion of placements with credit institutions (2011: €5.2 billion) and collateralised placements of €0.6 billion (2011: €0.9 billion).

### Financial performance

Treasury operations reported an operating profit of €202 million before hedge accounting adjustments compared with €113 million in 2011. The portfolio primarily generates profit through net interest income which in 2012 was €133 million compared with €102 million in 2011, reflecting the higher level of assets managed during the year. Lower levels of impairment charges in 2012, together with higher returns on Treasury activities contributed the balance of the improved performance in 2012.

## Capital

At the 2010 Annual Meeting, the Board of Governors approved an increase to the Bank's authorised capital of €10.0 billion, for which €1.0 billion was capitalised from the Bank's reserves while the other €9.0 billion was callable. The €9.0 billion of callable capital became effective in April 2011 when subscriptions representing 50 per cent of the number of newly authorised shares was reached. At 31 December 2012 this figure had grown to 99 per cent, increasing subscribed capital to €29.6 billion (2011: €28.4 billion)

Paid-in capital totalled €6.2 billion at 31 December 2012 (2011: €6.2 billion), of which €12 million was overdue (2011: €15 million).

The calculation of capital for gearing purposes under the Agreement Establishing the Bank is further explained under the Capital Management section of this report.

## Reserves

The Bank's reserves increased from €7.0 billion at the end of 2011 to €7.8 billion at the end of 2012, primarily reflecting the net profit for the year. Unrestricted general reserves increased by €858 million before net income allocations (2011: an increase of €552 million).

During the year, the Board of Governors set aside €1.0 billion for the SEMED ISF from unrestricted general reserves. At 31 December 2012 unrestricted general reserves totalled €4.0 billion (2011: €4.1 billion).

## Expenses

The Bank continues to focus on budgetary discipline, effective cost controls and a proactive cost-recovery programme. The Bank's general administrative expenses for 2012, including depreciation and amortisation, totalled €296 million (2011: €270 million). Sterling general administrative expenses for 2012, including depreciation and amortisation, totalled £260 million (2011: £229 million).

## Outlook for 2013

The Bank expects its net realised profit to remain relatively stable. However its overall profitability will remain vulnerable to volatility in financial markets, with the fair value of its share investments portfolio and the level of specific debt impairment having particular influence on its profits.

# Key financial indicators: 2008 – 12

Key financial indicators are presented for the Bank over the last five years. These ratios are influenced by the growth in portfolio and annual business volume of the five-year period in line with the Bank's strategy. This business growth utilises the Bank's capital capacity in pursuit of its mandate objectives, while underlying ratios remain at prudent levels broadly consistent with the upper quartile among international financial institutions (IFIs) in terms of capital strength and cost efficiency.

The Bank's profits and reserves show volatility due to movements in the valuations of share investments. Excluding these movements, the Bank has continued to grow its members' equity against an adverse economic background, with an average return on equity of 5 per cent over the last five years (2007-2011: an average of 7 per cent). The performance of the Bank's loan assets still remains relatively strong with a non-performing loan ratio at 31 December 2012 of 3 per cent (2011: 3 per cent).

The strong growth in members' equity in 2012 has allowed the Bank to support strong investment in its region of operations while key balance sheet indicators remain broadly unchanged.

Leverage – debt divided by members' equity – was 2.5 times at 31 December 2012 (2011: 2.4 times) reflecting the growth in the Bank's portfolio and the maintenance of a high level of liquidity.

The Bank's capital strength is illustrated by the level of members' equity, which was 27 per cent of total assets at 31 December 2012 (2011: 28 per cent), including Treasury assets with an average risk rating between AA and AA– with a reduced average maturity. Members' equity was 55 per cent of Banking assets ('development related exposure') at 31 December 2012 (2011: 54 per cent).

The Bank's capital strength is further underpinned by its 'triple-A' rating with a stable outlook reaffirmed by all three major rating agencies in 2012.

| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| **Financial performance** | | | | | |
| 1. Return on members' equity – IFRS basis | 8% | 0% | 12% | (2%) | (15%) |
| 2. Return on members' equity – Realised basis | 7% | 5% | 8% | 2% | 3% |
| **Efficiency** | | | | | |
| 3. Cost-to-income ratio | 22% | 25% | 24% | 25% | 17% |
| **Portfolio quality** | | | | | |
| 4. Non-performing loans ratio | 3% | 3% | 3% | 2% | 1% |
| 5. Average rating of Treasury liquid assets | 2.2 | 2.2 | 2.4 | 2.5 | 2.1 |
| 6. Average maturity of Treasury liquid assets (tenor) | 1.0 | 1.3 | 1.5 | 1.9 | 2.1 |
| **Liquidity and leverage** | | | | | |
| 7. Liquid assets/undisbursed Banking investments plus one-year debt service | 85% | 88% | 82% | 74% | 96% |
| 8. Debt/members' equity: leverage ratio | 249% | 241% | 192% | 172% | 157% |
| **Capital strength** | | | | | |
| 9. Members' equity/total assets | 27% | 28% | 33% | 35% | 35% |
| 10. Members' equity/Banking assets | 55% | 54% | 61% | 64% | 77% |

## Explanatory notes on ratios above:

1. (Total closing members' equity minus total opening members' equity) divided by total opening members' equity. Members' equity adjusted for net income allocations. IFRS – International Financial Reporting Standards.
2. (Total closing members' equity minus total opening members' equity) divided by total opening members' equity with unrealised Banking fair value adjustments excluded from members' equity and before net income allocations.
3. Total operating expenses divided by total operating income before net movements in equity valuations and Banking and Treasury loan provisions.
4. Total non-performing loans as a percentage of total loan operating assets (before accounting adjustments).
5. Represents the average credit rating weighted by peak counterparty exposure, based on the Bank's internal rating scale as disclosed within the Risk Management: credit risk section of this report.
6. The average tenor of Treasury assets in years is derived from the weighted average time to final maturity, with the exception of asset-backed securities whose final maturity is approximated by the average life of the transaction.
7. Treasury liquid assets divided by total Banking undrawn commitments (undisbursed but committed investments), plus one year's debt service, being debt due for redemption within one year and one year's estimated interest expense.
8. Total borrowings divided by total members' equity.
9. Total members' equity divided by total assets.
10. Total members' equity divided by total Banking assets at fair value.

# Additional reporting and disclosures

## Corporate governance

The EBRD is committed to the highest standards of corporate governance. Responsibilities and related controls throughout the Bank are properly defined and delineated. Transparency and accountability are integral elements of its corporate governance framework. This structure is further supported by a system of reporting, with information appropriately tailored for, and disseminated to, each level of responsibility within the Bank to enable the system of checks and balances on the Bank's activities to function effectively.

The Bank's governing constituent document is the Agreement Establishing the Bank ("the Agreement"), which states that the institution will have a Board of Governors, a Board of Directors, a President, Vice Presidents, officers and staff.

### Board of Governors

All the powers of the Bank are vested in the Board of Governors, which represents the Bank's 66 shareholders. With the exception of certain reserved powers, the Board of Governors has delegated the exercise of its powers to the Board of Directors, while retaining overall authority.

### Board of Directors

The Board of Directors comprises 23 Directors and is chaired by the President. Each Director represents one or more shareholders. Subject to the Board of Governors' overall authority, the Board of Directors is responsible for the direction of the Bank's general operations and policies. It exercises the powers expressly assigned to it by the Agreement and those powers delegated to it by the Board of Governors.

### Board Committees

The Board of Directors has established three Board Committees to assist with its work:

The **Audit Committee** assists the Board of Directors in fulfilling its responsibilities in relation to the following:

- the integrity of the Bank's financial statements and its accounting, financial reporting and disclosure policies and practices
- the soundness of the Bank's systems of internal controls that management has established regarding finance and accounting matters and their effective implementation
- the status, the ability to perform duties independently and the performance of the Bank's compliance, internal audit, evaluation and risk management functions
- the independence, qualifications and performance of the Bank's external auditor
- other responsibilities within its remit.

The **Budget and Administrative Affairs Committee** assists the Board of Directors in fulfilling its responsibilities in relation to the following:

- the budgetary, staff and administrative resources of the Bank
- efficiency, cost control and budgetary prudence
- the EBRD Shareholder Special Fund, the use of donor funding and relations with the donor community
- the Bank's Human Resources policies
- specific responsibilities in relation to Governors, the President, Vice Presidents and Directors of the Bank
- policies relating to governance and ethics
- the Bank's administrative arrangements
- other responsibilities within its remit.

The **Financial and Operations Policies Committee** assists the Board of Directors in fulfilling its responsibilities in relation to the following:

- the Bank's financial policies
- the Bank's Treasury operations, Liquidity Policy and Borrowing Programme
- the Bank's operational policies
- the Bank's strategic portfolio management within the framework of the Medium Term Strategy
- transparency and accountability of the Bank's operations within the framework of the Public Information Policy and the Project Complaint Mechanism
- other responsibilities within its remit.

The composition of these committees during 2012 is detailed in the separate Review section of the Annual Report.

### The President

The President is elected by the Board of Governors. He is the legal representative and chief of staff of the Bank. Under the direction of the Board of Directors, the President conducts the day-to-day business of the Bank.

The President chairs the Bank's Executive Committee, which also includes the Vice Presidents and other members of the Bank's senior management.

## Other Management Committees

Listed below are other management committees that assisted the President in the overall management of the Bank in 2012.

| Management Committees | Chair | Purpose of the Committee | Meeting frequency |
|---|---|---|---|
| Executive Committee | President | The Executive Committee reviews and decides on all aspects of Bank strategy, the budget and day-to-day management falling within the competence of the President and approves submissions to the Board. | Weekly |
| Operations Committee | First Vice President, Banking | Considers all banking transactions at various stages (concept, structure and final reviews) before submission by the President for consideration by the Board of Directors. | Weekly |
| Equity Committee | First Vice President, Banking | Maintains oversight over listed and unlisted share investments.<br>Reviews and identifies suitable exit opportunities and makes recommendation on such exits to the Operations Committee. | Quarterly |
| Procurement Complaints Committee | Deputy General Counsel, Banking and Finance | Considers complaints and disputes arising from tendering and contracts for goods, works and consultant services (including those funded by Cooperation funds or the Bank's budget) subject to the Procurement Policies and Rules or the Corporate Procurement Policy, as the case may be.<br>Reviews procurement and related matters referred to it by the Executive Committee. | As necessary |
| Technical Cooperation Committee | Vice President, Operational Policies | Decides on all transactional and non-transactional Technical Cooperation proposals except those expressly approved by the Board as being subject to an alternative approval process. | Weekly |
| Information Technology Governance Committee | Vice President, Risk and Resources | Ensures that the Bank's IT strategy and business plan support the Bank's business strategy.<br>Establishes the framework for measuring business benefits and oversees the realisation of benefits arising from IT projects.<br>Reviews and approves business requests for budget allocation on new projects from the approved IT budget. | At least six times per year |
| Crisis Management Team | Vice President and Chief Financial Officer | Prepares coordinated response to all critical internal and external issues arising in connection with events that affect the normal operations of the Bank.<br>Ensures that the crisis management plan and business recovery plan is in place and is tested on a regular basis. | At least three times per year |
| Strategic Human Resources Committee | President | Approves all senior appointments. | As necessary |
| Enforcement Committee | Deputy General Counsel, Banking and Finance | Oversees the Bank's policies and procedures for processing allegations of fraud, corruption, collusion or coercion in relation to activities and projects financed from the Bank's ordinary capital resources, Special Funds or cooperation funds administered by the Bank.<br>Decides on whether to take any enforcement action based on a third party finding or in implementation of any agreement for the mutual enforcement of debarment decisions in effect between the Bank and another international organisation. | As necessary |

## EBRD Codes of Conduct

The EBRD has Codes of Conduct for Officials of the Board of Directors and for Bank Personnel which articulate the values, duties and obligations, as well as the ethical standards that the Bank expects of its Board officials and staff. These Codes were reviewed in 2011 and the revised versions were adopted by the Bank's Board of Governors in February 2012. The revised Codes of Conduct prohibit retaliation against whistleblowers. The Codes of Conduct can be obtained at www.ebrd.com/pages/about/integrity/compliance.shtml.

In June 2012, the Code of Conduct Committee of the Board of Directors approved guidance notes to help EBRD personnel to interpret and apply four of the rules contained in the Code of Conduct for EBRD Personnel. The guidance notes issued relate to Rule 2 - Communications with Board Officials, Rule 5 - Political Activities, Rule 7 - Gifts, Hospitality, etc., and Rule 8 - Financial Interests.

## Compliance

The EBRD has an independent Office of the Chief Compliance Officer (OCCO), which is headed by a Chief Compliance Officer (CCO) who reports directly to the President, and quarterly, or as necessary, to the Audit Committee. The CCO can be dismissed by the President only in accordance with guidance given by the Board of Directors in an executive session.

The OCCO's mandate is to promote good governance throughout the EBRD and in its operations and to ensure that the highest standards of integrity are applied throughout all of the Bank's activities. The responsibilities of the OCCO include dealing with issues of integrity due diligence, confidentiality, conflicts of interest, accountability, ethics, anti-money-laundering, counter-terrorist financing and the prevention of fraudulent and corrupt practices.

The EBRD has adopted an Integrity Risks Policy which can be obtained at www.ebrd.com/downloads/integrity/integrityriskpol.pdf. This policy allocates responsibility within the EBRD for managing and mitigating integrity and compliance risks in the Bank's operations. Financial and integrity due diligence are integrated into the Bank's normal approval of new business and in the monitoring of its existing transactions. The OCCO provides independent expert advice to management as to the existence of potential integrity risks and whether these risks are acceptable to the Bank. It monitors the integrity due diligence information provided by the Banking Department to ensure that it is accurate and that integrity concerns are properly identified.

The OCCO is further responsible for investigating allegations of staff misconduct as well as fraud and corruption in relation to Bank projects and counterparties. Allegations of staff misconduct are investigated under the Conduct and Disciplinary Rules and Procedures (CDRPs). The CDRPs specify the rights and duties of both the Bank and staff member during the investigative and disciplinary processes and provide safeguards for the subject of the investigation.

Allegations of fraud and corruption in relation to Bank projects or counterparties are investigated under the Bank's Enforcement Policy and Procedures (EPPs). The EPPs also describe the process by which the Bank applies sanctions imposed by other Multilateral Development Banks (MDBs) pursuant to the Agreement for the Mutual Enforcement of Debarment Decisions. In 2012, the OCCO issued 58 Notices of Mutual Enforcement after receiving debarment decisions from MDBs with respect to 45 incorporated entities and 32 individuals. The EBRD's Enforcement Committee determined that the EBRD sanction the entities and individuals noted in the 58 Notices of Mutual Enforcement. Details of the individuals, entities and sanctions are posted at www.ebrd.com/pages/about/integrity/list.shtml.

The OCCO is also responsible for training Bank personnel on the Bank's integrity, anti-money-laundering and counter-terrorist finance requirements. In addition, it provides specialist training and advises, as necessary, individuals who are nominated by the Bank to serve as directors on the boards of companies in which the Bank holds an equity interest.

The Bank has an accountability mechanism which assesses and reviews complaints about Bank-financed projects and provides, where warranted, a determination as to whether the Bank acted in compliance with its relevant policies when it approved a particular project. The Project Complaint Mechanism (PCM) is administered by the OCCO and there is a dedicated PCM Officer, appointed by the President, who is responsible for its day-to-day implementation. Information on the PCM and registered complaints can be found at www.ebrd.com/pages/project/pcm/register.shtml.

The Bank's annual Anti-Corruption Report is published by the OCCO. The report describes the Bank's strategy to promote integrity and prevent fraud and corruption and highlights the most recent measures taken. The report can be found at www.ebrd.com/pages/about/integrity/reports.shtml.

## Reporting

The EBRD's corporate governance structure is supported by appropriate financial and management reporting. The Bank has a functioning mechanism to be able to certify in the *Financial Report 2012* as to the effectiveness of internal controls over external financial reporting, using the Committee of Sponsoring Organisations of the Treadway Commission internal control framework. This annual certification statement is signed by both the President and the Vice President and Chief Financial Officer (Vice President and CFO) and is subject to a review and an attestation by the Bank's external auditor. In addition, the Bank has a comprehensive system of reporting to its Board of Directors and its committees. This includes reporting to the Audit Committee on the activities of the Evaluation Department and the Internal Audit Department.

## Financial risks

Financial risks are discussed in the Risk Management section of this report.

## Operational risk

The Bank defines operational risk as all aspects of risk-related exposure other than those falling within the scope of credit, market and liquidity risk. This includes the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events and reputational risk. Examples include:

- errors or failures in transaction support systems and inadequate disaster recovery planning, including errors in the mathematical formulae of pricing or hedging models, or in the computation of the fair value of transactions
- external events
- damage to the Bank's name and reputation, either directly by adverse comments or indirectly
- errors or omissions in the processing and settlement of transactions, whether in the areas of execution, booking or settlement or due to inadequate legal documentation
- errors in the reporting of financial results or failures in controls, such as unidentified limit excesses or unauthorised trading/trading outside policies
- dependency on a limited number of key personnel, inadequate or insufficient staff training or skill levels.

The Bank has a low tolerance for material losses arising from operational risk exposures. Where material operational risks are identified (that is, those that may lead to material loss if not mitigated), appropriate mitigation and control measures are put in place after a careful weighing of the risk/return trade-off. Maintaining the Bank's reputation is of paramount importance and reputational risk has therefore been included in the Bank's definition of operational risk. The Bank will always take all reasonable and practical steps to safeguard its reputation.

Within the Bank, there are policies and procedures in place covering all significant aspects of operational risk. These include first and foremost the Bank's high standards of business ethics and its established system of internal controls, checks and balances and segregation of duties. These are supplemented with:

- the Bank's Codes of Conduct
- disaster recovery/contingency planning
- the Public Information Policy
- client and project integrity due diligence procedures, including anti-money-laundering measures
- procedures for reporting and investigating suspected staff misconduct, including fraud
- the information security framework
- procurement and purchasing policies, including the detection of corrupt practices in procurement.

Responsibility for developing the operational risk framework and for monitoring its implementation resides within the Risk and Resources Vice Presidency. Risk Management is responsible for the overall framework and structure to support line managers who control and manage operational risk as part of their day-to-day activities. Risk Management drafts proposals that are discussed and reviewed by the Operational Risk Management Group (ORMG), which implements the operational risk management policies and techniques throughout the Bank. The ORMG is chaired by the Vice President, Risk and Resources (Vice President Risk) and its membership comprises senior managers across the Bank who have been identified as potentially facing the most operational risk within their day-to-day activities. The ORMG's task is to develop and coordinate the Bank's approach to managing operational risk, and to ensure that it is widely implemented across all areas of the Bank.

The Bank's current operational risk framework includes an agreed definition (see above); the categorisation of different loss type events to capture the Bank's exposure to operational risk; a group of key risk indicators to measure such risks; the identification of specific operational risks through an annual self-assessment exercise; internal loss data collection; and use of external loss data.

Departments within the EBRD identify their operational risk exposures and evaluate the mitigating controls that help to reduce the inherent or pre-control risk. Each risk (both inherent and post control) is assessed for its impact, according to a defined value scale and the likelihood of occurrence, based on a frequency by time range. Departments also report operational risk incident losses or near misses above €5,000. The intention of collecting such data is primarily to improve the control environment by taking into account the cost of control strengthening and perceived potential future losses. The Bank is a member of GOLD, the external loss database where members "pool" operational risk incident information over a monetary threshold. This provides the Bank with access to a depth of information wider than its own experience and supplements its own analysis on reported internal incidents. GOLD is run as an unincorporated not-for-profit consortium of financial services institutions.

For financial risks, please refer to the Risk Management section of the report.

## External auditor

The external auditor is appointed by the Board of Directors, on the recommendation of the President, for a four-year term with a maximum of two consecutive terms. The Bank has appointed Deloitte LLP (UK) as auditor for the period 2011-14.

The external auditor performs an annual audit to enable the firm to express an opinion on whether the financial statements present fairly the financial position and the profit of the Bank in accordance with International Financial Reporting Standards. In addition, the external auditor reviews and offers its opinion on management's assertion as to the effectiveness of internal controls over financial reporting. This opinion is given as a separate report to the audit opinion. At the conclusion of its annual audit, the external auditor prepares a management letter for the Board of Governors, setting out its views and management's responses on the effectiveness and efficiency of internal controls and other matters. This letter is reviewed in detail and discussed with the Audit Committee. The Audit Committee reviews the performance and independence of the external auditor annually.

There are key provisions in the Bank's policies regarding the independence of the external auditor. The external auditor is prohibited from providing non-audit related services unless such service is judged to be in the interest of the Bank and unless it is approved by the Audit Committee. However, the external auditor can provide consultancy services paid for by cooperation funds relating to client projects; such incidents are reported periodically to the Audit Committee.

## Compensation policy

The Bank has designed a market-oriented staff compensation policy, within the constraints of the Bank's status as a multilateral institution, to meet the following objectives:

- To be competitive enough to attract and retain high calibre employees from a wide range of member countries
- To motivate and encourage superior performance
- To take account of differing levels of responsibility
- To allow the Bank flexibility to respond rapidly to changing conditions
- To support a climate of constant staff development
- To deliver benefits that provide social security in daily life

To help meet these objectives, the Bank's shareholders have agreed that the Bank should use market comparators to evaluate its staff compensation and that salary and performance-based compensation awards should be driven by performance. Market comparators for the Bank are primarily private sector financial institutions in each of its locations plus other IFIs.

The performance-based compensation awards are structured to recognise individual and team contributions to the Bank's overall performance. These payments represent a limited proportion of the overall total compensation and benefits package provided to staff.

## EBRD staff remuneration

All staff on fixed-term or regular contracts receive a salary which is reviewed on 1 April each year. In addition, professional members of staff are eligible to receive a performance-based compensation award depending on the Bank's and the individual staff member's performance.

All fixed-term and regular employees, as well as most of the Board of Directors,[6] the President and Vice Presidents, are covered by medical insurance, participate in the Bank's retirement plans and may be eligible to receive a mortgage subsidy. Professional staff hired from abroad may be eligible for Expatriate/Third Country National status and receive, subject to specific conditions, allowances to assist with relocation, accommodation (to defray the cost of renting or purchasing a home) and the education of their children.

There are two retirement plans in operation. The Money Purchase Plan is a defined contribution scheme to which both the Bank and staff contribute, with Plan members making individual investment decisions. The Final Salary Plan is a defined benefit scheme, to which only the Bank contributes. Both plans provide a lump sum benefit on leaving the Bank or at retirement age, such that retirement plan obligations to staff once they have left the Bank or retired are minimal (being limited to inflation adjustments on undrawn or deferred benefits under each plan). The rules for the retirement plans are approved by the Board of Directors and are monitored by a Retirement Plan Committee, a Retirement Plan Administration Committee and a Retirement Plan Investment Committee.

The salaries and emoluments of all staff are subject to an internal tax, applied at rates that vary according to the individual's salary and personal circumstances. Their salaries and emoluments are exempt from national income tax in the United Kingdom.

[6] Some Directors and Alternates are paid directly by their constituency and do not participate in the Bank's retirement plans and/or other benefits.

## President and Vice Presidents

The President is elected by the Board of Governors and typically receives a fixed-term contract of four years. The President's salary and benefits are approved by the Board of Governors. The President can participate in the same benefit schemes as the staff but s/he is not eligible for performance-based compensation awards.

The Vice Presidents are appointed by the Board of Directors on the recommendation of the President and typically have fixed-term contracts of four years. Their salaries and benefits are approved by the Board of Directors. The Vice Presidents can participate in the same benefit schemes as the staff but are not eligible for performance-based compensation awards.

The gross salary paid in the year from which internal tax is deducted, for each of these positions is as follows:

| | 2012<br>£ 000 | 2012<br>€ 000 | 2011<br>£ 000 | 2011<br>€ 000 |
|---|---|---|---|---|
| President[7] | 163 | 200 | n/a | n/a |
| President[8] | 164 | 201 | 317 | 366 |
| First Vice President, Banking | 298 | 365 | 281 | 324 |
| Vice President and Chief Financial Officer | 272 | 334 | 257 | 296 |
| Vice President, Risk and Resources[9] | 225 | 276 | n/a | n/a |
| Vice President, Risk and Resources[10] | n/a | n/a | 171 | 197 |
| Vice President, Operational Policies[11] | 158 | 194 | 257 | 296 |
| Acting Vice President, Operational Policies[12] | 75 | 92 | n/a | n/a |

## Board of Directors

Directors are elected by the Board of Governors for a term of three years and may be re-elected. Directors appoint Alternate Directors. The salaries of Directors and Alternate Directors are approved by the Board of Governors. They can participate in the same benefit schemes as staff but are not eligible for performance-based compensation awards. Some Directors and Alternates are paid directly by the directorship that they represent. In such cases, the funds that would otherwise be used by the Bank to pay such Directors and Alternates are made available to the directorship to offset other eligible costs to the directorship.

The most recently approved gross salaries from which internal tax is deducted, for these positions are as follows:

| | 2012<br>£ 000 | 2012<br>€ 000 | 2011<br>£ 000 | 2011<br>€ 000 |
|---|---|---|---|---|
| Director | 140 | 172 | 135 | 156 |
| Alternate Director | 116 | 142 | 112 | 129 |

## Senior management

Key management personnel comprises: members of the Bank's Executive Committee; Director of the President's Office; Managing Directors; the Treasurer; the Controller; the Director of Human Resources; the Director, Communications; the Head of Internal Audit and the Chief Compliance Officer. This group, excluding the President and Vice Presidents (for whom information is given above), consists of 27 individuals who received gross salaries, from which internal tax is deducted, in the ranges shown in the table below. The average performance-based compensation award for this group was 23 per cent of annual gross salaries in 2012 (2011: 23 per cent).

| 2012<br>£ 000 | 2012<br>€ 000 | 2011<br>£ 000 | 2011<br>€ 000 |
|---|---|---|---|
| 95 to 210 | 117 to 258 | 85 to 203 | 98 to 234 |

7 Employed from 3 July 2012.
8 Employed until 2 July 2012.
9 Employed from 5 March 2012.
10 Employed until 31 August 2012.
11 Employed until 8 November 2012 (on unpaid leave from 1 August 2012 to 8 November 2012).
12 Acting in role from 10 July 2012.

# Income statement

These financial statements have been approved for issue by the Board of Directors on 26 February 2013.

| For the year ended 31 December 2012 | Note | Year to 31 December 2012 € million | Year to 31 December 2011 € million |
|---|---|---|---|
| Interest and similar income | | | |
| From Banking loans | | 1,040 | 859 |
| From fixed-income debt securities and other interest | | 166 | 187 |
| Interest expense and similar charges | | (155) | (145) |
| Net interest expense on derivatives | | (176) | (118) |
| **Net interest income** | 3 | 875 | 783 |
| Net fee and commission income | 4 | 32 | 20 |
| Dividend income | | 87 | 115 |
| Net gains/(losses) from share investments at fair value through profit or loss | 5 | 274 | (424) |
| Net gains from loans at fair value through profit or loss | 6 | 11 | 5 |
| Net gains from loans at amortised cost | | 1 | 2 |
| Net losses from Treasury assets held at amortised cost | 7 | (16) | (34) |
| Net gains from Treasury activities at fair value through profit or loss and foreign exchange | 8 | 103 | 61 |
| Fair value movement on non-qualifying and ineffective hedges | 9 | 69 | (39) |
| Impairment provisions on Banking loan investments | 10 | (120) | (46) |
| General administrative expenses | 11 | (271) | (249) |
| Depreciation and amortisation | 20,21 | (25) | (21) |
| **Net profit for the year from continuing operations** | | 1,020 | 173 |
| Transfers of net income approved by the Board of Governors | | (190) | - |
| **Net profit after transfers of net income approved by the Board of Governors** | | 830 | 173 |
| Attributable to: | | | |
| **Equity holders** | | 830 | 173 |

Pages 19 to 75 are an integral part of these financial statements.

# Statement of comprehensive income

| For the year ended 31 December 2012 | Year to 31 December 2012 € million | Year to 31 December 2011 € million |
|---|---|---|
| Net profit after transfers of net income approved by the Board of Governors | 830 | 173 |
| Other comprehensive income/(expense) | | |
| Share investment designated as fair value through other comprehensive income | 6 | 2 |
| Cash flow hedges | (8) | 15 |
| Total comprehensive income | 828 | 190 |
| | | |
| Attributable to: | | |
| Equity holders | 828 | 190 |

Pages 19 to 75 are an integral part of these financial statements.

# Balance sheet

| At 31 December 2012 | Note | € million | 31 December 2012 € million | € million | 31 December 2011 € million |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Placements with and advances to credit institutions | 12 | 7,515 | | 5,172 | |
| Debt securities | 13 | | | | |
| At fair value through profit or loss | | 175 | | 411 | |
| At amortised cost | | 12,243 | | 11,161 | |
| Less: Provisions for impairment | | (8) | | (34) | |
| | | 12,410 | | 11,538 | |
| Collateralised placements | 14 | 600 | | 851 | |
| | | | 20,525 | | 17,561 |
| Other financial assets | 15 | | | | |
| Derivative financial instruments | | 4,671 | | 5,111 | |
| Other financial assets | | 354 | | 517 | |
| | | | 5,025 | | 5,628 |
| Loan investments | | | | | |
| *Banking portfolio:* | | | | | |
| Loans at amortised cost | 16 | 19,333 | | 18,088 | |
| Less: Provisions for impairment | 10 | (736) | | (672) | |
| Loans at fair value through profit or loss | 17 | 247 | | 239 | |
| | | | 18,844 | | 17,655 |
| Share investments | | | | | |
| *Banking portfolio:* | | | | | |
| At fair value through profit or loss | 18 | 6,649 | | 6,037 | |
| *Treasury portfolio:* | | | | | |
| Share investments at fair value through other comprehensive income | 19 | 64 | | 58 | |
| | | | 6,713 | | 6,095 |
| Intangible assets | 20 | | 41 | | 44 |
| Property, technology and office equipment | 21 | | 42 | | 38 |
| Paid-in capital receivable | | | 12 | | 15 |
| **Total assets** | | | 51,202 | | 47,036 |
| **Liabilities** | | | | | |
| Borrowings | | | | | |
| Amounts owed to credit institutions | 22 | 3,086 | | 2,610 | |
| Debts evidenced by certificates | 23 | 31,824 | | 29,195 | |
| | | | 34,910 | | 31,805 |
| Other financial liabilities | 24 | | | | |
| Derivative financial instruments | | 1,752 | | 1,643 | |
| Other financial liabilities | | 530 | | 415 | |
| | | | 2,282 | | 2,058 |
| **Total liabilities** | | | 37,192 | | 33,863 |
| **Members' equity attributable to equity holders** | | | | | |
| Paid-in capital | 25 | | 6,202 | | 6,199 |
| Reserves and retained earnings | 26 | | 7,808 | | 6,974 |
| **Total members' equity** | | | 14,010 | | 13,173 |
| **Total liabilities and members' equity** | | | 51,202 | | 47,036 |
| **Memorandum items** | | | | | |
| Undrawn commitments | 27 | | 10,995 | | 10,034 |

Pages 19 to 75 are an integral part of these financial statements.

# Statement of changes in equity

| For the year ended 31 December 2012 | Subscribed capital € million | Callable capital € million | Fair value through other comprehensive income reserve € million | Cash flow reserves € million | Retained earnings € million | Total equity € million |
|---|---|---|---|---|---|---|
| At 31 December 2010 | 20,793 | (14,596) | 8 | – | 6,772 | 12,977 |
| Total comprehensive income for the year | – | – | 2 | 15 | 173 | 190 |
| Internal tax for the year | – | – | – | – | 4 | 4 |
| Capital subscriptions | 7,587 | (7,585) | – | – | – | 2 |
| At 31 December 2011 | 28,380 | (22,181) | 10 | 15 | 6,949 | 13,173 |
| | | | | | | |
| Total comprehensive income for the year | – | – | 6 | (8) | 830 | 828 |
| Internal tax for the year | – | – | – | – | 6 | 6 |
| Capital subscriptions | 1,221 | (1,218) | – | – | – | 3 |
| **At 31 December 2012** | 29,601 | (23,399) | 16 | 7 | 7,785 | 14,010 |

Refer to note 26 “Reserves and retained earnings” for a further explanation of the Bank’s reserves.

Pages 19 to 75 are an integral part of these financial statements.

# Statement of cash flows

| For the year ended 31 December 2012 | € million | Year to 31 December 2012 € million | € million | Year to 31 December 2011 € million |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| Net profit for the year | 830 | | 173 | |
| Adjustments for: | | | | |
| Unwinding of the discount relating to impaired identified assets | (11) | | (11) | |
| Interest income | (1,195) | | (1,035) | |
| Interest expenses and similar charges | 331 | | 263 | |
| Net deferral of fees and direct costs | 108 | | 101 | |
| Internal tax | 6 | | 5 | |
| Realised gains on share investments and equity derivatives | (217) | | (162) | |
| Unrealised (gains)/losses on share investments and equity derivatives at fair value through profit or loss | (57) | | 586 | |
| Unrealised gains from loans at fair value through profit or loss | (7) | | (5) | |
| Realised gains on Banking loans | (6) | | (2) | |
| Realised gains on Treasury investments | (17) | | (7) | |
| Fair value movement on hedges | (69) | | 39 | |
| Unrealised mark-to-market movement | (96) | | 53 | |
| Foreign exchange gains | (2) | | (4) | |
| Depreciation and amortisation | 25 | | 21 | |
| Provisions for impairment of debt securities at amortised cost | (1) | | 27 | |
| Gross provisions charge for Banking loan losses | 120 | | 46 | |
| | (258) | | 88 | |
| Interest income received | 1,112 | | 914 | |
| Interest expenses and similar charges paid | (318) | | (224) | |
| (Increase)/decrease in operating assets: | | | | |
| Prepaid expenses | 138 | | (93) | |
| Proceeds from repayments of Banking loans | 6,147 | | 4,545 | |
| Funds advanced for Banking loans | (7,486) | | (7,246) | |
| Proceeds from sale of Banking share investments and equity derivatives | 856 | | 616 | |
| Funds advanced for Banking share investments | (1,135) | | (1,088) | |
| Net placements to credit institutions | (174) | | (464) | |
| (Decrease)/increase in operating liabilities: | | | | |
| Accrued expenses | (1) | | 24 | |
| **Net cash used in operating activities** | | (1,119) | | (2,000) |
| **Cash flows used in investing activities** | | | | |
| Proceeds from debt securities at amortised cost | 13,471 | | 11,246 | |
| Purchases of debt securities at amortised cost | (13,621) | | (12,581) | |
| Proceeds from sale of debt securities held at fair value through profit or loss | 1,026 | | 1,189 | |
| Purchases of debt securities held at fair value through profit or loss | (885) | | (874) | |
| Purchases of intangible assets, property, technology and office equipment | (25) | | (19) | |
| **Net cash used in investing activities** | | (34) | | (1,039) |
| **Cash flows from financing activities** | | | | |
| Capital received | 5 | | 4 | |
| Issue of debts evidenced by certificates | 13,631 | | 15,427 | |
| Redemption of debts evidenced by certificates | (11,041) | | (10,756) | |
| **Net cash from financing activities** | | 2,595 | | 4,675 |
| **Net increase in cash and cash equivalents** | | 1,442 | | 1,636 |
| **Cash and cash equivalents at beginning of the year** | | 4,450 | | 2,814 |
| **Cash and cash equivalents at 31 December[13]** | | 5,892 | | 4,450 |

Cash and cash equivalents are amounts with less than three months to maturity from the date of the transactions, which are available for use at short notice and are subject to insignificant risk of change in value. Within the 2012 balance is €236 million restricted for signed projects and operational costs for the SEMED ISF, and €17 million restricted for technical assistance to be provided to member countries in the SEMED region.

Pages 19 to 75 are an integral part of these financial statements

[13] See note 12 for total amounts in 'placements with and advances to credit institutions'.

# 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 at fair value through other comprehensive income, financial assets and financial liabilities held at fair value through profit or loss and all derivative contracts. In addition, financial assets and liabilities subject to amortised cost measurement which form part of a qualifying hedge relationship have been accounted for in accordance with hedge accounting rules – see "Derivative financial instruments and hedge accounting" within the section for Accounting policies. The financial statements have been prepared on a going concern basis. The going concern assessment is made by the Bank's Board of Directors at the time of approving the Bank's annual Liquidity Policy in the fourth quarter of the year and re-confirmed by the President and Vice President and CFO on 26 February 2013, the date on which they signed the financial statements.

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 Bank's 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.

### Standards, amendments to published standards and interpretations adopted by the Bank

The following standards, amendments to published standards and interpretations relevant to the Bank were adopted in the current year:[14]

**IFRS 7 (Amendment), Financial Instruments: Disclosures – Transfers of Financial Assets,** is effective for accounting periods beginning on or after 1 July 2011. The amendment requires disclosure of information that will assist in understanding the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities. It also requires information that will assist in the evaluation of the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets. The adoption of this amendment has not had a significant impact on the Bank.

[14] The Bank early adopted the first instalment of IFRS 9: Financial Instruments, concerning the classification and measurement of financial assets, in 2010 – see Annual Report 2010, Financial Report for details.

## Standards, amendments to published standards and interpretations that are not yet effective and have not been adopted early by the Bank

The following standards, amendments to published standards and interpretations are mandatory for the Bank's accounting periods beginning on or after 1 January 2013 or later periods. The Bank has not adopted them early and is currently considering their impact.

| Pronouncement | Nature of change | IASB effective date |
|---|---|---|
| IFRS 7 (Amendment) Financial Instruments: Disclosures – Offsetting of Financial Assets and Liabilities | The amendment 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. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 9 (Oct 2010): Financial Instruments – Liabilities | The standard maintains the two measurement classifications of amortised cost and fair value through profit or loss for financial liabilities. However, for financial liabilities measured at fair value through profit or loss, changes in fair value due to own credit risk are to be presented in other comprehensive income. | Accounting periods beginning on or after 1 January 2015 |
| IFRS 10: Consolidated Financial Statements | The standard establishes the principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 11: Joint Arrangements | The standard establishes the principles for financial reporting by parties to a joint arrangement. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 12: Disclosure of Interests in Other Entities | The standard consolidates the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 13: Fair Value Measurement | The standard defines fair value, establishes a single framework for measuring fair value and requires disclosures about fair value measurements. | Accounting periods beginning on or after 1 January 2013 |
| IAS 1 (Amendment): Presentation of Financial Statements | The amendment requires entities to group items presented in other comprehensive income on the basis of whether they are potentially re-classifiable to profit or loss. | Accounting periods beginning on or after 1 July 2012 |
| IAS 19 (Amendment): Employee Benefits | There are various amendments to the standard including:<br>• elimination of the option to defer the recognition of gains and losses through the use of the corridor method;<br>• streamlining the presentation of changes in assets and liabilities arising from defined benefit plans;<br>• enhancing disclosure requirements for defined benefit plans. | Accounting periods beginning on or after 1 January 2013 |
| IAS 27 (Reissued): Separate Financial Statements | The reissued standard 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*. | Accounting periods beginning on or after 1 January 2013 |
| IAS 28 (Reissued): Investments in Associates and Joint Ventures | The reissued standard 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. | Accounting periods beginning on or after 1 January 2013 |
| 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. | Accounting periods beginning on or after 1 January 2014 |

A number of existing standards were reviewed by the IASB in May 2012 as part of the IFRS improvements project. The following amendments are relevant to the Bank, but they do not have a significant impact on the Bank's financial statements:

- IAS 1, Presentation of Financial Statements (effective for accounting periods beginning on or after 1 January 2013)
- IAS 16, Property, Plant and Equipment (effective for accounting periods beginning on or after 1 January 2013)
- IAS 34, Interim Financial Reporting (effective for accounting periods beginning on or after 1 January 2013).

## B. Significant accounting policies

### Financial assets – Classification and measurement

The Bank 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 Bank 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 Bank'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. Except for debt securities held at amortised cost which are recognised on trade date, the Bank's financial assets at amortised cost are recognised at settlement date.

Collateralised placements are measured at amortised cost. These are structures wherein the risks and rewards associated with the ownership of a reference asset are transferred to another party through the use of a 'total return' swap contract, and represent a form of collateralised lending.

#### 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, will require that instrument to be classified at fair value through profit or loss, an example being a convertible loan.

Debt instruments classified at fair value through profit or loss are recognised on a settlement date basis if within the Banking loan portfolio and on a trade date basis if within the Treasury portfolio.

The Bank's share investments – equity investments held within its Banking portfolio – are measured at fair value through profit or loss, including associate investments. The Bank considers the latter to be venture capital investments for which IAS 28: Investments in Associates and Joint Ventures does not require the equity method of accounting.

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 Bank determines its classification as a debt or an equity instrument on the basis of how the investment was internally appraised and presented at its Operations Committee for approval.

The basis of fair value for listed share investments in an active market is the quoted bid market price on the balance sheet date. The basis of fair value for share investments that are either unlisted or listed in an inactive market is determined using valuation techniques appropriate to the market and industry of each investment. The primary valuation techniques used are net asset value and earnings-based valuations to which a multiple is applied based on information from comparable companies and discounted cash flows. Techniques used to support these valuations include industry valuation benchmarks and recent transaction prices.

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

At initial recognition, the Bank 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.

A strategic equity investment held by Treasury is measured at fair value through other comprehensive income. All fair value gains or losses are recognised in the statement of comprehensive income and not recycled through the income statement.

### Derecognition of financial assets

The Bank derecognises a financial asset, or a portion of a financial asset, where the contractual rights to that asset have expired or where the rights to further cash-flows from the asset have been transferred to a third party and, with them, either:

(i) substantially all the risks and rewards of the asset, or

(ii) significant risks and rewards, along with the unconditional ability to sell or pledge the asset.

Where significant risks and rewards have been transferred, but the transferee does not have the unconditional ability to sell or pledge the asset, the Bank continues to account for the asset to the extent of its continuing involvement. Where neither derecognition nor continuing involvement accounting is appropriate, the Bank continues to recognise the asset in its entirety and recognises any consideration received as a financial liability.

## Financial liabilities

The Bank has not adopted early that part of IFRS 9 which relates to financial liabilities[15] and therefore still applies IAS 39: Financial Instruments.

With the exception of derivative instruments which must be measured at fair value, the Bank does not designate any financial liabilities at fair value through profit or loss. All are measured at amortised cost, unless they qualify for hedge accounting in which case the amortised cost is adjusted for the fair value attributable to the risks being hedged. Liabilities deriving from issued securities are recognised on a trade date basis with other liabilities on a settlement date basis.

Interest expense is accrued using the effective interest rate method and is recognised within the 'interest expense and similar charges' line of the income statement except for the allocated cost funding Treasury's trading assets which is recognised within 'net gains from Treasury activities at fair value through profit or loss'.

## Derivative financial instruments and hedge accounting

The Bank primarily makes use of derivatives for three purposes:

(i) the majority of the Bank's issued securities, excluding commercial paper, are individually paired with a swap to convert the issuance proceeds into the currency and interest rate structure sought by the Bank;

(ii) to manage the net interest rate risks and foreign exchange risks arising from all of its financial assets and liabilities; and

(iii) to provide potential exit strategies for its unlisted equity investments through negotiated put options.

All derivatives are measured at fair value through the income statement unless they form part of a qualifying cash flow hedge, in which case the fair value is taken to reserves and released into the income statement at the same time as the risks on the hedged instrument are recognised therein. Any hedge ineffectiveness will result in the relevant proportion of the fair value remaining in the income statement. Fair values are derived primarily from discounted cash-flow models, option-pricing models and from third-party quotes. Derivatives are carried as assets when their fair values are positive and as liabilities when their fair values are negative. All hedging activity is explicitly identified and documented by the Bank's Treasury department.

### Hedge accounting

Hedge accounting is designed to bring accounting consistency to financial instruments that would not otherwise be permitted. A valid hedge relationship exists when a specific relationship can be identified between two or more financial instruments in which the change in value of one instrument (the hedging instrument) is highly negatively correlated to the change in value of the other (the hedged item). To qualify for hedge accounting this correlation must be within a range of 80 to 125 per cent, with any ineffectiveness within these boundaries recognised within "Fair value movement on non-qualifying and ineffective hedges" in the income statement. The Bank applies hedge accounting treatment to individually identified hedge relationships. Also included within this caption of the income statement are the gains and losses attributable to derivatives that the Bank uses for hedging interest-rate risk on a macro basis, but for which the Bank does not apply hedge accounting.

The Bank documents the relationship between hedging instruments and hedged items upon initial recognition of the transaction. The Bank also documents its assessment, on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

### Fair value hedges

The Bank's hedging activities are primarily designed to mitigate interest rate risk by using swaps to convert the interest rate risk profile, on both assets and liabilities, into floating rate risk. Such hedges are known as "fair value" hedges. Changes in the fair value of the derivatives that are designated and qualify as fair value hedges, and that prove to be highly effective in relation to hedged risk, are included in the income statement, along with the corresponding change in fair value of the hedged asset or liability that is attributable to that specific hedged risk.

In the case of a fair value hedge of a financial liability, where the hedge ceases to qualify for hedge accounting and the financial liability contains an embedded derivative which is of a different economic character to the host instrument, that embedded derivative is bifurcated and measured at fair value through the income statement. This is not required of hedged financial assets as IFRS 9 does not require bifurcation of embedded derivatives in the case of financial assets.

[15] The IASB's second instalment to IFRS 9, relating to financial liabilities, was issued in October 2010. It is effective for accounting periods beginning on or after 1 January 2015.

**Cash flow hedges**

The Bank has engaged in cash flow hedges, principally to minimise the exchange rate risk associated with the fact that its future administrative expenses are incurred in sterling. The amount and timing of such hedges fluctuates in line with the Bank's view on opportune moments to execute the hedges. Hedging is mainly through the purchase of sterling in the forward foreign exchange market, but currency options can also be used. The movement in the fair value of cash flow hedges is recognised directly in reserves until such time as the relevant expenditure is incurred. At 31 December 2012 the Bank had a number of cash flow hedges in place for future budgeted administrative expenditure to be incurred in sterling.

For further information on risk and related management policies see the Risk Management section of the report.

## Financial guarantees

Issued financial guarantees are initially recognised at their fair value, and subsequently measured at the higher of the unamortised balance of the related fees received and deferred, and the expenditure required to settle the commitment at the balance sheet date. The latter is recognised when it is both probable that the guarantee will need to be settled and that the settlement amount can be reliably estimated. Financial guarantees are recognised within other financial assets and other financial liabilities.

## 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 Bank 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
- 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. A separate methodology is applied for all sovereign risk assets that takes into account the Bank's preferred creditor status afforded by its members. The Bank's methodology calculates impairment on an incurred loss basis. Impairment is deducted from the asset categories on the balance sheet.

The Bank maintains a loan loss reserve to set aside an amount of retained earnings within members' equity equal to the difference between the impairment losses expected over the full life of the loan portfolio, and the cumulative amount provisioned through the Bank's income statement on an incurred loss basis.

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.

## 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 Bank'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, except when deferred in reserves as qualifying cash flow hedges.

## Capital subscriptions

The Bank's share capital is denominated in euro.

## Intangible assets

Costs associated with maintaining computer software programmes are recognised as an expense as incurred. Costs that are directly associated with identifiable and unique software products controlled by the Bank, and that will generate economic benefits exceeding costs beyond one year, are recognised as intangible assets. Direct costs include the staff costs of the software development team and an appropriate portion of relevant overheads.

Expenditure that enhances or extends the performance of computer software programmes beyond their original specifications is recognised as a capital improvement and is added to the original cost of the software. Computer software development costs recognised as intangible assets are amortised using the straight-line method over an estimated life of three years.

## Property, technology and office equipment

Property, technology and office equipment is stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method to write off the cost of each asset to its residual value over the estimated life as follows:

| | |
|---|---|
| Freehold property | 30 years |
| Improvements on leases of less than 50 years unexpired | Unexpired periods |
| Technology and office equipment | Three years |

## Accounting for leases

Leases of assets under which all the risks and benefits of ownership are effectively retained by the lessor are classified as operating leases. The Bank has entered into such leases for most of its office accommodation, both in London and in the Bank's countries of operations. Payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease. When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which the termination takes place.

## Interest, fees, commissions and dividends

Interest income and expense is recognised on an accruals basis using the effective interest rate method (EIR). This method requires that, in addition to the contractual interest rate attaching to a financial instrument, those fees and direct costs associated with originating and maintaining the instrument are also recognised as interest income or expense over the life of the instrument. The amortisation of such fees and costs is recognised in the same line of interest income or expense as the instruments to which they relate. Further details are provided below.

- Banking loans: this represents interest income on banking loans. Interest is recognised on impaired loans through unwinding the discount used in deriving the present value of expected future cash flows.
- Fixed-income debt securities and other: this represents interest income on Treasury investments with the exception of those measured at fair value where the interest is recognised in 'net gains from Treasury activities at fair value through profit or loss'. Where hedge accounting is applied to an underlying investment – typically using a swap to convert fixed-rate interest into floating – the net interest of the swap is included within this interest income line.
- Interest expense and similar charges: this represents interest expense on all borrowed funds. The majority of the Bank's borrowings are undertaken through the issuance of bonds which are almost always paired with a one-to-one swap to convert the proceeds into the currency and floating rate profile sought by the Bank. Hedge accounting is applied to such relationships and the net interest of the associated swap is included within interest expense.
- Net interest income/(expense) on derivatives: in addition to swaps where the interest is associated with specific investments or borrowings, the Bank also employs a range of derivatives to manage the risk deriving from interest rate mismatches between the asset and liability side of the balance sheet. The net interest associated with these derivatives is presented separately as it is not identifiable to individual assets or liabilities presented elsewhere within 'net interest income'. This lack of specific "matching" also means that hedge accounting is not applied in respect of the risks hedged by these derivatives. Certain limited format changes have been made to prior year amounts to conform to the current year presentation.

Fees received in respect of services provided over a period of time are recognised as income as the services are provided. Other fees and commissions are classed as income when received. Issuance fees and redemption premiums or discounts are amortised over the period to maturity of the related borrowings on an effective yield basis.

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.

## Staff retirement plans

The Bank has a defined contribution scheme and a defined benefit scheme to provide retirement benefits to its staff. Under the defined contribution scheme, the Bank and staff contribute to provide a lump sum benefit. The defined benefit scheme is funded entirely by the Bank and benefits are based on years of service and a percentage of final gross base salary as defined in the scheme.

The asset in respect of the defined benefit scheme is the fair value of plan assets minus the present value of the defined benefit obligation at the balance sheet date, together with adjustments for unrecognised actuarial gains/losses and past service cost. Independent actuaries calculate the defined benefit obligation at least every three years by using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows (relating to service accrued to the balance sheet date) using the yields available on high-quality corporate bonds. For intermediate years, the defined benefit obligation is estimated using approximate actuarial roll-forward techniques that allow for additional benefit accrual, actual cash flows and changes in the underlying actuarial assumptions.

The Bank keeps all contributions to the schemes, and all other assets and income held for the purposes of the schemes, separately from all of its other assets. Actual contributions made to the defined contribution scheme are charged to the income statement and transferred to the scheme's independent custodians. The charge to the income statement in respect of the defined benefit scheme is based on the current service cost and other actuarial adjustments, as determined by qualified external actuaries. Also included in this charge are actuarial gains and losses in excess of a 10 per cent corridor that are amortised over the estimated average service life remaining of the Bank's employees. The 10 per cent corridor is the higher of 10 per cent of the defined benefit obligation or the fair value of assets. The Bank's contributions to the defined benefit scheme are determined by the Retirement Plan Committee, with advice from the Bank's actuaries, and the contributions are transferred to the scheme's independent custodians.

### Taxation

In accordance with Article 53 of the Agreement, within the scope of its official activities, the Bank, its assets, property and income are exempt from all direct taxes. Taxes and duties levied on goods or services are likewise exempted or reimbursable except for those parts of taxes or duties that represent charges for public utility services.

## C. Critical accounting estimates and judgements

Preparing financial statements in conformity with IFRS requires the Bank 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.

These estimates are highly dependent on a number of variables that reflect the economic environment and financial markets of the Bank's countries of operations, but which are not directly correlated to market risks such as interest rate and foreign exchange risk. The Bank's critical accounting estimates and judgements are as follows:

### Fair value of derivative financial instruments

The fair values of the Bank'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 inputs have been used, a sensitivity analysis has been included under "fair value hierarchy" within the Risk Management section of the report.

### Fair value of Banking loans at fair value through profit or loss

The fair values of the Bank's loans at fair value through profit or loss are determined by using a combination of discounted cash flow models and options 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 inputs have been used, a sensitivity analysis has been included under "fair value hierarchy" within the Risk Management section of the report.

### Fair value of share investments

The Bank'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 18. In relation to the Bank's share investments where the valuations are not based on observable market inputs, additional sensitivity information has been included under "fair value hierarchy" within the Risk Management section of the report.

### Provisions for the impairment of loan investments

The Bank'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.

Portfolio provisions for the unidentified impairment of non-sovereign loan investments at 31 December 2012 were €439 million (2011: €409 million). The sensitivity of portfolio provisions to the key variables used in determining the level of impairment is provided below.

### Risk ratings

- If all non-sovereign loan investments were upgraded by one category on the Bank's probability of default rating, this would result in a credit to the income statement of €519 million. This credit is due to a reduction of €239 million in portfolio provisions on loan investments, and a reduction of €280 million in specific provisions.

- Conversely, if all non-sovereign loan investments were downgraded by one category on the Bank's probability of default rating this would result in a total charge to the income statement of €1.4 billion. This comprises a charge to the income statement of €174 million in relation to portfolio provisions for non-sovereign loans. On downgrade by one probability of default rating category, 14 per cent of non-sovereign loan investments would become individually impaired. Consequently, specific provisions for identified impairment would increase by approximately €1.2 billion.

## 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 approximately €329 million. The loan loss reserve would increase by an offsetting amount as the change of the emergence period does not affect the overall estimated loss on the portfolio.

## 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 2012 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 €49 million, increasing provisions for unidentified impairment of non-sovereign loan investments to €488 million. 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 €49 million, decreasing provisions for unidentified impairment of non-sovereign loan investments to €390 million.

## Loss given default rates

- A decrease in loss given default rates by 10 percentage points would lead to a decrease in portfolio provisions of €67 million, reducing provisions for unidentified impairment in non-sovereign loans to €372 million.
- An increase in loss given default rates by 10 percentage points would lead to an increase in portfolio provisions for unidentified impairment of non-sovereign loans by €67 million, to a total of €506 million.

## Sovereign ratings

- Portfolio provisions for the unidentified impairment of sovereign loan investments at 31 December 2012 amounted to €17 million (2011: €13 million). Due to the Bank's preferred creditor status afforded by its members, a downgrade or upgrade by one risk rating category would not have had a significant impact on the level of sovereign portfolio provisions, and hence the income statement.

The methodology and judgements used for estimating provisions for the impairment of loan investments are reviewed annually.

# Risk management

## Financial risks

The independent identification, measurement, monitoring and mitigation of all risks incurred by the Bank in both its Banking and Treasury activities is the overall responsibility of the Vice President Risk, a member of the Bank's Executive Committee. The Vice President Risk has overall responsibility for formulating the risk management strategy for both Banking and Treasury functions and ensuring that any risks are correctly identified, managed and mitigated through comprehensive and rigorous processes, which reflect industry best practice.

In carrying out its mission, the Bank is exposed to financial risks through both its Banking and Treasury activities. The principal financial risks to which the Bank is exposed are credit, market and liquidity risk. The last year saw a volatility in eastern European equity markets as systemic risks remained a concern but eased in the second half of the year. Debt performance, however, remained relatively strong.

## A. Credit risk

Credit risk is the potential loss to a portfolio that could result from either the default of a counterparty or the deterioration of its creditworthiness. The Bank also monitors 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 Bank is exposed to credit risk in both its Banking and Treasury activities, as borrowers and Treasury counterparties could default on their contractual obligations, or the value of the Bank's investments could become impaired.

The Bank's maximum exposure to credit risk from financial instruments is represented by their carrying amounts on the balance sheet, inclusive of the undrawn commitments related to loans and guarantees (see note 27).

Details of collateral and other forms of risk reduction are provided within the respective sections on Banking and Treasury below.

### Credit risk in the Banking portfolio: Management

The Board of Directors 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 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 overseeing Banking portfolio management and approving significant changes to existing operations. Risk Management is responsible for recommendations for provisions for the impairment of Banking loans and reports these quarterly to the Operations Committee. The Equity Committee acts as governance committee for the equity portfolio.

The Bank conducts reviews of all 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.

<table>
<tr><th>EBRD PD rating[16]</th><th>EBRD risk class[17]</th><th>External rating equivalent</th><th>Category name</th><th>Broader category</th></tr>
<tr><td>1</td><td>1.0</td><td>AAA</td><td>Excellent</td><td rowspan="4">Investment grade</td></tr>
<tr><td>2</td><td>1.7<br>2.0<br>2.3/2.5</td><td>AA+<br>AA<br>AA-</td><td>Very Strong</td></tr>
<tr><td>3</td><td>2.7<br>3.0<br>3.3</td><td>A+<br>A<br>A-</td><td>Strong</td></tr>
<tr><td>4</td><td>3.7<br>4.0<br>4.3</td><td>BBB+<br>BBB<br>BBB-</td><td>Good</td></tr>
<tr><td>5</td><td>4.7<br>5.0<br>5.3</td><td>BB+<br>BB<br>BB-</td><td>Fair</td><td></td></tr>
<tr><td>6</td><td>5.7<br>6.0<br>6.3</td><td>B+<br>B<br>B-</td><td>Weak</td><td></td></tr>
<tr><td>7</td><td>6.7<br>7.0<br>7.3</td><td>CCC+<br>CCC<br>CCC-</td><td>Special Attention</td><td rowspan="2">Classified</td></tr>
<tr><td>8</td><td>8.0</td><td>CC/CD</td><td>Expected Loss/Impaired</td></tr>
</table>

Disbursements are managed by the Operations Administration Unit (OAU) within the Office of the General Counsel (OGC). The OAU 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 OAU 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, guarantors, put counterparties and sovereigns in the Banking and Treasury portfolios. Counterparty ratings reflect the financial strength of the risk counterparty as well as consideration of any implicit support, for example from a major shareholder. The sovereign rating takes into consideration the ratings assessed by external rating agencies. For sovereign risk projects, the overall rating is the same as the sovereign rating. 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. During the year the Bank continued to roll out some changes in its probability of default rating process and methodology to improve calibration and consistency. 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.

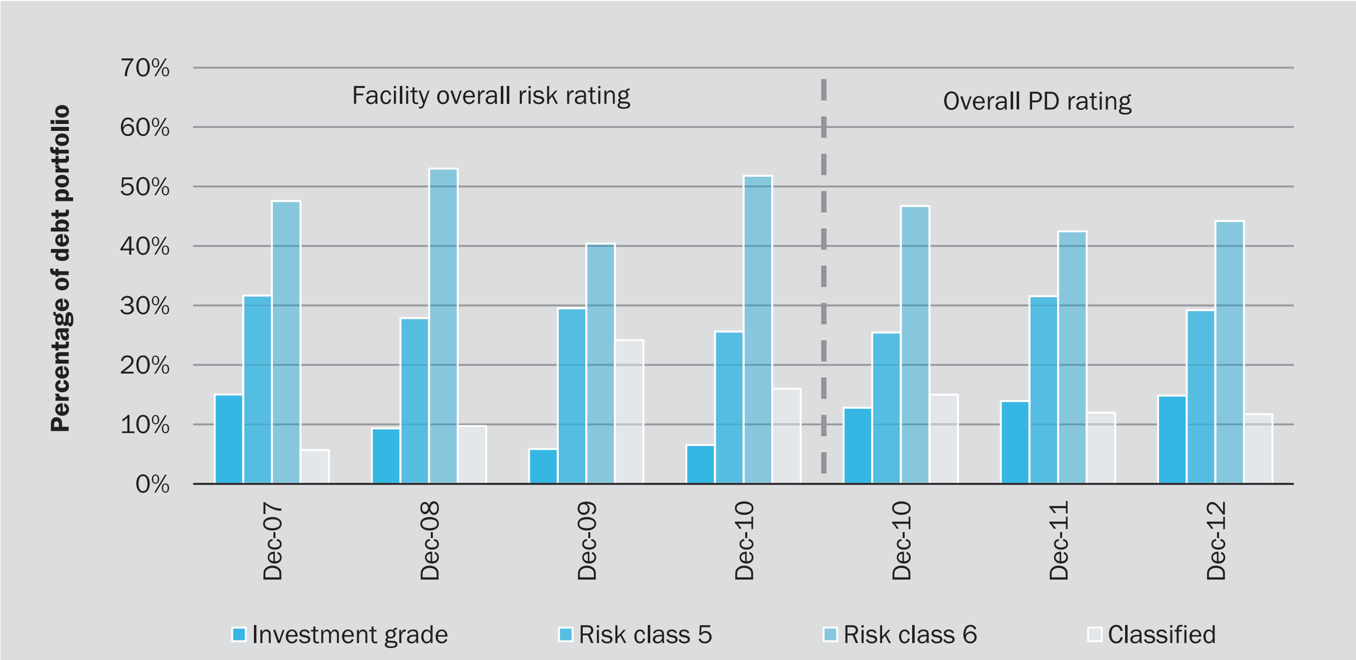
Risk Management reports on the development of the portfolio as a whole on a quarterly basis to the Audit Committee. The report includes a summary of key factors affecting the portfolio and provides analysis and commentary on trends within the portfolio and within various sub-portfolios. It also includes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

[16] Probability of default.
[17] Risk rating 9 and 10 were eliminated during 2012 due to limited additional information content and are now grounded in rating category 8.0.

## Credit risk in the Banking portfolio: 2012 results

Total Banking loan exposure (operating assets including fair value adjustments but before provisions) increased during the year from €18.3 billion at 31 December 2011 to €19.6 billion at 31 December 2012. The total signed Banking loan portfolio (operating assets, excluding fair value adjustments and provisions but including undrawn commitments) and guarantees increased from €26.9 billion at 31 December 2011 to €29.3 billion at 31 December 2012.

The average credit profile of the portfolio has been improving since 2009 and was relatively stable in 2012 as weighted average probability default rating moved slightly from 5.56 to 5.59. Classified assets (those risk rated 6.7 to 8.0) were also fairly stable, improving from 12.0 per cent to 11.7 per cent although the absolute level increased from €3.2 billion to €3.4 billion. This performance largely reflected continued stabilisation in the Bank's countries of operations since the crisis years of 2008 and 2009. This has been the dominant trend so far despite negative pressures from the neighbouring eurozone, a generally lacklustre recovery, and some small areas of country risk deterioration in the Bank's countries of operations.




Note (1) The vertical line at December 2010 represents changes in reporting from Facility Overall Risk Rating to Overall Probability of Default (PD) Risk Rating. December 2010 is presented with both rating methodologies to show the impact of the methodology change.

Non-performing loan assets[18] still remain low relative to the average portfolio risk rating. However, they have crept up over recent years from a very low base to €676 million in 2012 or 3.4 per cent of operating assets (€491 million or 2.6 per cent at year-end 2011). Distressed restructured loans[19] were also relatively low, comprising an additional €372 million or 1.9 per cent of operating assets at year-end 2012. Net write-offs amounted to €38 million in 2012. This brings the total net write-offs over the last five years to €79 million. Write-offs are typically relatively low as the Bank benefits from its strong liquidity and capitalisation to work out distressed loans.

[18] Non-performing loan assets are either: where the borrower is more than 90 days past due on payment to any material creditor, or where the Bank considers the counterparty is unlikely to pay its credit obligations in full, without recourse by the bank to actions such as realised security (if held). Non-performing loan assets include impaired loans of €624 million (2011: €484 million) and loans at fair value through profit or loss of €52 million (2011: €7 million).

[19] 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.

### Loan investments at amortised cost

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

| Risk rating | Neither past due nor impaired € million | Past due but not impaired € million | Impaired € million | Total € million | Total % | Portfolio provisions for unidentified impairment € million | Specific provisions for identified impairment € million | Total net of impairment € million | Impairment provisions % |
|---|---|---|---|---|---|---|---|---|---|
| 2: Very strong | 79 | – | – | 79 | 0.4 | – | – | 79 | 0.0 |
| 3: Strong | 482 | – | – | 482 | 2.5 | (1) | – | 481 | 0.2 |
| 4: Good | 2,805 | – | – | 2,805 | 14.5 | (7) | – | 2,798 | 0.2 |
| 5: Fair | 6,222 | – | - | 6,222 | 32.2 | (21) | - | 6,201 | 0.3 |
| 6: Weak | 7,298 | 17 | – | 7,315 | 37.9 | (180) | – | 7,135 | 2.5 |
| 7: Special attention | 1,761 | 45 | | 1,806 | 9.3 | (247) | - | 1,559 | 13.6 |
| 8: Expected loss/impaired | - | – | 624 | 624 | 3.2 | – | (280) | 344 | 45.0 |
| **At 31 December 2012** | 18,647 | 62 | 624 | 19,333 | 100.0 | (456) | (280) | 18,597 | - |

| Risk rating | Neither past due nor impaired € million | Past due but not impaired € million | Impaired € million | Total € million | Total % | Portfolio provisions for unidentified impairment € million | Specific provisions for identified impairment € million | Total net of impairment € million | Impairment provisions % |
|---|---|---|---|---|---|---|---|---|---|
| 2: Very strong | 69 | - | - | 69 | 0.4 | - | - | 69 | 0.0 |
| 3: Strong | 502 | - | - | 502 | 2.8 | (1) | - | 501 | 0.2 |
| 4: Good | 2,285 | - | - | 2,285 | 12.6 | (6) | - | 2,279 | 0.3 |
| 5: Fair | 5,739 | - | - | 5,739 | 31.7 | (24) | - | 5,715 | 0.4 |
| 6: Weak | 6,993 | - | - | 6,993 | 38.7 | (152) | - | 6,841 | 2.2 |
| 7: Special attention | 1,999 | 17 | - | 2,016 | 11.1 | (239) | - | 1,777 | 11.9 |
| 8: Expected loss/impaired | - | - | 484 | 484 | 2.7 | - | (250) | 234 | 51.7 |
| **At 31 December 2011** | 17,587 | 17 | 484 | 18,088 | 100.0 | (422) | (250) | 17,416 | - |

Of the past due loans, €57 million were outstanding for less than 30 days (2011: €2 million), No loans were outstanding for more than 30 days but less than 90 days (2011: €8 million) and €5 million were outstanding for more than 90 days (2011: €7 million).

At 31 December 2012 the estimated fair value of collateral held over impaired and past due loans was €375 million (2011: €248 million). Most of this collateral is illiquid and therefore difficult to value. As there are normally no recent independent valuations, this value represents the Bank's best estimate. The collateral coverage over the outstanding amount for each impaired loan can vary, as reflected in the specific impairment levels. In general, the Bank requires security for lending to the corporate sector. It also benefits from guarantees and risk-sharing provided by Special Funds (see note 30: Related Parties) which provided credit enhancement of approximately €108 million at the year-end.

### Loans at fair value through profit or loss

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

| Risk rating | Fair value 2012 € million | Fair value 2011 € million |
|---|---|---|
| 5: Fair | 41 | 17 |
| 6: Weak | 102 | 193 |
| 7: Special attention | 74 | 29 |
| 8: Expected loss/impaired | 30 | - |
| At 31 December | 247 | 239 |

### Undrawn commitments and guarantees

Set out below is an analysis of the Bank's undrawn commitments and guarantees for each of the Bank's relevant internal risk rating categories.

| Risk rating | Undrawn commitments[20] 2012 € million | Guarantees 2012 € million | Undrawn commitments 2011 € million | Guarantees 2011 € million |
|---|---|---|---|---|
| 2: Very strong | - | - | - | - |
| 3: Strong | 13 | - | 230 | 3 |
| 4: Good | 870 | 24 | 567 | 30 |
| 5. Fair | 2,103 | 86 | 2,608 | 15 |
| 6: Weak | 4,916 | 460 | 3,712 | 417 |
| 7: Special attention | 718 | 57 | 519 | 88 |
| 8: Expected loss/impaired | 106 | - | 42 | - |
| At 31 December | 8,726 | 627 | 7,678 | 553 |

For projects risk rated 8 or worse, it is unlikely that commitments would be drawn down without additional assurances that credit quality would improve. In addition, the Bank would typically have conditions precedent that would need to be satisfied before further disbursements on its debt transactions.

### Paid-in capital receivable

Set out below is an analysis of the Bank's paid-in capital receivable at 31 December 2012 and 31 December 2011, none of which was considered impaired.

| | 2012 € million | 2011 € million |
|---|---|---|
| Cash and promissory notes due but not yet received | 12 | 15 |
| Paid-in capital receivable at 31 December | 12 | 15 |

[20] References to undrawn commitments within the Credit Risk Management section relates to Banking loans only.

## Credit risk in the Banking portfolio: Concentration

### Concentration by country

The following table breaks down the main Banking credit risk exposures in their carrying amounts by country.[21] The Bank is generally well diversified by country apart from its concentration in Russia which accounts for 23 per cent of loans specifically (as shown below) and 26 per cent of the Bank's total portfolio including equity at cost. However, by nature of the regional focus in the Bank's business model, some groups of countries in which the Bank operates are highly correlated

| | Loans 2012 € million | Undrawn commitments and guarantees 2012 € million | Total 2012 € million | Loans 2011 € million | Undrawn commitments and guarantees 2011 € million | Total 2011 € million |
|---|---|---|---|---|---|---|
| Albania | 318 | 131 | 449 | 277 | 131 | 408 |
| Armenia | 207 | 59 | 266 | 209 | 41 | 250 |
| Azerbaijan | 390 | 223 | 613 | 434 | 234 | 668 |
| Belarus | 178 | 163 | 341 | 61 | 185 | 246 |
| Bosnia and Herzegovina | 467 | 385 | 852 | 412 | 466 | 878 |
| Bulgaria | 832 | 282 | 1,114 | 872 | 163 | 1,035 |
| Croatia | 646 | 277 | 923 | 689 | 264 | 953 |
| Czech Republic | 28 | 1 | 29 | 34 | 1 | 35 |
| Estonia | 18 | 1 | 19 | 16 | 3 | 19 |
| Former Yugoslav Republic of Macedonia | 153 | 374 | 527 | 125 | 289 | 414 |
| Georgia | 418 | 139 | 557 | 445 | 165 | 610 |
| Hungary | 446 | 43 | 489 | 480 | 71 | 551 |
| Jordan | - | 76 | 76 | - | - | - |
| Kazakhstan | 964 | 445 | 1,409 | 970 | 523 | 1,493 |
| Kosovo[22] | 20 | 4 | 24 | - | - | - |
| Kyrgyz Republic | 127 | 72 | 199 | 74 | 129 | 203 |
| Latvia | 31 | 86 | 117 | 32 | 90 | 122 |
| Lithuania | 125 | 33 | 158 | 147 | 1 | 148 |
| Moldova | 151 | 184 | 335 | 155 | 129 | 284 |
| Mongolia | 303 | 203 | 506 | 175 | 59 | 234 |
| Montenegro | 130 | 139 | 269 | 100 | 147 | 247 |
| Morocco | - | 13 | 13 | - | - | - |
| Poland | 1,025 | 565 | 1,590 | 1,001 | 457 | 1,458 |
| Romania | 1,697 | 734 | 2,431 | 1,744 | 457 | 2,201 |
| Russia | 4,994 | 1,571 | 6,565 | 4,791 | 1,513 | 6,304 |
| Serbia | 1,079 | 939 | 2,018 | 1,083 | 905 | 1,988 |
| Slovak Republic | 412 | 89 | 501 | 303 | 41 | 344 |
| Slovenia | 86 | 60 | 146 | 92 | 61 | 153 |
| Tajikistan | 46 | 66 | 112 | 42 | 35 | 77 |
| Tunisia | - | 15 | 15 | - | - | - |
| Turkey | 1,819 | 420 | 2,239 | 1,211 | 135 | 1,346 |
| Turkmenistan | 31 | 9 | 40 | 28 | 3 | 31 |
| Ukraine | 2,390 | 1,550 | 3,940 | 2,255 | 1,530 | 3,785 |
| Uzbekistan | 49 | 2 | 51 | 70 | 2 | 72 |
| **At 31 December** | 19,580 | 9,353 | 28,933 | 18,327 | 8,230 | 26,557 |

[21] Based on location of used funds. The Bank eliminated the category of "Regional" in 2012, with these assets distributed proportionally on the basis of projected use of funds.
[22] Operations previously under Serbia have now been reallocated to Kosovo.

## Eurozone exposure

The Banking portfolio has both direct and indirect exposure to the eurozone. Direct exposure occurs in the case of the Bank's three countries of operations located in the eurozone or loans or investments to counterparties based in the eurozone where the Bank's funds are then on-lent or invested in the Bank's countries of operations. For most of these counterparties the main operations and therefore main country risk is in the Bank's countries of operations.

The Bank's indirect exposure arises due to loans or investments to subsidiaries of eurozone-based economic groups[23] which is common due to the strong business linkages between the regions. In many cases, the subsidiary has standalone creditworthiness apart from its eurozone parent. Exposures at year-end 2012 where the main operating company parent is located in the eurozone are detailed in the table below. Countries are included in Sub-group 1 eurozone where the sovereign credit default swap is priced in excess of 200 basis points at year-end 2012.

| € million | Portfolio | Operating assets | Undrawn | Undrawn % | Total eurozone operating assets % |
|---|---|---|---|---|---|
| Greece | 471 | 469 | 2 | 0% | 6% |
| Italy | 1,405 | 1,298 | 107 | 8% | 18% |
| Portugal | 234 | 213 | 21 | 9% | 3% |
| Slovenia | 150 | 87 | 63 | 42% | 1% |
| Spain | 599 | 521 | 78 | 13% | 7% |
| **Sub-group 1** | 2,859 | 2,588 | 271 | 9% | 35% |
| Austria | 1,609 | 1,431 | 178 | 11% | 20% |
| Belgium | 235 | 153 | 82 | 35% | 2% |
| Estonia | 54 | 54 | - | 0% | 1% |
| Finland | 178 | 132 | 46 | 26% | 2% |
| France | 2,195 | 1,805 | 390 | 18% | 25% |
| Germany | 967 | 913 | 54 | 6% | 12% |
| Slovak Republic | 258 | 246 | 12 | 5% | 3% |
| **Sub-group 2** | 5,496 | 4,734 | 762 | 14% | 65% |
| **Total eurozone** | 8,355 | 7,322 | 1,033 | 12% | 100% |

In addition to these more direct business relationships there are strong economic linkages between the eurozone and the Bank's countries of operations including trade ownership of local banking sectors, in particular central and southeast Europe.

[23] Economic groups are defined on the basis of the common majority owner.

### Concentration by industry sector

The following table breaks down the main Banking credit exposures in their carrying amounts by the industry sector of the project. The portfolio is generally well diversified with only Banking constituting a material sector concentration.

| | Loans 2012 € million | Undrawn commitments and guarantees 2012 € million | Total 2012 € million | Loans 2011 € million | Undrawn commitments and guarantees 2011 € million | Total 2011 € million |
|---|---|---|---|---|---|---|
| Agribusiness | 2,044 | 612 | 2,656 | 1,866 | 444 | 2,310 |
| Banking | 4,881 | 958 | 5,839 | 4,950 | 882 | 5,832 |
| Information & Communication Technologies | 298 | 34 | 332 | 186 | 39 | 225 |
| Insurance and financial services | 990 | 85 | 1,075 | 866 | 52 | 918 |
| Manufacturing and services | 2,251 | 493 | 2,744 | 1,964 | 627 | 2,591 |
| Municipal and environmental infrastructure | 1,102 | 760 | 1,862 | 1,033 | 800 | 1,833 |
| Natural resources | 1,153 | 781 | 1,934 | 1,209 | 440 | 1,649 |
| Power and energy | 1,817 | 1,390 | 3,207 | 1,636 | 895 | 2,531 |
| Property and tourism | 469 | 243 | 712 | 409 | 274 | 683 |
| Small business finance | 690 | 53 | 743 | 575 | 138 | 713 |
| Transport | 1,195 | 763 | 1,958 | 1,158 | 633 | 1,791 |
| Non-sovereign | 16,890 | 6,172 | 23,062 | 15,852 | 5,224 | 21,076 |
| Sovereign | 2,690 | 3,181 | 5,871 | 2,475 | 3,006 | 5,481 |
| At 31 December | 19,580 | 9,353 | 28,933 | 18,327 | 8,230 | 26,557 |

### Concentration by counterparty

The Bank has a maximum Banking counterparty exposure limit[24] of 5 per cent of paid-in capital and reserves which is applied on an economic group basis (ignoring standalone creditworthiness of subsidiaries). Maximum exposure to an economic group was €592 million and to a single legal entity was €363 million at year-end 2012.

## Credit risk in the Treasury portfolio: Management

For Treasury exposures, the Board of Directors approves a Treasury and Treasury Risk Management Authority (T&TRMA), which defines the risk parameters for funding, cash management, asset and liability management and the investment activities of the Bank. This document is updated annually by the Finance and Risk and Resources Vice Presidencies and approved by the Board. It covers all aspects of Treasury where financial risks arise and also Risk Management's identification, measurement, management and mitigation of those risks. In addition, Treasury and Treasury Risk Management guidelines have been issued in respect of Treasury risk taking and the related risk management processes and procedures.

The T&TRMA is the document by which the Board of Directors delegates authority to the Vice President and CFO to manage and the Vice President Risk to identify, measure, monitor and mitigate the Bank's Treasury exposures. The two Vice Presidents jointly interpret the T&TRMA and notify the Board of Directors of any material interpretation. The Financial and Operations Policies Committee reviews the T&TRMA annually and its review is submitted to the Board for approval.

Treasury risks are reviewed by the Treasury Exposure Committee (TEC). The TEC is chaired by the Vice President and CFO and its membership comprises senior managers of the Bank. The TEC is responsible for reviewing and monitoring the implementation of the T&TRMA and related guidelines. It assesses Treasury and Risk Management policy proposals for approval by the Board, and monitors and reviews the asset/liability profile and risk/return trade off in aggregate Treasury exposures. It also evaluates new product proposals for Treasury. Impairment of Treasury assets is identified by Risk Management, assessed by the TEC and approved by the Vice Presidents of Finance and Risk and Resources.

Maximum credit limits for Treasury counterparties are based on internal credit ratings determined by Risk Management. These ratings are based on internal analysis of approved counterparties' creditworthiness through the synthesis of externally provided credit research and market data, including approved external agency ratings. The internal credit rating is the same as that used for Banking exposure.

Eligible Treasury exposures are normally rated between 1.0 and 3.3 (approximately equivalent to S&P AAA to A– ratings), with the exception of counterparties approved for local currency activities in the Bank's countries of operations. These transactions support the Bank's initiatives to provide local currency financing to Banking clients and to develop local capital markets.

[24] A very limited group of bank counterparties have a higher 10 per cent threshold but are currently managed to the lower 5 per cent limit.

The Board-approved T&TRMA states the minimum rating and maximum tenor by type of eligible counterparty. Operational guidelines approved and issued by the Vice President Risk set the maximum exposure size limits per rating class and counterparty type. The actual exposure size limit and/or tenor limit attributed to individual counterparties by Risk Management may be smaller or shorter, respectively, based on the likely direction of its credit quality over the medium term, its internal outlook, or on sector considerations. The limits apply for the range of eligible products for the relevant counterparty with product exposures measured on a risk adjusted basis. All individual counterparty lines for banks, corporates and insurance companies are measured, monitored and reviewed by Risk Management annually.

In cases where the creditworthiness of security issuers deteriorates to levels below the standard of eligibility for new exposures, Risk Management and Treasury jointly recommend actions for the approval of the Vice President Risk and the Vice President and CFO. Any decision to retain ineligible exposures is reported to the TEC and the Audit Committee.

The Bank's exposure measurement methodology for Treasury credit risk uses a "Monte Carlo" simulation technique that produces, to a high degree of confidence, maximum exposure amounts at future points in time for each counterparty (in practice, 95 per cent eVaR).[25] This includes all transaction types and is measured out to the maturity of the longest dated transaction with that counterparty. Exposures are calculated and controlled against approved limits on a daily basis with exceptions escalated to the relevant authority level approval.

Risk mitigation techniques and risk transferring instruments reduce calculated credit exposure measures. For example, Credit Support Annexes for over-the-counter (OTC) derivatives activity reduce potential future exposures in line with collateral posting expectations. Likewise, buying credit protection via a credit default swap usually decreases measured exposure on the reference entity. At 31 December 2012, credit protection of €182 million was held via credit default swaps.

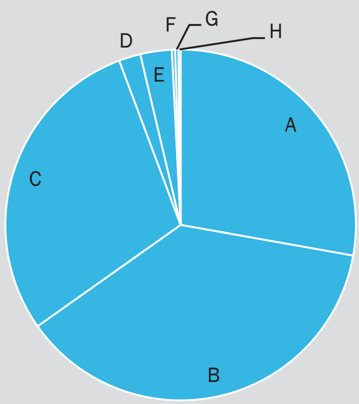
## Credit risk in the Treasury portfolio: 2012 results

Treasury peak credit exposure stood at €16.7 billion at 31 December 2012, compared with €14.9 billion at 31 December 2011.

Despite continued rating downgrades of Treasury counterparties, Treasury continued to maintain a superior average credit risk during 2012 by investing new liquidity in triple-A rated sovereign and other highly rated assets. This resulted in a stable weighted average probability of default rating for the Treasury portfolio as weighed by peak counterparty exposure of 2.21 at 31 December 2012 (2011: 2.21). This measure understates credit quality improvement as Treasury has increased its senior collateralised exposures (such as covered bonds) while reducing investments in subordinated debt. Seniority of claim and the associated better recoveries of collateralised exposures are not reflected in the probability of default ratings but rather in loss given default ratings.

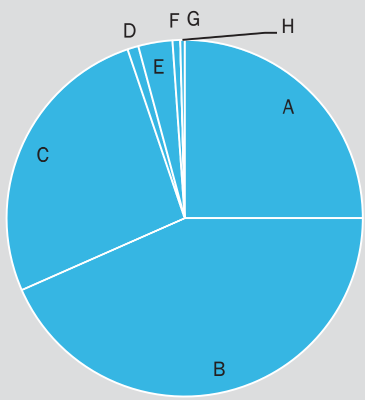
A very low proportion of Treasury exposures are below investment grade quality,[26] amounting to 3.7 per cent at 31 December 2012 (2011: 4.2 per cent). These consist of the small pool of local currency liquidity held with counterparties from the countries of operations, several asset-backed security (ABS) investments originally rated triple-A by leading external rating agencies and several financial sector bonds where the issuer was downgraded after the time of purchase.

Credit quality of the Treasury portfolio 31 December 2012




| | Risk rating | % |
|---|---|---|
| A | 1.0 | 27.8 |
| B | 1.7-2.5 | 37.4 |
| C | 2.7-3.3 | 29.1 |
| D | 3.7-4.3 | 2.0 |
| E | 4.7-5.3 | 2.9 |
| F | 5.7-6.3 | 0.3 |
| G | 6.7-7.3 | 0.3 |
| H | 8.0 | 0.2 |

Credit quality of the Treasury portfolio 31 December 2011




| | Risk rating | % |
|---|---|---|
| A | 1.0 | 25.0 |
| B | 1.7-2.5 | 43.4 |
| C | 2.7-3.3 | 26.4 |
| D | 3.7-4.3 | 1.0 |
| E | 4.7-5.3 | 3.1 |
| F | 5.7-6.3 | 0.7 |
| G | 6.7-7.3 | 0.0 |
| H | 8.0 | 0.4 |

Non-performing assets in the Treasury portfolio are very low at €34.5 million or 0.2 per cent of the Treasury peak potential future exposure.[27] This represented an improvement on 2011 as the Bank managed down several legacy assets from the 2009 crisis.

[25] VaR is a statistical estimate of the maximum probable loss that can be incurred, due to adverse movements in major risk drivers, over a one-day trading horizon and estimated at a given confidence level. Expected shortfall, or eVaR, is the average loss beyond the VaR level and is a more accurate measure of large potential losses.

[26] BBB-/Baa3/BBB- level or worse.

[27] The percentage is calculated on the basis of potential future exposure and includes one asset which is fair valued and therefore does not carry a specific provision but is considered non-performing by the Bank.

### Placements with and advances to credit institutions

Set out below is an analysis of the Bank's placements with and advances to credit institutions for each of the Bank's relevant internal risk rating categories.

| Risk rating | 2012 € million | 2011 € million |
|---|---|---|
| 1-3: Excellent to strong | 7,208 | 4,894 |
| 4: Good | - | 260 |
| 5-6: Fair to weak | 307 | 18 |
| At 31 December | 7,515 | 5,172 |

At 31 December 2012 there were no placements with and advances to credit institutions that were past due or impaired (2011: €nil).

### Debt securities at fair value through profit or loss

Set out below is an analysis of the Bank's debt securities at fair value through profit or loss for each of the Bank's relevant internal risk rating categories. No collateral is held over impaired debt securities.

| Risk rating | 2012 € million | 2011 € million |
|---|---|---|
| 1-3: Excellent to strong | 16 | 336 |
| 4: Good | 7 | 23 |
| 5-6: Fair to weak | 117 | 45 |
| 7-8: Special attention to expected loss/impaired | 35 | 7 |
| At 31 December | 175 | 411 |

There were no debt securities at fair value past due in 2012 or 2011.

### Debt securities at amortised cost

Set out below is an analysis of the Bank's debt securities at amortised cost for each of the Bank's relevant internal risk rating categories.

| Risk rating | Neither past due nor impaired € million | Impaired gross € million | Total € million | Cumulative impairment losses € million | Total net of impairment € million |
|---|---|---|---|---|---|
| 1-3: Excellent to strong | 11,894 | - | 11,894 | - | 11,894 |
| 4: Good | 318 | - | 318 | - | 318 |
| 5-6: Fair to weak | 7 | - | 7 | - | 7 |
| 7-8 Special attention to expected loss/impaired | 3 | 21 | 24 | (8) | 16 |
| At 31 December 2012 | 12,222 | 21 | 12,243 | (8) | 12,235 |

| Risk rating | Neither past due nor impaired € million | Impaired gross € million | Total € million | Cumulative impairment losses € million | Total net of impairment € million |
|---|---|---|---|---|---|
| 1-3: Excellent to strong | 10,866 | - | 10,866 | - | 10,866 |
| 4: Good | 162 | - | 162 | - | 162 |
| 5-6: Fair to weak | 27 | - | 27 | - | 27 |
| 7-8: Special attention to expected loss/impaired | - | 106 | 106 | (34) | 72 |
| At 31 December 2011 | 11,055 | 106 | 11,161 | (34) | 11,127 |

### Derivative financial assets

Set out below is an analysis of the Bank's derivatives for each of the Bank's internal rating categories.

| Risk rating | 2012 € million | 2011 € million |
|---|---|---|
| 1-3: Excellent to strong | 4,328 | 4,764 |
| 4: Good | 155 | 87 |
| 5-6: Fair to weak | 178 | 182 |
| 7-8: Special attention to expected loss/impaired | 10 | 78 |
| At 31 December | 4,671 | 5,111 |

There were no derivative financial assets past due in 2012 or 2011.

### Derivatives

The Bank makes use of derivatives for different purposes within both its Banking portfolio and its Treasury portfolio. Within the Banking portfolio option contracts are privately negotiated with third party sponsors to provide potential exit routes for the Bank on many of its unlisted share investments. Banking also has a limited portfolio of swaps with clients to hedge their market risks or to facilitate hard currency funding. Furthermore, the Banking portfolio has a small portfolio of currency swaps which are fully hedged and have been entered into with clients to assist them in the management of their market risks. Within the Treasury portfolio, use of exchange-traded and OTC derivatives is primarily focused on hedging interest rate and foreign exchange risks arising from Bank-wide activities. Market views expressed through derivatives are also undertaken as part of Treasury's activities, while the transactions through which the Bank funds itself in capital markets are typically swapped into floating-rate debt with derivatives. In addition, Treasury has a small legacy portfolio of credit derivatives but is no longer active in this market.

The risks arising from derivative instruments are combined with those deriving from all other instruments dependent on the same underlying risk factors, and are subject to overall market and credit risk limits, as well as to stress tests. Additionally, special care is devoted to those risks that are specific to the use of derivatives, through, for example, the monitoring of volatility risk for options, credit spread risk for swaps and basis risk for futures. The table below shows the fair value of the Bank's derivative financial assets and liabilities at 31 December 2012 and 31 December 2011.

| | Assets 2012 € million | Liabilities 2012 € million | Total 2012 € million | Assets 2011 € million | Liabilities 2011 € million | Total 2011 € million |
|---|---|---|---|---|---|---|
| Derivates held for trading | | | | | | |
| OTC foreign currency products | | | | | | |
| Currency swaps | 89 | (94) | (5) | 150 | (30) | 120 |
| Spot and forward currency transactions | 86 | (179) | (93) | 195 | (76) | 119 |
| | 175 | (273) | (98) | 345 | (106) | 239 |
| OTC interest rate products | | | | | | |
| Interest rate swaps | 111 | (163) | (52) | 96 | (151) | (55) |
| OTC credit products | | | | | | |
| Credit default swaps | 1 | (3) | (2) | 14 | (7) | 7 |
| Banking derivatives | | | | | | |
| Fair value of equity derivatives held in relation to the Banking portfolio | 411 | (60) | 351 | 433 | (81) | 352 |
| Total derivatives held for trading and Banking derivatives | 698 | (499) | 199 | 888 | (345) | 543 |
| Derivatives held for hedging | | | | | | |
| Derivatives designated as fair value hedges | | | | | | |
| Interest rate swaps | 1,600 | (330) | 1,270 | 1,681 | (346) | 1,335 |
| Cross currency interest rate swaps | 2,352 | (649) | 1,703 | 2,509 | (863) | 1,646 |
| Embedded derivatives | 12 | (272) | (260) | 19 | (89) | (70) |
| | 3,964 | (1,251) | 2,713 | 4,209 | (1,298) | 2,911 |
| Derivatives designated as cash flow hedges | | | | | | |
| Forward currency transactions | 9 | (2) | 7 | 14 | - | 14 |
| Total derivatives held for hedging | 3,973 | (1,253) | 2,720 | 4,223 | (1,298) | 2,925 |
| Total derivatives at 31 December | 4,671 | (1,752) | 2,919 | 5,111 | (1,643) | 3,468 |

In order to manage credit risk in OTC derivative transactions,[28] the Bank's policy is to approve, ex ante, each counterparty individually and to review its creditworthiness and eligibility regularly. Derivatives limits are included in overall counterparty limits. OTC derivative transactions are normally carried out only with the most creditworthy counterparties, rated at the internal equivalent of single-A and above. Furthermore, the Bank pays great attention to mitigating the credit risk of OTC derivatives through the negotiation of appropriate legal documentation with counterparties. OTC derivative transactions are systematically documented with a Master Agreement (MA) and a Credit Support Annex (CSA). These provide for close-out netting and the posting of collateral by the counterparty once the Bank's exposure exceeds a given threshold, which is a function of the counterparty's risk rating.

The Bank has also expanded the scope for applying risk mitigation techniques by documenting the widest possible range of instruments transacted with a given counterparty under a single MA and CSA, notably foreign exchange transactions. The Bank also systematically resorts to unwinding-upon-credit-downgrading clauses and, for long-dated transactions, unilateral break clauses. Similarly, the Bank emphasises risk mitigation for repurchase and reverse repurchase agreements and related transaction types through MA documentation.

At 31 December 2012, 99 per cent (2011: 100 per cent) of the Bank's gross exposure to derivatives counterparties was against counterparties with whom an MA and CSA had been completed, allowing for receipt of collateral in the form of cash or liquid, triple-A-rated and double A+-rated government securities.

### Collateral

The Bank mitigates credit risk by holding collateral against exposures to derivative counterparties.

Counterparty exposure, for the purposes of collateralising credit risk, is only concerned with counterparties with whom the Bank has an overall net positive exposure. At 31 December 2012 this exposure stood at €3.1 billion (2011: €3.5 billion). Against this, the Bank held collateral of €3.0 billion (2011: €3.3 billion), reducing its net credit exposure to €0.1 billion (2011: €0.2 billion).

Where the Bank borrows or purchases securities subject to a commitment to resell them (a reverse repurchase agreement) but does not acquire the risk and rewards of ownership, the transactions are treated as collateralised loans. The securities are not included in the balance sheet and are held as collateral.

The table below illustrates the fair value of collateral held that is permitted to be sold or repledged in the absence of default. Sold or repledged collateral includes collateral on-lent through bond lending activities. In all cases the Bank has an obligation to return equivalent securities.

| Collateral held as security | Held collateral 2012 € million | Sold or repledged 2012 € million | Held collateral 2011 € million | Sold or repledged 2011 € million |
|---|---|---|---|---|
| Derivative financial instruments | | | | |
| Triple-A-rated government securities | 1,075 | - | 1,808 | - |
| Cash | 1,932 | 1,932 | 1,445 | 1,445 |
| Reverse sale and repurchase transactions | 4,199 | - | 2,800 | - |
| **At 31 December** | 7,206 | 1,932 | 6,053 | 1,445 |

The term "collateralised placements" in the Bank's balance sheet is used to describe the economic substance of the transactions in that category. Such transactions involve the purchase of a financial asset together with entering into a total return swap whereby the risks and rewards of ownership of the asset are transferred back to the entity selling the asset. For accounting purposes, therefore, the economic substance of such transactions is a form of collateralised lending. However as the assets are legally owned by the Bank, they do not represent collateral for the purposes of the above disclosure. At 31 December 2012, the Bank held €0.6 billion (2011: €0.9 billion) of collateralised placements.

[28] This does not include negotiated options associated with share investments.

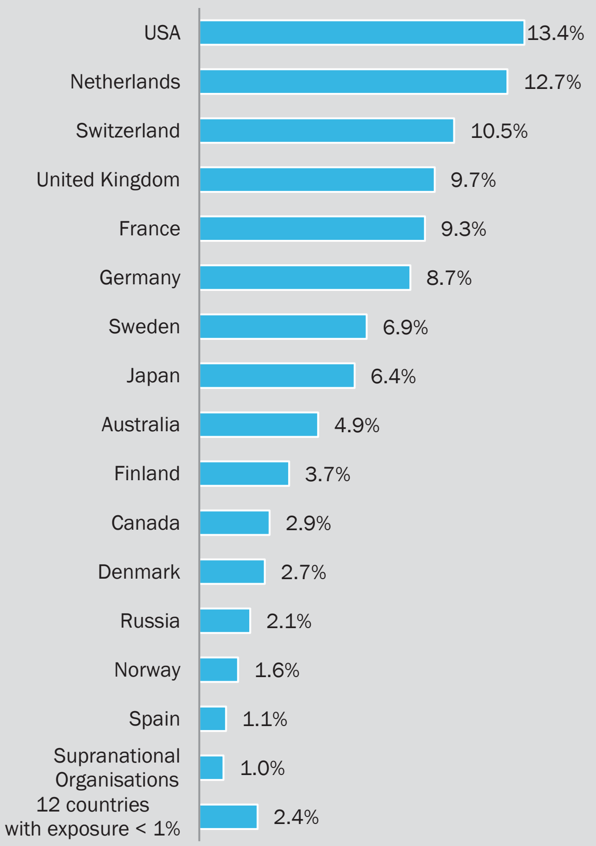
## Credit risk in the Treasury portfolio: Concentration

### Concentration by country

At the end of 2012, Treasury credit risk exposure was allocated across 28 countries. The top five countries (by percentage of the total exposure) were the United States (13 per cent), the Netherlands (13 per cent), Switzerland (11 per cent), United Kingdom (10 per cent) and France (9 per cent). In 2011 the top five countries (by percentage of the total exposure) were the United States (18 per cent), the Netherlands (14 per cent), France (12 per cent), United Kingdom (10 per cent) and Germany (9 per cent).

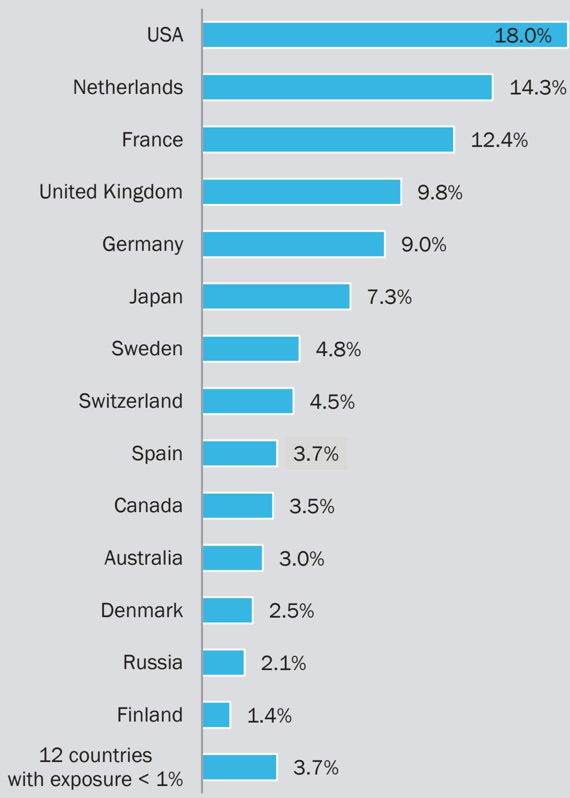
Concentration of Treasury peak exposure by country/region

31 December 2012



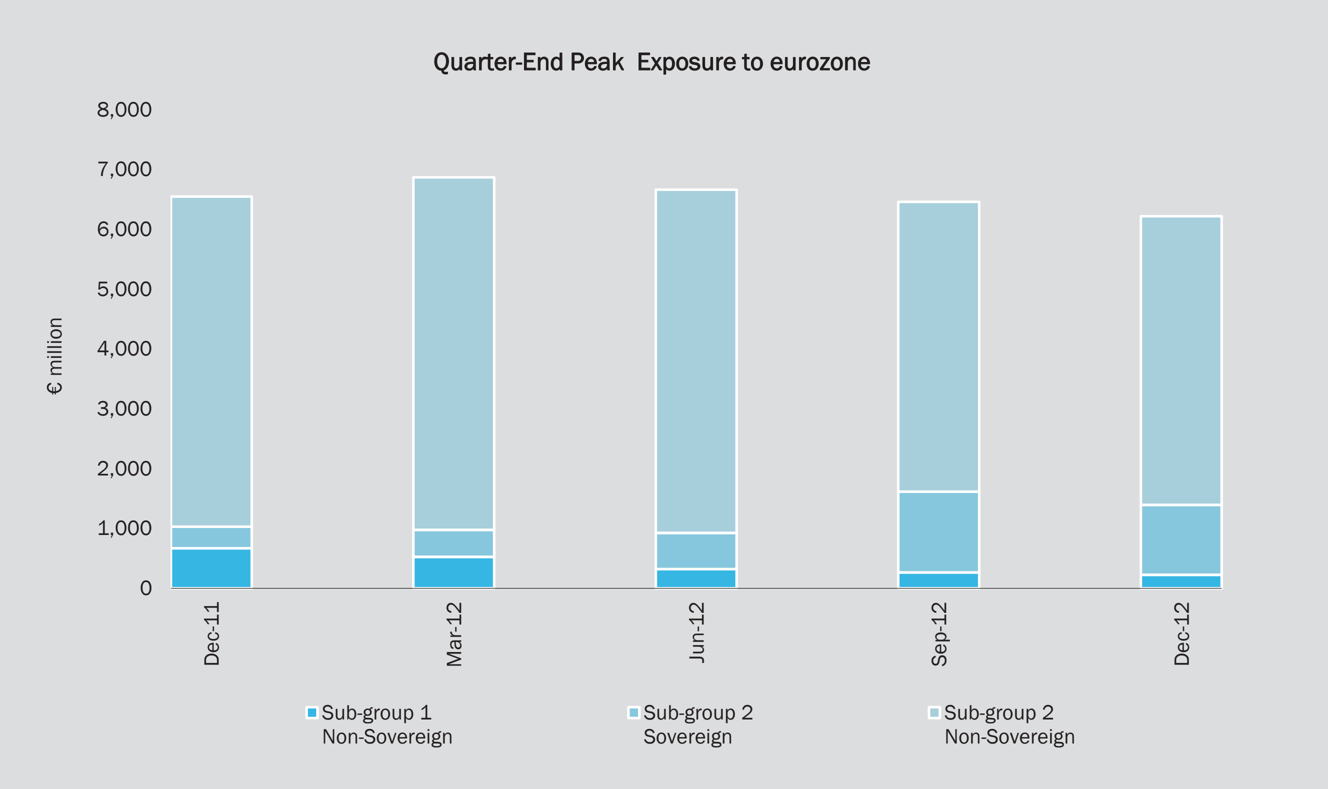

Concentration of Treasury peak exposure by country/region

31 December 2011



### Eurozone concentration

Treasury has direct exposure to the eurozone, in particular to non-sovereign counterparties in the better rated eurozone countries. Exposure to Sub-Group 1 has declined by 66 per cent during the year and now consists of €224 million exposure to non-sovereign counterparties. There is no longer exposure to sovereign counterparties in Sub-Group 1.



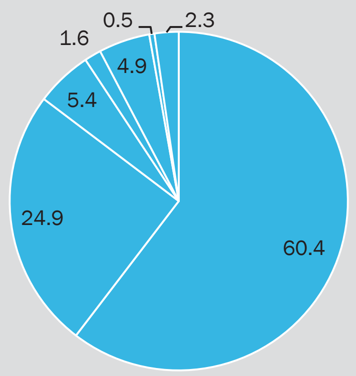

Sub-group 1: Spain, Italy and Ireland.

Sub-group 2: Belgium, France, Germany, Finland, Austria, Luxembourg and the Netherlands.

### Concentration by counterparty type

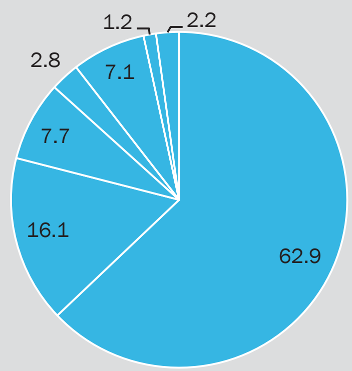
The Bank continues to be largely exposed to banks in the Treasury portfolio although this declined slightly as a proportion during 2012. Banks represented the largest portion of the portfolio peak exposure at 60 per cent at 31 December 2012 (2011: 63 per cent). Direct[29] sovereign exposure increased to 25 per cent (2011: 22 per cent) and while exposure to counterparties in the countries of operations increased marginally, it remained within the normal historical range.

**Exposure by counterparty type 31 December 2012**




| | % |
|---|---|
| Banks | 60.4 |
| Sovereigns | 24.9 |
| ABS | 5.4 |
| Insurance Co/DPCs | 1.6 |
| PSEs | 4.9 |
| Corporates | 0.5 |
| CoO | 2.3 |

**Exposure by counterparty type 31 December 2011[30]**




| | % |
|---|---|
| Banks | 62.9 |
| Sovereigns | 16.1 |
| ABS | 7.7 |
| Insurance Co/DPCs | 2.8 |
| PSEs | 7.1 |
| Corporates | 1.2 |
| CoO | 2.2 |

CoO: Countries of operation ABS: Asset-backed securities PSEs: Public sector entities DPCs: Derivative product companies

## B. Market risk

Market risk is the potential loss that could result from adverse market movements. The drivers of market risk are: (i) interest rate risk; (ii) foreign exchange risk; (iii) equity risk; and (iv) commodity price risk. Interest rate risks are further broken down into yield curve risk, which measures the impact of changes in the position and shape of the yield curve for a given currency, and volatility risk, which deals with risks specific to interest rate option transactions. Yield curve risk can in turn be divided into changes in the overall level of interest rates (a parallel shift of an entire yield curve), and changes in the slope or the shape of the yield curve.

Similarly, foreign exchange rate risks are split into risk emanating from changes in the level of foreign exchange rates, and volatility risk, which is inherent within foreign exchange options. In the market risk area, the continued European sovereign debt crisis meant that uncertainty remained high in the markets, although interest rate volatilities and volatility in currency movements were generally reduced compared with last year. Equity markets continued to rally in the first quarter, only to fall back in the second quarter (to Q3 2011 levels) before gaining more sustainably in the second half of the year to end the year higher than 2011. The most significant market risk is in listed equities (Banking) and its associated foreign exchange risk, whereas interest rate risk is kept to a minimum.

## Market risk in the Banking portfolio

The Banking loan portfolio is match-funded by Treasury in terms of currency, so for loan facilities extended in currencies other than euro the foreign exchange risk is hedged via the Treasury portfolio. Likewise, interest rate risk to which the Banking loan portfolio would normally be exposed is managed through the Treasury portfolio. As such there is minimal residual foreign exchange or interest rate risk present in the Banking loan portfolio. The main exposure to market risk in the Banking portfolio arises from the exposure of share investments to foreign exchange and equity price risk, neither of which is captured in the VaR figures discussed under “Market risk in the Treasury portfolio”. Additional sensitivity information for the Bank’s share investments has been included under “fair value hierarchy” later in this section of the report.

[29] Indirect exposure is not included – that is, where the Bank holds government securites as collateral.
[30] The Bank had some counterparty type classification changes over 2012 resulting in very small changes in year-end 2011 breakdown.

### Foreign exchange risk

The tables below summarises the potential impact on the Bank's net profit from a strengthening or weakening of foreign exchange rates relative to the euro.

## Share investments at fair value through profit or loss

| | 5 year rolling average movement in exchange rate % | Fair value € million | Impact on net profit € million |
|---|---|---|---|
| Croatian kuna | 0.6 | 530 | 3 |
| Euro | - | 1,845 | - |
| Kazakhstan tenge | 2.9 | 149 | 5 |
| Polish zloty | 3.1 | 367 | 11 |
| Romanian leu | 4.5 | 270 | 12 |
| Russian rouble | 2.5 | 1,617 | 41 |
| United States dollar | 2.1 | 1,237 | 26 |
| Other non-euro | 2.3 | 634 | 15 |
| **At 31 December 2012** | - | 6,649 | 113 |

| | 5 year rolling average movement in exchange rate % | Fair value € million | Impact on net profit € million |
|---|---|---|---|
| Croatian kuna | 0.5 | 556 | 3 |
| Euro | - | 1,804 | – |
| Kazakhstan tenge | 3.5 | 178 | 6 |
| Polish zloty | 3.4 | 214 | 7 |
| Romanian leu | 5.1 | 263 | 13 |
| Russian rouble | 4.0 | 1,336 | 53 |
| United States dollar | 0.1 | 1,007 | 1 |
| Other non-euro | 2.4 | 679 | 16 |
| **At 31 December 2011** | – | 6,037 | 99 |

### Equity price risk

In terms of equity price risk, the Bank expects the effect on net profit will bear a linear relationship to the movement in equity indices. The table below summarises the potential impact on the Bank's net profit from an increase or decrease in relevant benchmark indices.

## Share investments at fair value through profit or loss

| | | 5 year rolling average movement in benchmark index % | Fair value € million | Impact on net profit € million |
|---|---|---|---|---|
| Croatia | CROBEX Index | 12.6 | 530 | 67 |
| Hungary | CHTX Index | 2.1 | 63 | 1 |
| Kazakhstan | KASE Index | 6.7 | 193 | 13 |
| Poland | WIG Index | 4.0 | 663 | 26 |
| Romania | BET Index | 1.6 | 278 | 4 |
| Russia | RTS Index | 13.5 | 2,463 | 332 |
| Serbia | BELEX15 Index | 15.7 | 149 | 23 |
| Ukraine | PFTS Index | 0.5 | 154 | 1 |
| Regional and other | Weighted average | 10.4 | 2,156 | 224 |
| At 31 December 2012 | | - | 6,649 | 691 |

| | | 5 year rolling average movement in benchmark index % | Fair value € million | Impact on net profit € million |
|---|---|---|---|---|
| Croatia | CROBEX Index | - | 556 | - |
| Hungary | CHTX Index | 3.1 | 121 | 4 |
| Kazakhstan | KASE Index | 2.4 | 186 | 4 |
| Poland | WIG Index | 0.8 | 451 | 3 |
| Romania | BET Index | 2.2 | 263 | 6 |
| Russia | RTS Index | 15.2 | 2,006 | 305 |
| Serbia | BELEX15 Index | 9.0 | 142 | 13 |
| Slovak Republic | SAX Index | 11.7 | 205 | 24 |
| Ukraine | PFTS Index | 35.2 | 203 | 71 |
| Regional and other | Weighted average | 10.5 | 1,904 | 201 |
| At 31 December 2011 | | - | 6,037 | 631 |

### Commodity risk in the Banking portfolio

The Bank is exposed to commodity risk both directly through some investments but also due to the significant importance of commodities in several of its countries of operation.

## Market risk in the Treasury portfolio

The Bank's market risk exposure arises from the fact that the movement of interest rates and foreign exchange rates may have an impact on positions taken by the Bank. These risks are centralised and hedged by the Asset and Liabilities management desk in Treasury.

The Bank monitors its exposure to market risk in its portfolio through a combination of limits, based on Monte Carlo simulation-based eVaR, also known as Expected Shortfall, and a variety of additional risk measures. The Bank's overall eVaR limit is laid down in the Board-approved T&TRMA. Foreign exchange exposures are further constrained by a dedicated eVaR sub-limit.

Additional eVaR measures are monitored, in particular for drilling down from aggregate eVaR measures to individual market factors (marginal eVaR and VaR sensitivities). For the options portfolio, dedicated options eVaR computations are performed in order to factor in the non-linear behaviour of option instruments.

For internal monitoring purposes, eVaR is defined as the average (above a certain threshold) potential loss that could be incurred due to adverse fluctuations in interest rates and foreign exchange rates over a one-day trading horizon and computed with a 95 per cent confidence level. For enhanced comparability across institutions, numbers disclosed in this financial report are also VaR-based and scaled up to a 99 per cent confidence level over a 10-trading-day horizon.

Although eVaR is a more robust measure of market risk than VaR and is used to measure Treasury portfolio risk, it also remains limited by its historical framework insofar as past market events are not necessarily a perfect predictor of future unfolding scenarios. For these reasons a number of other risk measures are employed to complement eVaR and VaR data, with numbers produced using a different set of assumptions and based on a set of risk factor sensitivities. This is also to ensure that material risks are not ignored by focusing on one particular set of risk measures. Foreign exchange risk and the various types of interest rate risks, whether for outright exposures or for options, are monitored with sensitivity-based measures independently for each currency and type of option. A series of stress tests is also produced on a daily basis. These primarily encompass:

- stress-testing the options portfolio for joint large changes in the level of the price of the underlying security and that of volatility
- analysing, for each currency separately, the profit and loss impact of large changes in the level and shape of the yield curve
- stress tests covering the entire Treasury portfolio based on historical scenarios.

This approach is in line with the needs for complementary risk monitoring as evidenced in the recent market turmoil, and will be further strengthened and refined in light of the lessons learnt from the economic crisis.

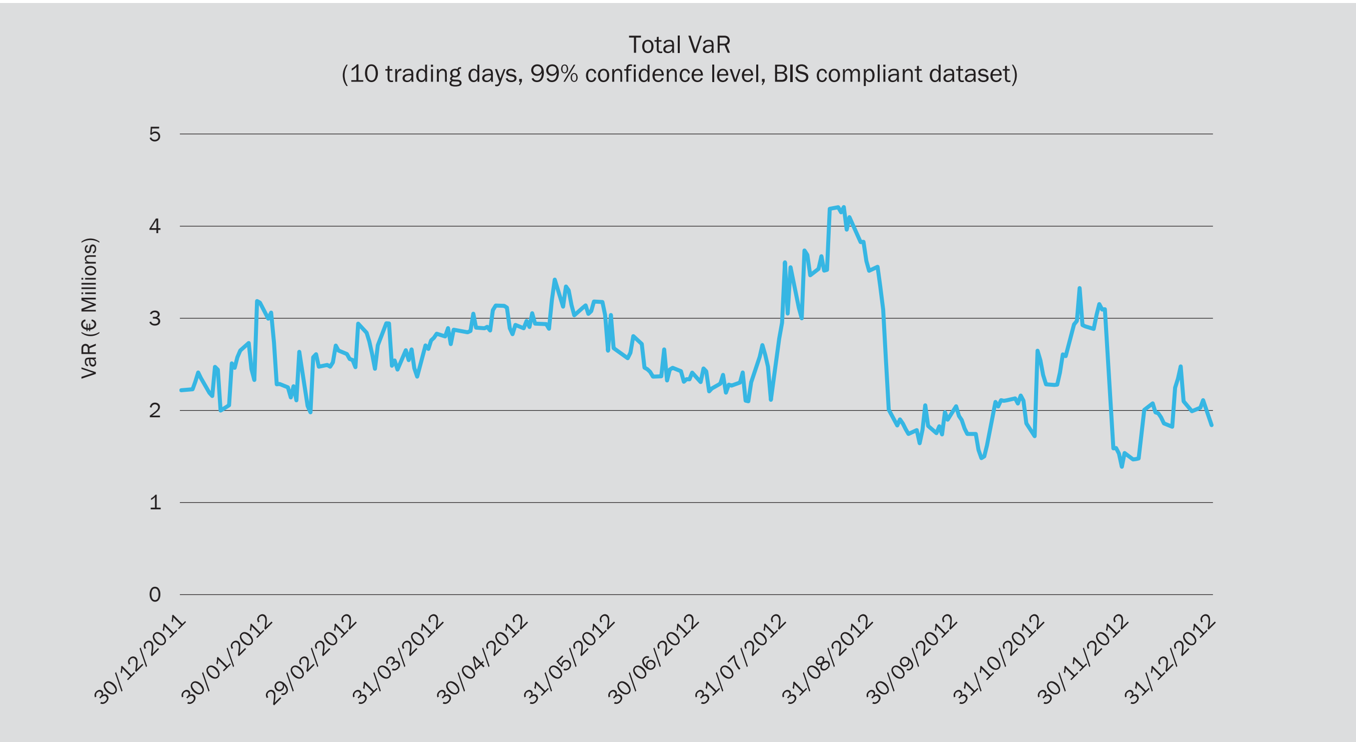
The Bank aims to limit and manage market risks through active asset and liability management. Interest rate risks are managed by synthetically hedging the interest rate profiles of assets and liabilities, mainly through the use of exchange-traded and OTC derivatives for hedging purposes. Exposures to foreign exchange and interest rate risks are measured and monitored daily by Risk Management to ensure compliance with authorised limits. The limits themselves are low compared with the Bank's capital, and in addition to that, actual limit utilisation has been quite low (typically less than 20 per cent). The corresponding profit and loss movements have also been very limited through 2012 illustrating the low risk levels to market risk as specified above.

### Interest rate and foreign exchange 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 the extent to which it is exposed to interest rate risk.

The Bank's interest rate risk measurement is complemented by accepted market techniques including VaR, (non-credit) spread risk and volatility risk, on which frequent management reporting takes place.

At 31 December 2012, the aggregate VaR of the Bank's Treasury portfolio, calculated by reference to a 99 per cent confidence level and over a ten-trading-day horizon, stood at €1.8 million (2011: €2.2 million). The maximum VaR level was €4.2 million in August, well within the Board-approved total VaR limit for all Treasury funds.[31] The average VaR over the year was €2.6 million (2011: €2.1 million), while the range during the year was between €1.4 million and €4.2 million (2011: between €1.1 million and €4.0 million). The peak 3potential future exposure of the portfolio to which these figures relate was €16.7 billion at 31 December 2012 (2011: €14.9 billion).




[31] This limit stands at €27 million as of 20 July 2010.

The specific contribution from foreign exchange risk to the overall VaR stood at €0.5 million at year-end (2011: €0.1 million). As in previous years, this contribution was small throughout 2012 and never exceeded €1.2 million (2011: €1.6 million). Interest rate positioning continued to represent the majority of the Bank's market risk exposure. Interest rate option exposure remained modest throughout the year with option VaR at just €0.3 million at year-end (2011: €0.03 million), having peaked at €1.4 million in August (2011: €1.4 million also in August).

In addition to the above, the sterling budget hedges portfolio, tied to the EUR/GBP currency movements, had a stand-alone VaR figure of €11.3 million at year-end. Since the portfolio is not actively managed (nor limit-based), it would be inappropriate to combine the VaR figure with other risk measures for the Treasury portfolio.

#### Equity price risk

The Bank has direct exposure to equity risk through one Treasury share investment. Indirect exposure to equity risk occurs in the form of linked structures that are traded on a back-to-back basis and therefore result in no outright exposure.

## C. Liquidity risk

### Liquidity risk management process

The Bank's liquidity policies are set out in its Liquidity Policy Review which is updated annually and approved by the Board of Directors. The policies are designed to ensure that the Bank maintains a prudent level of liquidity, given the risk environment in which it operates, and to support its 'triple-A' credit rating.

The Bank's medium term liquidity policy has two elements to it and is based on a multi-year context:

- net Treasury liquid assets should be at least 45 per cent of the next three years' projected net cash requirements, with a 90 per cent operating target; and
- gross Treasury liquid assets should be at least 75 per cent of the total of undrawn commitments plus one year's debt service with a 100 per cent operating target.

For the purposes of these ratios, all assets managed within its Treasury portfolio are considered to be liquid assets while "net" treasury liquid assets represent gross treasury assets net of short-term debt.[32] "One year's debt service" represents all interest and principal outflows on debt which either matures within one year or could be called within the same period.

On this basis the Bank exceeded the minimum requirement on each ratio, both at 31 December 2012 and consistently throughout the year. The average weighted maturity of assets managed by Treasury at 31 December 2012 was 1.0 years (2011: 1.3 years).

In the fourth quarter of 2012 the Bank introduced a new short-term liquidity policy which is based on the principles of the Liquidity Coverage Ratio proposed as part of the Basle III reform package. The policy requires that the ratio of eligible liquid assets and scheduled cash inflows to cash outflows over both a 30-day and 90-day horizon must be a minimum of 100 per cent. Since its introduction, these minimum ratios have been consistently exceeded.

In addition to the above, Treasury actively manages the Bank's liquidity position on a daily basis.

The Bank has a proven record of access to funding in the capital markets via its commercial paper facilities and euro medium-term note programme. The Bank's AAA credit rating was affirmed by the three major rating agencies in December 2012.

The Bank's liquidity policies are subject to independent review by Risk Management and by the Treasury Exposure Committee that is chaired by the Vice President and CFO.

IFRS 7 Financial Instruments: Disclosures, requires a maturity analysis of the undiscounted cash flows deriving from the Bank's financial liabilities. Cash flows are presented in the earliest maturity band in which they could potentially fall due. For this purpose, the Bank profiles its callable debt in line with options conferring the right to its derivative counterparties to terminate the associated hedging instruments prior to legal maturity. This reflects how the Bank manages its debt in practice despite the fact that the debt is callable at the option of the Bank and therefore there is no legal obligation to redeem the debt before its legal maturity.

Net settling interest rate derivatives typically include interest rate swaps and forward rate agreements. Gross settling interest rate derivatives include cross currency interest rate swaps. While the pay legs of these derivatives must be disclosed, the inflows have also been presented in the accompanying table for information purposes. Foreign exchange derivatives include currency forwards and currency swaps. As exchange-traded interest rate futures and options are cash settled daily, their undiscounted future cash flows at the balance sheet date are negligible.

[32] For this ratio, short-term debt is debt with a maturity of one year or less at the point of acquisition – that is, it is not debt where the remaining maturity is one year or less.

As the figures represent undiscounted cash flows, they do not agree to the balance sheet.

| Financial liabilities at 31 December 2012 | Up to and including 1 month € million | Over 1 month and up to and including 3 months € million | Over 3 months and up to and including 1 year € million | Over 1 year and up to and including 3 years € million | Over 3 years € million | Total € million |
|---|---|---|---|---|---|---|
| **Non-derivative cash flows** | | | | | | |
| Amounts owed to credit institutions | (3,084) | (2) | - | - | - | (3,086) |
| Debts evidenced by certificates | (728) | (1,713) | (7,077) | (9,062) | (16,678) | (35,258) |
| Other financial liabilities | (2) | (4) | (84) | (70) | - | (160) |
| **At 31 December 2012** | (3,814) | (1,719) | (7,161) | (9,132) | (16,678) | (38,504) |
| **Trading derivative cash flows** | | | | | | |
| Net settling interest rate derivatives | (6) | (8) | (32) | (75) | (54) | (175) |
| Gross settling interest rate derivatives – outflow | (48) | (321) | (1,399) | (1,360) | (1,131) | (4,259) |
| Gross settling interest rate derivatives – inflow | 44 | 300 | 1,324 | 1,202 | 1,081 | 3,951 |
| Foreign exchange derivatives – outflow | (3,345) | (2,587) | (1,461) | - | - | (7,393) |
| Foreign exchange derivatives – inflow | 3,264 | 2,521 | 1,426 | - | - | 7,211 |
| Credit derivatives | - | (1) | (2) | - | - | (3) |
| **At 31 December 2012** | (91) | (96) | (144) | (233) | (104) | (668) |
| **Hedging derivative cash flows** | | | | | | |
| Net settling interest rate derivatives | 7 | (7) | (80) | (113) | (83) | (276) |
| Gross settling interest rate derivatives – outflow | (93) | (541) | (1,194) | (1,626) | (1,850) | (5,304) |
| Gross settling interest rate derivatives – inflow | 110 | 468 | 1,224 | 1,549 | 1,517 | 4,868 |
| **At 31 December 2012** | 24 | (80) | (50) | (190) | (416) | (712) |
| **Total financial liabilities at 31 December 2012** | (3,881) | (1,895) | (7,355) | (9,555) | (17,198) | (39,884) |
| **Other financial instruments** | | | | | | |
| Undrawn commitments | | | | | | |
| Financial institutions | (2,082) | – | – | – | – | (2,082) |
| Non-financial institutions | (8,913) | – | – | – | – | (8,913) |
| **At 31 December 2012** | (10,955) | – | – | – | – | (10,955) |

| Financial liabilities at 31 December 2011 | Up to and including 1 month € million | Over 1 month and up to and including 3 months € million | Over 3 months and up to and including 1 year € million | Over 1 year and up to and including 3 years € million | Over 3 years € million | Total € million |
|---|---|---|---|---|---|---|
| Non-derivative cash flows | | | | | | |
| Amounts owed to credit institutions | (2,614) | - | - | - | - | (2,614) |
| Debts evidenced by certificates | (676) | (2,069) | (5,593) | (8,217) | (17,517) | (34,072) |
| Other financial liabilities | (2) | (4) | (59) | (81) | - | (146) |
| At 31 December 2011 | (3,292) | (2,073) | (5,652) | (8,298) | (17,517) | (36,832) |
| Trading derivative cash flows | | | | | | |
| Net settling interest rate derivatives | (2) | (5) | (26) | (76) | (55) | (164) |
| Gross settling interest rate derivatives – outflow | (4) | (123) | (479) | (1,140) | (505) | (2,251) |
| Gross settling interest rate derivatives – inflow | 2 | 126 | 483 | 1,122 | 480 | 2,213 |
| Foreign exchange derivatives – outflow | (898) | (1,461) | (348) | - | - | (2,707) |
| Foreign exchange derivatives – inflow | 888 | 1,418 | 326 | - | - | 2,632 |
| Credit derivatives | - | - | - | - | - | - |
| At 31 December 2011 | (14) | (45) | (44) | (94) | (80) | (277) |
| Hedging derivative cash flows | | | | | | |
| Net settling interest rate derivatives | 1 | (15) | (30) | (121) | (55) | (220) |
| Gross settling interest rate derivatives – outflow | (97) | (214) | (2,539) | (2,874) | (2,545) | (8,269) |
| Gross settling interest rate derivatives – inflow | 115 | 162 | 2,635 | 2,989 | 2,273 | 8,174 |
| At 31 December 2011 | 19 | (67) | 66 | (6) | (327) | (315) |
| Total financial liabilities at 31 December 2011 | (3,287) | (2,185) | (5,630) | (8,398) | (17,924) | (37,424) |
| Other financial instruments | | | | | | |
| Undrawn commitments | | | | | | |
| Financial institutions | (2, 236) | – | – | – | – | (2,236) |
| Non-financial institutions | (7,798) | – | – | – | – | (7,798) |
| At 31 December 2011 | (10,034) | – | – | – | – | (10,034) |

## D. Capital management

The Bank's original authorised share capital was €10.0 billion. Under Resolution No. 59, adopted on 15 April 1996, the Board of Governors approved a doubling of the Bank's authorised capital stock to €20.0 billion.

In accordance with the requirements of Article 5.3 of the Agreement, the Board of Governors reviews the capital stock of the Bank at intervals of not more than five years. At the Annual Meeting in May 2010 the Bank's Board of Governors approved the Fourth Capital Resources Review (CRR4) which established the Bank's strategy for the period 2011 to 2015. This included an analysis of the transition impact and operational activity of the Bank; an assessment of the economic outlook and transition challenges in the region; the formulation of medium-term portfolio development strategy and objectives; and a detailed analysis of the Bank's projected future financial performance and capital adequacy. The review underlined that the Bank relies on a strong capital base and stressed the need for prudent financial policies supporting conservative provisioning, strong liquidity and long-term profitability.

As a result of the assessment of capital requirements in CRR4, in May 2010 the Board of Governors approved a two-step increase in the authorised capital stock of the Bank: an immediate €1.0 billion increase in authorised paid-in shares (Resolution No. 126), and a €9.0 billion increase in authorised callable capital shares (Resolution No. 128). This amounts to an aggregate increase in the authorised capital stock of the Bank of €10.0 billion (collectively referred to as the second capital increase). The increase in callable capital became effective on 20 April 2011 when subscriptions were received for at least 50 per cent of the newly authorised callable capital. Subscriptions were originally all to be received on or before 30 April 2011, but the Board of Directors has extended this date to no later than 31 December 2012. The callable shares are subject to redemption in accordance with the terms of Resolution No. 128. At 31 December 2012, €8.8 billion of the callable capital increase had been subscribed (2011: €7.6 billion).

The Bank does not have any other classes of capital.

The Bank's capital usage is guided by statutory and financial policy parameters. Article 12 of the Agreement establishes a 1:1 gearing ratio which limits the total amount of outstanding loans, share investments and guarantees made by the Bank in its countries of operations to the total amount of the Bank's unimpaired subscribed capital, reserves and surpluses. This capital base is defined in the Bank's Reserves, Capital Measurement and Prudential Limits Policy and incorporates unimpaired subscribed capital, the unrestricted general reserves, loan loss reserve, special reserve and adjustments for accumulated specific and general loan impairment provisions and equity losses. The capital base for these purposes amounted to €37.7 billion[33] at 31 December 2012 (2011: €35.5 billion).

Article 12 also limits the total amount of disbursed share investments to the total amount of the Bank's unimpaired paid-in subscribed capital, surpluses and general reserve. The Bank interprets the gearing ratio on a "disbursed Banking assets" or "operating assets" basis. At 31 December 2012 the Bank's gearing ratio on an aggregated basis was 70 per cent (2011: 70 per cent). No capital utilisation limits were breached during the year (2011: none). The reduction in the Bank's gearing ratio compared with the end of 2010 reflects the increase to date in subscribed callable capital. As an illustration, if the €9.0 billion increase in callable capital under Resolution 128 had been immediately effective and fully subscribed, the Bank's gearing ratio would have been 70 per cent at 31 December 2012 and 67 per cent at 31 December 2011.

The Bank's statutory measure of capital adequacy under the gearing ratio is supplemented by a risk-based prudential capital adequacy limit under its Economic Capital Policy.

The Bank defines required economic capital as the potential capital losses – both expected and unexpected – it may incur based on probabilities consistent with the Bank's 'triple-A' credit rating. The main risk categories assessed under the economic capital framework are credit risk, market risk and operational risk, and the total risk is managed within an available economic capital base that excludes callable capital, while maintaining a prudent capital buffer.

One of the main objectives of the Economic Capital Policy is to manage the Bank's capital within a medium-term planning framework, providing a consistent measurement of capital headroom over time. The Bank's objective is to prevent the need to call on subscribed callable capital and to use only available risk capital including paid-in capital, reserves and provisions. The available economic capital managed by the Bank consists of paid-in capital, the unrestricted general reserves, loan loss reserve, special reserve and adjustments for accumulated general loan impairment provisions and equity losses, assessed at the period end. This capital base amounted to €14.0 billion at 31 December 2012 (2011: €13.1 billion).

At 31 December 2012 the ratio of required economic capital to available economic capital was 74 per cent, compared with a policy threshold for this ratio of 90 per cent (2011: 75 per cent). The Bank's risk-based capital requirement under this policy is managed alongside the Bank's statutory capital constraint.

The Bank's prudent approach to capital management is reflected in the key financial ratios presented on page 7. At 31 December 2012, the ratio of members' equity to total assets was 27 per cent (2011: 28 per cent) and the ratio of members' equity to banking assets was 55 per cent (2011: 54 per cent).

[33] The capital base incorporates subscribed capital (paid-in and callable), reserves and retained earnings, as well as provisions (as this capital base is compared to operating assets prior to provisions). Deductions are made to exclude revaluation reserves related to Banking assets (as operating assets are considered at cost) and for net income allocations other than to the SEMED ISF (as the associated investments are included in operating assets).

# E. Fair value of financial assets and liabilities

## Classification and fair value of financial assets and liabilities

| Financial assets at 31 December 2012 | Carrying amount € million | Fair value € million |
|---|---|---|
| Financial assets measured at fair value through profit or loss or fair value through other comprehensive income: | | |
| – Debt securities | 175 | 175 |
| – Derivative financial instruments | 4,671 | 4,671 |
| – Banking loans at fair value through profit or loss | 247 | 247 |
| – Banking portfolio: Share investments at fair value through profit or loss | 6,649 | 6,649 |
| – Treasury portfolio: Share investments at fair value through other comprehensive income | 64 | 64 |
| | 11,806 | 11,806 |
| Financial assets measured at amortised cost: | | |
| – Placements with and advances to credit institutions | 7,515 | 7,515 |
| – Debt securities | 12,235 | 12,144 |
| – Collateralised placements | 600 | 624 |
| – Other financial assets | 354 | 354 |
| – Banking loan investments at amortised cost | 18,597 | 19,560 |
| – Paid in capital receivable | 12 | 12 |
| | 39,313 | 40,209 |
| Total | 51,119 | 52,015 |

| Financial assets at 31 December 2011 | Carrying amount € million | Fair value € million |
|---|---|---|
| Financial assets measured at fair value through profit or loss or fair value through other comprehensive income: | | |
| – Debt securities | 411 | 411 |
| – Derivative financial instruments | 5,111 | 5,111 |
| – Banking loans at fair value through profit or loss | 239 | 239 |
| – Banking portfolio: Share investments at fair value through profit or loss | 6,037 | 6,037 |
| – Treasury portfolio: Share investments at fair value through other comprehensive income | 58 | 58 |
| | 11,856 | 11,856 |
| Financial assets measured at amortised cost: | | |
| – Placements with and advances to credit institutions | 5,172 | 5,172 |
| – Debt securities | 11,127 | 10,569 |
| – Collateralised placements | 851 | 891 |
| – Other financial assets | 517 | 517 |
| – Banking loan investments at amortised cost | 17,416 | 17,621 |
| – Paid in capital receivable | 15 | 15 |
| | 35,098 | 34,766 |
| Total | 46,954 | 46,622 |

| Financial liabilities at 31 December 2012 | Held for trading € million | At fair value through profit or loss € million | Derivatives held for hedging purposes € million | Financial liabilities at amortised cost € million | Carrying amount € million | Fair value € million |
|---|---|---|---|---|---|---|
| Amounts owed to credit institutions | - | - | - | (3,086) | (3,086) | (3,086) |
| Debts evidenced by certificates | - | - | - | (31,824) | (31,824) | (31,738) |
| Derivative financial instruments | (439) | (60) | (1,253) | - | (1,752) | (1,752) |
| Other financial liabilities | - | - | - | (530) | (530) | (530) |
| Total financial liabilities | (439) | (60) | (1,253) | (35,440) | (37,192) | (37,106) |

| Financial liabilities at 31 December 2011 | Held for trading € million | At fair value through profit or loss € million | Derivatives held for hedging purposes € million | Financial liabilities at amortised cost € million | Carrying amount € million | Fair value € million |
|---|---|---|---|---|---|---|
| Amounts owed to credit institutions | - | - | - | (2,610) | (2,610) | (2,610) |
| Debts evidenced by certificates | - | - | - | (29,195) | (29,195) | (29,056) |
| Derivative financial instruments | (264) | (81) | (1,298) | - | (1,643) | (1,643) |
| Other financial liabilities | - | - | - | (415) | (415) | (415) |
| Total financial liabilities | (264) | (81) | (1,298) | (32,220) | (33,863) | (33,724) |

At 31 December 2012, the Bank's balance sheet approximates to fair value in all financial asset and liability categories, with the exception of debt securities at amortised cost, loan investments at amortised cost and debts evidenced by certificates.

The basis of fair value for debt securities listed in an active market is the quoted bid market price on the balance sheet date.

The basis of fair value for debt securities that are unlisted or listed in an inactive market is determined using valuation techniques appropriate to the market and industry of each investment. The primary valuation techniques used are quotes from brokerage services and discounted cash flows. Techniques used to support these valuations include industry valuation benchmarks and recent transaction prices.

Banking loan investments whereby the objective of the Bank's business model is to hold these investments 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, are recognised at amortised cost. The fair value of these loans was calculated by discounting the cash flows at a year end interest rate applicable to each loan and further discounting the value by an internal measure of credit risk.

"Debts evidenced by certificates" represents the Bank's borrowing activities executed through the issuance of commercial paper and bonds. Due to the short-tenor nature of commercial paper, amortised cost approximates fair value.[34]

## Fair value hierarchy

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. This level includes listed share investments on stock exchanges.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). This level includes debt securities and most derivative products. The sources of inputs include prices available from screen-based services such as Reuters and Bloomberg, broker quotes and observable market data such as interest rates and foreign exchange rates which are used in deriving the valuations of derivative products.
- Level 3 – Inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes share investments and debt securities or derivative products for which not all market data is observable.

[34] Adjusted for hedge accounting as applicable.

The table below provides information at 31 December 2012 about the Bank's financial assets and financial liabilities measured at fair value. Financial assets and financial liabilities are classified in their entirety based on the lowest level input that is significant to the fair value measurement.

| | At 31 December 2012 | | | |
|---|---|---|---|---|
| | Level 1 € million | Level 2 € million | Level 3 € million | Total € million |
| Debt securities | - | 131 | 44 | 175 |
| Derivative financial instruments | - | 4,256 | 415 | 4,671 |
| Banking loans | - | - | 247 | 247 |
| Share investments (Banking portfolio) | 1,094 | - | 5,555 | 6,649 |
| Share investments (Treasury portfolio) | - | 64 | - | 64 |
| **Total financial assets at fair value** | 1,094 | 4,451 | 6,261 | 11,806 |
| | | | | |
| Derivative financial instruments | – | (1,692) | (60) | (1,752) |
| **Total financial liabilities at fair value** | – | (1,692) | (60) | (1,752) |

| | At 31 December 2011 | | | |
|---|---|---|---|---|
| | Level 1 € million | Level 2 € million | Level 3 € million | Total € million |
| Debt securities | - | 209 | 202 | 411 |
| Derivative financial instruments | - | 4,678 | 433 | 5,111 |
| Banking loans | - | - | 239 | 239 |
| Share investments (Banking portfolio) | 952 | - | 5,085 | 6,037 |
| Share investments (Treasury portfolio) | - | 58 | - | 58 |
| **Total financial assets at fair value** | 952 | 4,945 | 5,959 | 11,856 |
| | | | | |
| Derivative financial instruments | – | (1,560) | (83) | (1,643) |
| **Total financial liabilities at fair value** | – | (1,560) | (83) | (1,643) |

There have been no transfers between Level 1 and Level 2 during the year.

The table below provides a reconciliation of the fair values of the Bank's Level 3 financial assets and financial liabilities for the year ended 31 December 2012.

| | Level 3 financial assets and financial liabilities Year ended 31 December 2012 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Debt securities € million | Derivative financial instruments € million | Banking loans € million | Banking share investments € million | Total assets € million | Derivative financial instruments € million | Total liabilities € million |
| Balance at 31 December 2011 | 202 | 433 | 239 | 5,085 | 5,959 | (83) | (83) |
| Total gains/(losses) for the year ended 31 December 2012 in: | | | | | | | |
| Net profit/(loss) | 24 | (18) | 4 | 10 | 20 | 22 | 22 |
| Purchases/issues | - | - | 36 | 949 | 985 | - | - |
| Sales/settlements | (182) | - | (32) | (489) | (703) | - | - |
| Transfers out of Level 3 | - | - | - | - | - | 1 | 1 |
| **Balance at 31 December 2012** | 44 | 415 | 247 | 5,555 | 6,261 | (60) | (60) |
| **Total gains/(losses) for the period included in net profit for assets and liabilities held at 31 December 2012** | 1 | 32 | 11 | 134 | 178 | (15) | (15) |

| | Debt securities € million | Derivative financial instruments € million | Banking loans € million | Banking share investments € million | Total assets € million | Derivative financial instruments € million | Total liabilities € million |
|---|---|---|---|---|---|---|---|
| | **Level 3 financial assets and financial liabilities Year ended 31 December 2011** | | | | | | |
| Balance at 31 December 2010 | 197 | 590 | 221 | 4,006 | 5,014 | (41) | (41) |
| Total gains/(losses) for the year ended 31 December 2011 in: | | | | | | | |
| Net profit/(loss) | 6 | (142) | 21 | 232 | 117 | (42) | (42) |
| Purchases/issues | - | - | 38 | 968 | 1,006 | | |
| Sales/settlements | (14) | (15) | (41) | (422) | (492) | | |
| Transfers in to Level 3 | 13 | - | - | 301 | 314 | | |
| **Balance at 31 December 2011** | 202 | 433 | 239 | 5,085 | 5, 959 | (83) | (83) |
| **Total (losses)/gains for the period included in net profit for assets and liabilities held at 31 December 2011** | (2) | 102 | 21 | 242 | 363 | 75 | 75 |

Transfers into and out of Level 3 for Banking share investments relate to listed investments that switch from/(to) an actively traded market. Transfers into and out of Level 3 for derivative financial instruments relate to whether a model used to value a derivative is based on observable market inputs or otherwise.

## Level 3 – sensitivity analysis

The table below presents the Level 3 financial instruments carried at fair value at 31 December 2012, main valuation models/techniques[35] used in the valuation of these financial instruments and estimated increases or decreases in fair value based on reasonably possible alternative assumptions:

| | | Impact on net profit in 2012 | | |
|---|---|---|---|---|
| Assets | Main valuation models/techniques | Carrying amount € million | Favourable change € million | Unfavourable change € million |
| Debt securities | Discounted cash flow models, broker quotes and observable market data | 44 | 2 | (2) |
| Derivative financial instruments | Discounted cash flow models | 4 | - | (1) |
| Banking loans | Discount cash flow and option pricing models | 247 | 7 | (20) |
| Banking share investments & associated derivatives[36] | NAV and EBITDA multiples, discount cash flow models, compounded interest and option pricing models | 5,906 | 970 | (1,371) |
| At 31 December | | 6,201 | 979 | (1,394) |

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

[35] NAV = net asset value; EBITDA =earnings before interest, tax, depreciation and amortisation.

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

| Assets | Main valuation models/techniques | Impact on net profit in 2011<br>Carrying amount € million | Favourable change € million | Unfavourable change € million |
|---|---|---|---|---|
| Debt securities | Discounted cash flow models, broker quotes and observable market data | 202 | 34 | (1) |
| Banking loans | Discount cash flow and option pricing models | 239 | 6 | (21) |
| Banking share investments | NAV and EBITDA multiples, discount cash flow models, compounded interest and option pricing models | 5,437 | 442 | (759) |
| At 31 December | | 5,878 | 482 | (781) |

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| Liabilities | Main valuation models/techniques | Impact on net profit in 2011<br>Carrying amount € million | Favourable change € million | Unfavourable change € million |
|---|---|---|---|---|
| Derivative financial instruments | Discounted cash flow models | (2) | – | (1) |
| At 31 December | | (2) | - | (1) |

## Treasury debt securities and derivative financial instruments

The Bank's derivative instruments held within the Treasury portfolio are valued though discounted cash flow models. Valuations are reconciled to counterparty statements on a monthly basis. Therefore the reasonable possible alternative valuations have been determined based on the range of discrepancies between the Bank's valuations and those of our counterparties.

A majority of the Bank's debt securities are priced via a third party market data service, screen-based services such as Reuters and Bloomberg or using broker quotes. For the few debt securities where an active market does not exist, reasonable, alternative valuations have been derived from discounted cash flow models or reasonable adjustments to similarly priced assets.

## Banking loans

Banking loans at fair value through profit or loss mainly comprise convertible loans or loans with an element of performance-based return. The valuation models/techniques used to fair value these instruments are discounted cash flow 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.

## Banking share investments and derivatives

The Bank's unlisted equity portfolio comprises direct share investments, equity derivatives and equity funds. The main valuation models/techniques used to fair value these financial instruments are net asset value (NAV) multiples, earnings before interest, tax, depreciation and amortisation (EBITDA) multiples and discounted cash flow (DCF) models.

NAV multiples are most commonly applied to bank investments and equity funds. Reasonable possible alternative valuations have been determined based on the NAV multiple ranges in the valuations received for bank investments, and by considering the impact of adjusting the portfolio discount applied to equity funds. For investments valued using EBITDA multiples and DCF models, sensitivity analyses have been performed for the largest investments using reasonable possible alternative assumptions for each investment (for example, increase or decrease in the discount rate).

# Notes to the financial statements

## 1. Establishment of the Bank

### i Agreement Establishing the Bank

The European Bank for Reconstruction and Development (the Bank), whose principal office is located in London, is an international organisation formed under the Agreement Establishing the Bank dated 29 May 1990 (the Agreement). At 31 December 2012, the Bank's shareholders comprised 64 countries, together with the European Union (EU) and the European Investment Bank.

### ii Headquarters Agreement

The status, privileges and immunities of the Bank and persons connected with the Bank in the United Kingdom are confirmed and supplemented in the Headquarters Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Bank (Headquarters Agreement). The Headquarters Agreement was signed in London at the start of the Bank's operations on 15 April 1991.

## 2. Segment information

The Bank's activities are primarily Banking and Treasury. Banking activities represent investments in projects that, in accordance with the Agreement, are made for the purpose of assisting the countries of operations in their transition to a market economy, while applying sound banking principles. The main investment products are loans, share investments and guarantees. Treasury activities include raising debt finance, investing surplus liquidity, managing the Bank's foreign exchange and interest rate risks and assisting clients in asset and liability management matters.

Information on the financial performance of Banking and Treasury operations is prepared regularly and provided to the chief operating decision maker. On this basis, Banking and Treasury operations have been identified as the operating segments.

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing the performance of the operating segments, is the President.

### Segment performance

The President assesses the performance of the operating segments based on the net profit for the year, which is measured in a manner consistent with the financial statements. The segment information provided to the President for the operating segments for the year ended 31 December 2012 and 31 December 2011 is as follows:

| | Banking 2012 € million | Treasury 2012 € million | Aggregated 2012 € million | Banking 2011 € million | Treasury 2011 € million | Aggregated 2011 € million |
|---|---|---|---|---|---|---|
| Interest income | 1,040 | 166 | 1,206 | 859 | 187 | 1,046 |
| Other income/(expense) | 405 | 87 | 492 | (282) | 27 | (255) |
| **Total segment revenue** | 1,445 | 253 | 1,698 | 577 | 214 | 791 |
| Less interest expense and similar charges[37] | (382) | 133 | (249) | (321) | 17 | (304) |
| Net interest expense on derivatives | - | (176) | (176) | - | (118) | (118) |
| Allocation of the return on capital | 84 | 10 | 94 | 143 | 16 | 159 |
| Less general administrative expenses | (254) | (17) | (271) | (234) | (15) | (249) |
| Less depreciation and amortisation | (24) | (1) | (25) | (20) | (1) | (21) |
| **Segment result before provisions and hedges** | 869 | 202 | 1,071 | 145 | 113 | 258 |
| Fair value movement on non-qualifying and ineffective hedges | - | 69 | 69 | - | (39) | (39) |
| Provisions for impairment of loan investments | (120) | - | (120) | (46) | - | (46) |
| **Net profit for the year** | 749 | 271 | 1,020 | 99 | 74 | 173 |
| Transfers of net income approved by the Board of Governors | | | (190) | | | - |
| **Net profit after transfers approved by the Board of Governors** | | | 830 | | | 173 |
| **Segment assets** | | | | | | |
| **Total assets** | 26,249 | 24,953 | 51,202 | 24,617 | 22,419 | 47,036 |
| **Segment liabilities** | | | | | | |
| **Total liabilities** | 215 | 36,977 | 37,192 | 238 | 33,625 | 33,863 |

[37] Interest expense and similar charges and allocation of the return on capital equates to the interest expense and similar charges on the face of the income statement.

## Segment revenues – Geographic

The Bank's activities are divided into five regions for internal management purposes.

| Risk rating | Segment revenue 2012 € million | Segment revenue 2011 € million |
|---|---|---|
| Advanced countries[38] | 256 | (24) |
| Early/Intermediate countries[39] | 526 | 435 |
| Russia | 585 | 136 |
| Turkey | 78 | 30 |
| OECD | 253 | 214 |
| **Total** | 1,698 | 791 |

Revenues are attributed to countries on the basis of the location in which a project operates.

# 3. Net interest income

| | 2012 € million | 2011 € million |
|---|---|---|
| **Interest and similar income** | | |
| Banking loans | 1,040 | 859 |
| Debt securities | 111 | 134 |
| Collateralised placements | 8 | 9 |
| Reverse repurchase agreements | 6 | 9 |
| Cash and short-term funds | 41 | 32 |
| Other | - | 3 |
| **Interest and similar income** | 1,206 | 1,046 |
| **Interest expense and similar charges** | | |
| Debts evidenced by certificates | (155) | (145) |
| Other | - | - |
| **Interest expense and similar charges** | (155) | (145) |
| **Net interest expense on derivatives** | (176) | (118) |
| **Net interest income** | 875 | 783 |

Interest income accrued on impaired financial assets at 31 December 2012 was €11 million (2011: €11 million).

[38] Advanced countries are Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.
[39] Early/Intermediate countries are Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Former Yugoslav Republic of Macedonia, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Moldova, Mongolia, Montenegro, Romania, Serbia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

## 4. Net fee and commission income

The main components of net fee and commission income are as follows:

| | 2012 € million | 2011 € million |
|---|---|---|
| Trade finance fees | 10 | 10 |
| Administration fees | 15 | 5 |
| Syndication and agency fees | 4 | 3 |
| Other | 2 | 3 |
| Prepayment fees | 1 | 1 |
| Donor fund expenses | - | (2) |
| **Net fee and commission income** | 32 | 20 |

Front-end and commitment fees of €119 million (2011: €109 million) received in 2012, together with related direct costs of €8 million (2011: €5 million), have been deferred on the balance sheet. They will be recognised in interest income over the period from disbursement to repayment of the related loan, in accordance with IAS 18. In 2012, €92 million (2011: €70 million) of previously deferred fees and direct costs were recognised in interest income.

## 5. Net gains/(losses) from share investments at fair value through profit or loss

| | 2012 € million | 2011 € million |
|---|---|---|
| Net realised gains from share investments and equity related derivatives | 217 | 162 |
| Net unrealised gains/(losses) from share investments and equity related derivatives | 57 | (586) |
| **Net gains/(losses) from share investments at fair value through profit or loss** | 274 | (424) |

On exit of an equity investment, the cumulative realised gain/loss and the corresponding reversal of cumulative unrealised gain/loss are recognised.

## 6. Net gains from loans at fair value through profit or loss

| | 2012 € million | 2011 € million |
|---|---|---|
| Net realised gains from loans at fair value through profit or loss | 4 | - |
| Net unrealised gains from changes in fair value | 7 | 5 |
| **Net gains from loans at fair value through profit or loss** | 11 | 5 |

## 7. Net losses from Treasury assets held at amortised cost

| | 2012 € million | 2011 € million |
|---|---|---|
| Net realised losses from debt securities | (17) | (7) |
| Recoveries of previously recognised impairments on debt securities | 2 | 2 |
| Impairment losses from debt securities | (1) | (29) |
| **Net losses from Treasury assets held at amortised cost** | (16) | (34) |

During the year the Bank sold €289 million of debt securities held at amortised cost (2011: €349 million).

## 8. Net gains from Treasury activities at fair value through profit or loss

| | 2012 € million | 2011 € million |
|---|---|---|
| Debt buy-backs and termination of related derivatives | 16 | 21 |
| Treasury portfolio | 85 | 36 |
| FX gains | 2 | 4 |
| **Net gains from Treasury activities at fair value through profit or loss** | 103 | 61 |

Net gains on the Treasury portfolio include both realised and unrealised gains or losses, together with associated interest income and expense.

## 9. Fair value movement on non-qualifying and ineffective hedges

The hedging practices and accounting treatment are disclosed under "Derivative financial instruments and hedge accounting" in the Accounting policies section of the report.

The fair value movement on non-qualifying and ineffective hedges represents an accounting adjustment in respect of hedging relationships undertaken by the Bank that either do not qualify for hedge accounting or do not fully offset when measured in accordance with IFRS. This unrealised adjustment does not reflect economic substance, inasmuch as the reported losses would not be realised in cash were the hedging relationships to be terminated. The adjustment will reverse over time as the underlying deals approach their maturities.

The Bank applies hedge accounting where there is an identifiable, one-to-one relationship between a hedging derivative instrument and a hedged cash instrument. These relationships predominantly arise within the context of the Bank's borrowing activities in which the Bank's issued bonds are combined with swaps to achieve floating-rate debt in the currency sought by the Bank. While such hedges are matched in cash flow terms, accounting rules may require different valuation methodologies to be applied to such cash flows. In particular, a pricing component of currency swaps (known as the basis swap spread) is not applied to the related hedged bond. This component is a feature of supply and demand requirements for other currencies relative to the US dollar or euro. Such differences can create hedge ineffectiveness or hedge failures under IFRS, the combined effect of which is reported within this line of the income statement. For the year this resulted in a gain of €83 million (2011: loss of €13 million), comprising gains of €468 million (2011: gain of €792 million) on the derivative hedging instruments and losses of €385 million (2011: €805 million) on the hedged items.

In addition to the one-to-one hedge relationships for which the Bank applies hedge accounting, the Bank also hedges interest rate risk across total assets and liabilities on a portfolio basis, for which hedge accounting is not applied. This activity results in the gains or losses arising on the hedging derivative instruments being recognised in the periods in which they occur, while the offsetting impact deriving from the hedged cash instruments will accrue over a different timescale in keeping with the interest rates applicable to the specific periods for those instruments. For the year this resulted in a loss of €14 million (2011: loss of €26 million).

The combined effect of all the hedging activities described above was a gain of €69 million for the year (2011: loss of €39 million).

### Cash flow hedges

The Bank hedges on an annual basis to minimise the exchange rate risk associated with incurring administrative expenses in sterling. In 2012 and 2011 there was no ineffectiveness recognised in the income statement arising from cash flow hedges.

## 10. Provisions for impairment of Banking loan investments at amortised cost

| Charge for the year | 2012 € million | 2011 € million |
|---|---|---|
| Portfolio provisions for the unidentified impairment of loan investments: | | |
| Non-sovereign loan investments | (32) | (25) |
| Sovereign loan investments | (5) | (1) |
| Specific provisions for the identified impairment of loan investments[40] | (83) | (20) |
| **Provisions for impairment of Banking loan investments at amortised cost** | (120) | (46) |

| Movement in provisions | 2012 € million | 2011 € million |
|---|---|---|
| At 1 January | (672) | (630) |
| Charge for the year to the income statement | (120) | (46) |
| Unwinding of the discount relating to the identified impairment of assets | 11 | 11 |
| Foreign exchange adjustments | 7 | (12) |
| Release against amounts written off | 38 | 5 |
| **At 31 December** | (736) | (672) |
| **Analysed between** | | |
| Portfolio provisions for the unidentified impairment of loan investments: | | |
| Non-sovereign loan investments | (439) | (409) |
| Sovereign loan investments | (17) | (13) |
| Specific provisions for the identified impairment of loan investments | (280) | (250) |
| **At 31 December** | (736) | (672) |

## 11. General administrative expenses

| | 2012 € million | 2011 € million |
|---|---|---|
| Personnel costs | (193) | (173) |
| Overhead expenses | (86) | (81) |
| General administrative expenses | (279) | (254) |
| Release of deferral of direct costs related to loan origination and commitment maintenance | 8 | 5 |
| **Net general administrative expenses** | (271) | (249) |

Sterling general administrative expenses totalled £240 million (2011: £213 million).[41]

Direct costs of €8 million (2011: €5 million) relating to loan origination in 2012, together with front-end and commitment fee receipts of €119 million (2011: €109 million), have been deferred on the balance sheet in accordance with IAS 18. These figures will be recognised in interest income over the period from disbursement to repayment of the related loans.

The following fees for work performed by the Bank's external auditor were included in overhead expenses:

| Audit and assurance services | 2012 € 000 | 2011 € 000 |
|---|---|---|
| Services as auditor of the Bank | (268) | (231) |
| Internal controls framework assurance | (137) | (121) |
| Cooperation fund services | - | (136) |
| Retirement plan audit | (24) | (21) |
| Tax recovery audit | (11) | (7) |
| **Audit and assurance services** | (440) | (516) |

[40] Comprises new specific provisions of €118 million against €35 million of released provisions (2011: €42 million against €22 million respectively).
[41] Excludes depreciation.

## 12. Placements with and advances to credit institutions

| Analysed between | 2012 € million | 2011 € million |
|---|---|---|
| Cash and cash equivalents | 5,892 | 4,450 |
| Other current placements and advances | 1,623 | 722 |
| At 31 December | 7,515 | 5,172 |

Cash and cash equivalents are those placements and advances which have a tenor equal to, or less than, three months from the trade date. "Current" is defined as those assets maturing, or liabilities due, within the next 12 months. All other assets or liabilities are "non-current".

## 13. Debt securities

| | 2012 € million | 2011 € million |
|---|---|---|
| **Treasury portfolio at fair value through profit or loss** | | |
| Internally managed portfolio | 175 | 411 |
| At 31 December | 175 | 411 |
| | | |
| **Debt securities at amortised cost** | | |
| Debt securities | 12,235 | 11,127 |
| At 31 December | 12,235 | 11,127 |
| | | |
| Debt securities at 31 December | 12,410 | 11,538 |
| | | |
| **Analysed between** | | |
| Current | 6,620 | 5,900 |
| Non-current | 5,790 | 5,638 |
| Debt securities at 31 December | 12,410 | 11,538 |

| | 2012 € million | 2011 € million |
|---|---|---|
| **Cumulative impairment losses** | | |
| Balance at 1 January | (34) | (110) |
| Charge for the year | (1) | (27) |
| Amounts recovered during the year | 2 | - |
| Amounts released | 25 | 102 |
| Foreign exchange movements | - | 1 |
| At 31 December | (8) | (34) |

## 14. Collateralised placements

| Analysed between | 2012 € million | 2011 € million |
|---|---|---|
| Current | - | 226 |
| Non-current | 600 | 625 |
| At 31 December | 600 | 851 |

## 15. Other financial assets

| | 2012 € million | 2011 € million |
|---|---|---|
| Fair value of derivatives designated as fair value hedges | 3,964 | 4,209 |
| Fair value of derivatives designated as cash flow hedges | 9 | 14 |
| Fair value of derivatives held for trading | 287 | 455 |
| Fair value of derivatives held in relation to the Banking portfolio | 411 | 433 |
| Interest receivable | 255 | 253 |
| Other | 99 | 264 |
| At 31 December | 5,025 | 5,628 |

| Analysed between | 2012 € million | 2011 € million |
|---|---|---|
| Current | 1,083 | 1,210 |
| Non-current | 3,942 | 4,418 |
| At 31 December | 5,025 | 5,628 |

Included within "Other" above are deferred fair values related to Banking derivative instruments that have a determinable return. Specifically, this relates to Banking derivatives that are valued using valuation techniques other than observable market data. On initial recognition, the difference between the transaction price and the value derived from the valuation technique is deferred. These amounts are recognised in profit when market data becomes observable, when the underlying equity is exited or when the derivative is exercised. At 31 December 2012, net gains of €57 million were deferred.

## 16. Banking loan investments at amortised cost

| Operating assets | 2012 Sovereign loans € million | 2012 Non-sovereign loans € million | 2012 Total loans € million | 2011 Sovereign loans € million | 2011 Non-sovereign loans € million | 2011 Total loans € million |
|---|---|---|---|---|---|---|
| At 1 January | 2,440 | 15,648 | 18,088 | 2,341 | 12,902 | 15,243 |
| Movement in fair value revaluation[42] | - | (1) | (1) | - | 23 | 23 |
| Disbursements | 625 | 6,825 | 7,450 | 435 | 6,773 | 7,208 |
| Repayments and prepayments | (357) | (5,752) | (6,109) | (362) | (4,140) | (4,502) |
| Foreign exchange movements | (16) | (22) | (38) | 31 | 131 | 162 |
| Movement in net deferral of front end fees and related direct costs | (2) | (17) | (19) | (5) | (35) | (40) |
| Written off | - | (38) | (38) | - | (6) | (6) |
| At 31 December | 2,690 | 16,643 | 19,333 | 2,440 | 15,648 | 18,088 |
| Impairment at 31 December | (17) | (719) | (736) | (13) | (659) | (672) |
| Total operating assets net of impairment at 31 December | 2,673 | 15,924 | 18,597 | 2,427 | 14,989 | 17,416 |
| Analysed between | | | | | | |
| Current | | | 3,042 | | | 3,145 |
| Non-current | | | 15,555 | | | 14,271 |
| Total operating assets net of impairment at 31 December | | | 18,597 | | | 17,416 |

At 31 December 2012 the Bank categorised 72 loans as impaired, with operating assets totalling €624 million (2011: 58 loans totalling €484 million).

[42] This movement in fair value relates to a hedge adjustment to fixed rate loans which qualify for hedge accounting for interest rate risk.

## 17. Banking loan investments at fair value through profit or loss

| Non-sovereign loans | 2012 € million | 2011 € million |
|---|---|---|
| At 1 January | 239 | 221 |
| Disbursements | 36 | 38 |
| Repayments and prepayments | (32) | (41) |
| Movement in fair value revaluation | 7 | 6 |
| Foreign exchange movements | (3) | 15 |
| **Fair value at 31 December** | 247 | 239 |
| | | |
| **Analysed between** | | |
| Current | 36 | 83 |
| Non-current | 211 | 156 |
| **At 31 December** | 247 | 239 |

## 18. Share investments at fair value through profit or loss

| | 2012 Fair value Unlisted € million | 2012 Fair value Listed € million | 2012 Fair value Total € million | 2011 Fair value Unlisted € million | 2011 Fair value Listed € million | 2011 Fair value Total € million |
|---|---|---|---|---|---|---|
| **Outstanding disbursements** | | | | | | |
| At 1 January | 4,444 | 1,627 | 6,071 | 3,908 | 1,529 | 5,437 |
| Disbursements | 908 | 227 | 1,135 | 945 | 143 | 1,088 |
| Disposals | (470) | (158) | (628) | (409) | (45) | (454) |
| Written off | (11) | - | (11) | – | – | – |
| **At 31 December** | 4,871 | 1,696 | 6,567 | 4,444 | 1,627 | 6,071 |
| | | | | | | |
| **Fair value adjustment** | | | | | | |
| At 1 January | 141 | (175) | (34) | 12 | 349 | 361 |
| Movement in fair value revaluation | 4 | 112 | 116 | 129 | (524) | (395) |
| **At 31 December** | 145 | (63) | 82 | 141 | (175) | (34) |
| | | | | | | |
| **Fair value at 31 December** | 5,016 | 1,633 | 6,649 | 4,585 | 1,452 | 6,037 |

Summarised financial information on share investments where the Bank owned greater than, or equal to, 20 per cent of the investee share capital at 31 December 2012, is detailed under note 30, “Related parties”.

## 19. Treasury share investments at fair value through other comprehensive income

Treasury holds a strategic share investment in The Currency Exchange Fund N.V. Through this investment the Bank can access the foreign currency hedging products offered by the fund and therefore it was deemed appropriate to designate this investment to be measured at fair value through other comprehensive income.

| | 2012 € million | 2011 € million |
|---|---|---|
| **Share investment designated at fair value through other comprehensive income** | | |
| The Currency Exchange Fund N.V. | 64 | 58 |

There was no dividend income received on this share investment during 2012 (2011: €nil).

## 20. Intangible assets

| | Computer software development costs 2012 € million | Computer software development costs 2011 € million |
|---|---|---|
| **Cost** | | |
| At 1 January | 163 | 149 |
| Additions | 16 | 14 |
| **At 31 December** | 179 | 163 |
| **Amortisation** | | |
| At 1 January | (119) | (102) |
| Charge | (19) | (17) |
| **At 31 December** | (138) | (119) |
| **Net book value at 31 December** | 41 | 44 |

## 21. Property, technology and office equipment

| | Property 2012 € million | Property under construction 2012 € million | Technology and office equipment 2012 € million | Total 2012 € million | Property 2011 € million | Property under construction 2011 € million | Technology and office equipment 2011 € million | Total 2011 € million |
|---|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | | |
| At 1 January | 43 | 5 | 25 | 73 | 43 | 3 | 27 | 73 |
| Additions | 6 | 2 | 2 | 10 | 1 | 2 | 1 | 4 |
| Transfers | - | - | - | - | – | – | – | – |
| Disposals | (1) | - | (2) | (3) | (1) | – | (3) | (4) |
| **At 31 December** | 48 | 7 | 25 | 80 | 43 | 5 | 25 | 73 |
| **Depreciation** | | | | | | | | |
| At 1 January | (17) | - | (18) | (35) | (15) | – | (20) | (35) |
| Charge | (4) | - | (2) | (6) | (3) | – | (1) | (4) |
| Disposals | 1 | - | 2 | 3 | 1 | – | 3 | 4 |
| **At 31 December** | (20) | - | (18) | (38) | (17) | – | (18) | (35) |
| **Net book value at 31 December** | 28 | 7 | 7 | 42 | 26 | 5 | 7 | 38 |

## 22. Borrowings

| | 2012 € million | 2011 € million |
|---|---|---|
| **Amounts owed to credit institutions** | | |
| Current | (3,086) | (2,610) |

## 23. Debts evidenced by certificates

The Bank's outstanding debts evidenced by certificates and related fair value hedging swaps are summarised below, both in the currency of the bond and the currency obtained after currency swap hedges have been taken into account.

| | Bond denominations € million | Currency after swap 2012 € million | Currency after swap 2011 € million |
|---|---|---|---|
| Australian dollars | (2,023) | - | - |
| Canadian dollars | (70) | - | - |
| Euro | (2,116) | (5,693) | (7,037) |
| Japanese yen | (2,562) | - | (8) |
| Mexican peso | (52) | - | - |
| New Turkish lira | (1,832) | - | - |
| New Zealand dollars | (100) | - | - |
| Norwegian krone | (131) | - | - |
| Romanian leu | (37) | (4) | (4) |
| Russian roubles | (1,108) | (685) | (767) |
| South African rands | (754) | - | - |
| Sterling | (5,055) | (3,200) | (2,246) |
| Swedish krona | (762) | - | - |
| Swiss franc | (46) | - | - |
| United States dollars | (15,176) | (22,242) | (19,133) |
| At 31 December | (31,824) | (31,824) | (29,195) |

Where the swap counterparty exercises a right to terminate the hedging swap prior to legal maturity, the Bank is committed to exercise the same right with its issued bond.

| Analysed between | 2012 € million | 2011 € million |
|---|---|---|
| Current | (8,591) | (6,267) |
| Non-current | (23,233) | (22,928) |
| Debts evidenced by certificates at 31 December | (31,824) | (29,195) |

During the year the Bank redeemed €0.39 billion of bonds and medium-term notes prior to maturity (2011: €1.06 billion), generating a net gain of €16 million (2011: €21 million).

## 24. Other financial liabilities

| | 2012 € million | 2011 € million |
|---|---|---|
| Fair value of derivatives designated as fair value hedges | (1,251) | (1,298) |
| Fair value of derivatives designated as cash flow hedges | (2) | – |
| Fair value of derivatives held for trading | (439) | (264) |
| Fair value of other derivatives held in relation to the Banking portfolio | (60) | (81) |
| Interest payable | (240) | (227) |
| Other | (290) | (188) |
| At 31 December | (2,282) | (2,058) |

| Analysed between | 2012 € million | 2011 € million |
|---|---|---|
| Current | (1,141) | (728) |
| Non-current | (1,141) | (1,330) |
| At 31 December | (2,282) | (2,058) |

## 25. Subscribed capital

| | 2012 Number of shares | 2012 Total € million | 2011 Number of shares | 2011 Total € million |
|---|---|---|---|---|
| Authorised shared capital | 3,000,000 | 30,000 | 3,000,000 | 30,000 |
| of which | | | | |
| Subscriptions by members – initial capital | 993,055 | 9,931 | 992,615 | 9,926 |
| Subscriptions by members – first capital increase | 988,055 | 9,881 | 987,515 | 9,875 |
| Subscriptions by members – second capital increase | 979,033 | 9,789 | 857,828 | 8,579 |
| Subscribed capital | 2,960,143 | 29,601 | 2,837,958 | 28,380 |
| Unsubscribed capital | 39,857 | 399 | 162,042 | 1,620 |
| **At 31 December** | 3,000,000 | 30,000 | 3,000,000 | 30,000 |

The Bank's capital stock is divided into paid-in shares and callable shares. Each share has a par value of €10,000. At the Bank's Annual Meeting in May 2010, the Board of Governors approved a two-step increase in the authorised capital stock of the Bank: a €1.0 billion increase in authorised paid-in shares and a €9.0 billion increase in authorised callable capital shares, amounting to a €10.0 billion aggregate increase in the authorised capital stock of the Bank (collectively referred to as the second capital increase). Resolution No. 126 authorised the increase in authorised capital stock by 100,000 paid-in shares, each share having a par value of €10,000, taking the authorised capital stock of the Bank to €21.0 billion. Resolution No. 128 authorised the increase in the authorised capital stock of the Bank by 900,000 callable shares, each share having a par value of €10,000, with the shares subject to redemption in accordance with the terms of Resolution No. 128. The increase in callable capital became effective in April 2011.

Payment for the paid-in shares issued as part of the original authorised capital stock, and as part of the first capital increase and subscribed to by members, is made over a period of years determined in advance. Payment for the paid-in shares issued under the second capital increase was by way of a reallocation of net income previously allocated to surplus for other purposes, namely for the payment of such paid-in shares, pursuant to Article 36.1 of the Agreement and approved by Board of Governors Resolution No. 126, dated 14 May 2010. Article 6.4 of the Agreement states that payment of the amount subscribed to the callable capital is subject to call by the Bank, taking account of Articles 17 and 42 of the Agreement, only as and when required by the Bank to meet its liabilities. Article 42.1 states that in the event of the termination of the Bank's operations, the liability of all members for all uncalled subscriptions to the capital stock will continue until all claims of creditors, including all contingent claims, have been discharged.

The Agreement allows for a member to withdraw from the Bank, in which case the Bank is required to repurchase the former member's shares. No member has ever withdrawn its membership. The stability in the membership reflects the fact that the members are 64 countries[43] and two inter-governmental organisations, and that the purpose of the Bank is to foster the transition process in politically qualifying countries from central Europe to central Asia.

Moreover, there is a financial disincentive to withdrawing membership. The upper limit of the amount of the repurchase price of the former member's shares is the amount of its paid-in capital, yet a former member remains liable for its direct obligations and its contingent liabilities to the Bank for as long as any part of the loans, share investments or guarantees contracted before it ceased to be a member are outstanding. Were a member to withdraw from the Bank, the Bank would be able to impose conditions and set dates in respect of payments for shares repurchased. If, for example, paying a former member would have adverse consequences for the Bank's financial position, the Bank could defer payment until the risk had passed, and indefinitely if appropriate. If a payment was then made to a former member, the member would be required to repay, on demand, the amount by which the repurchase price would have been reduced if the losses for which the former member remained liable had been taken into account at the time of payment.

Under the Agreement, payment for the paid-in shares of the initial capital stock subscribed to by members was made in five equal annual instalments. Of each instalment, up to 50 per cent was payable in non-negotiable, non-interest-bearing promissory notes or other obligations issued by the subscribing member and payable to the Bank at par value upon demand. Under Resolution No. 59, payment for the paid-in shares subscribed to by members under the first capital increase was made in eight equal annual instalments. Under Resolution No. 126, payment for the paid-in shares issued to members under the second capital increase was made in one instalment immediately following approval of Resolution No. 126.

A statement of capital subscriptions showing the amount of paid-in and callable shares subscribed to by each member, together with the amount of unallocated shares and votes, is set out in the following table. Under Article 29 of the Agreement, the voting rights of members that have failed to pay any part of the amounts due in respect of their capital subscription are proportionately reduced until payment is made.

[43] Kosovo became a member in 2012.

## Statement of capital subscriptions

| At 31 December 2012<br>Members | Total shares (number) | Resulting votes[44] (number) | Total capital €million | Callable capital €million | Paid-in capital €million |
|---|---|---|---|---|---|
| Albania | 3,001 | 2,511 | 30 | 24 | 6 |
| Armenia | 1,499 | 1,499 | 15 | 12 | 3 |
| Australia | 30,014 | 30,014 | 300 | 237 | 63 |
| Austria | 68,432 | 68,432 | 684 | 541 | 143 |
| Azerbaijan | 3,001 | 3,001 | 30 | 24 | 6 |
| Belarus | 6,002 | 6,002 | 60 | 47 | 13 |
| Belgium | 68,432 | 68,432 | 684 | 541 | 143 |
| Bosnia and Herzegovina | 5,071 | 5,071 | 51 | 40 | 11 |
| Bulgaria | 16,598 | 16,598 | 166 | 117 | 49 |
| Canada | 102,049 | 102,049 | 1,020 | 807 | 213 |
| Croatia | 10,942 | 10,942 | 109 | 86 | 23 |
| Cyprus | 3,001 | 3,001 | 30 | 24 | 6 |
| Czech Republic | 25,611 | 25,611 | 256 | 203 | 53 |
| Denmark | 36,017 | 36,017 | 360 | 285 | 75 |
| Egypt | 2,101 | 2,101 | 21 | 15 | 6 |
| Estonia | 3,001 | 3,001 | 30 | 24 | 6 |
| European Investment Bank | 90,044 | 90,044 | 900 | 712 | 188 |
| European Union | 90,044 | 90,044 | 900 | 712 | 188 |
| Finland | 37,518 | 37,518 | 375 | 297 | 78 |
| Former Yugoslav Republic of Macedonia | 1,762 | 1,762 | 18 | 14 | 4 |
| France | 255,651 | 255,651 | 2,557 | 2,024 | 533 |
| Georgia | 3,001 | 1,917 | 30 | 24 | 6 |
| Germany | 255,651 | 255,651 | 2,557 | 2,024 | 533 |
| Greece | 19,508 | 19,508 | 195 | 154 | 41 |
| Hungary | 23,711 | 23,711 | 237 | 188 | 49 |
| Iceland | 3,001 | 3,001 | 30 | 24 | 6 |
| Ireland | 9,004 | 9,004 | 90 | 71 | 19 |
| Israel | 19,508 | 19,508 | 195 | 154 | 41 |
| Italy | 255,651 | 255,651 | 2,557 | 2,024 | 533 |
| Japan | 255,651 | 255,651 | 2,557 | 2,024 | 533 |
| Jordan | 986 | 986 | 10 | 8 | 2 |
| Kazakhstan | 6,902 | 6,902 | 69 | 55 | 15 |
| Korea, Republic of | 30,014 | 30,014 | 300 | 237 | 63 |
| Kosovo | 580 | 580 | 6 | 5 | 1 |
| Kyrgyz Republic | 2,101 | 1,010 | 21 | 15 | 6 |
| Latvia | 3,001 | 3,001 | 30 | 24 | 6 |
| Liechtenstein | 599 | 599 | 6 | 5 | 1 |
| Lithuania | 3,001 | 3,001 | 30 | 24 | 6 |
| Luxembourg | 6,002 | 6,002 | 60 | 47 | 13 |
| Malta | 210 | 210 | 2 | 1 | 1 |
| Mexico | 4,501 | 4,501 | 46 | 35 | 11 |
| Moldova | 3,001 | 2,435 | 30 | 24 | 6 |
| Mongolia | 299 | 299 | 3 | 2 | 1 |
| Montenegro | 420 | 420 | 4 | 3 | 1 |

[44] Voting rights are restricted for non-payment of amounts due in respect of the member's obligations in relation to paid-in shares. Total votes before restrictions amount to 2,960,143 (2011: 2,837,958).

## Statement of capital subscriptions

| At 31 December 2012 | Total shares (number) | Resulting votes (number) | Total capital €million | Callable capital €million | Paid-in capital €million |
|---|---|---|---|---|---|
| Morocco | 1,478 | 1,478 | 15 | 11 | 4 |
| Netherlands | 74,435 | 74,435 | 744 | 589 | 155 |
| New Zealand | 1,050 | 1,050 | 11 | 7 | 4 |
| Norway | 37,518 | 37,518 | 375 | 297 | 78 |
| Poland | 38,418 | 38,418 | 384 | 304 | 80 |
| Portugal | 12,605 | 12,605 | 126 | 100 | 26 |
| Romania | 14,407 | 14,407 | 144 | 114 | 30 |
| Russian Federation | 120,058 | 120,058 | 1,201 | 951 | 250 |
| Serbia | 14,031 | 14,031 | 140 | 111 | 29 |
| Slovak Republic | 12,807 | 12,807 | 128 | 101 | 27 |
| Slovenia | 6,295 | 6,295 | 63 | 50 | 13 |
| Spain | 102,049 | 102,049 | 1,020 | 807 | 213 |
| Sweden | 68,432 | 68,432 | 684 | 541 | 143 |
| Switzerland | 68,432 | 68,432 | 684 | 541 | 143 |
| Tajikistan | 2,101 | 602 | 21 | 15 | 6 |
| Tunisia | 986 | 986 | 10 | 8 | 2 |
| Turkey | 34,515 | 34,515 | 345 | 273 | 72 |
| Turkmenistan | 210 | 164 | 2 | 1 | 1 |
| Ukraine | 24,011 | 24,011 | 240 | 190 | 50 |
| United Kingdom | 255,651 | 255,651 | 2,557 | 2,024 | 533 |
| United States of America | 300,148 | 300,148 | 3,002 | 2,375 | 626 |
| Uzbekistan | 4,412 | 4,134 | 44 | 31 | 13 |
| **Capital subscribed by members** | 2,960,143 | 2,955,089 | 29,601 | 23,399 | 6,202 |

## 26. Reserves and retained earnings

| | 2012 € million | 2011 € million |
|---|---|---|
| **Special reserve** | | |
| At 1 January | 306 | 306 |
| **At 31 December** | 306 | 306 |
| **Loan loss reserve** | | |
| At 1 January | 676 | 753 |
| Transferred from/(to) retained earnings | 13 | (77) |
| **At 31 December** | 689 | 676 |
| **Net income allocation** | | |
| At 1 January | 210 | – |
| Transferred from retained earnings to restricted reserves | 1,000 | 210 |
| Transferred from reserves on signing of grant agreement | (190) | – |
| SEMED TC expenses | (3) | – |
| SEMED ISF retained earnings | (4) | – |
| **At 31 December** | 1,013 | 210 |
| **General reserve – other reserve** | | |
| **Revaluation reserve** | | |
| At 1 January | 10 | 8 |
| Net gains arising on revaluation of share investments at fair value through other comprehensive income | 6 | 2 |
| **At 31 December** | 16 | 10 |
| **Hedging reserve – cash flow hedges** | | |
| At 1 January | 15 | - |
| Gains from changes in fair value recognised in equity | 9 | 15 |
| Gains removed from equity and included in general administrative expenses | (17) | – |
| **At 31 December** | 7 | 15 |
| **Other** | | |
| At 1 January | 193 | 189 |
| Internal tax for the year | 6 | 4 |
| **At 31 December** | 199 | 193 |
| **General reserve – other reserve at 31 December** | 222 | 218 |
| **General reserve – retained earnings** | | |
| At 1 January | 5,564 | 5,524 |
| Transferred (to)/from loan loss reserve | (13) | 77 |
| Transferred to net income allocation | (803) | (210) |
| Net profit after transfers of net income approved by the Board of Governors | 830 | 173 |
| **General reserve retained earnings at 31 December** | 5,578 | 5,564 |
| **Total reserves and retained earnings at 31 December** | 7,808 | 6,974 |

The **special reserve** is maintained, in accordance with Article 16 of the Agreement, for meeting certain defined losses of the Bank. The special reserve has been established, in accordance with the Bank's financial policies, by setting aside 100 per cent of qualifying fees and commissions received by the Bank associated with loans, guarantees and underwriting the sale of securities. In 2011, the Board of Directors decided that the size of the special reserve was adequate.

In 2005, the Bank created a **loan loss reserve** within members' equity, to set aside an amount of retained earnings equal to the difference between the impairment losses expected over the life of the loan portfolio and the amount recognised through the Bank's income statement on an incurred loss basis.

The **general reserve** represents all reserves except those amounts allocated to the special and loan loss reserves and it primarily comprises retained earnings. It also includes the retention of internal tax paid in accordance with Article 53 of the Agreement. This requires that all Directors, Alternate Directors, officers and employees of the Bank are subject to an internal tax imposed by the Bank on salaries and emoluments paid by the Bank and which is retained for its benefit. At the end of the year internal tax amounted to €89 million (2011: €84 million).

The **hedging reserve** includes forward exchange contracts entered into by the Bank to hedge part of its estimated future sterling operating expenditure. At 31 December 2012 there was €7 million unrealised mark-to-market gains on these contracts (2011: €15 million). These gains remain in reserves until such time as the related hedged expenditure is incurred.

| Reserves and retained earnings | 2012 € million | 2011 € million |
|---|---|---|
| Special reserve | 306 | 306 |
| Loan loss reserve | 689 | 676 |
| Net income allocation | 1,013 | 210 |
| Unrealised gains | 1,832 | 1,672 |
| **Total restricted reserves** | 3,840 | 2,864 |
| Unrestricted general reserves | 3,968 | 4,110 |
| **At 31 December** | 7,808 | 6,974 |

The Bank's reserves are used to determine, in accordance with the Agreement, what part of the Bank's net income will be allocated to surplus or other purposes and what part, if any, will be distributed to its members. For this purpose, the Bank uses unrestricted general reserves.

Article 36 of the Agreement relates to the allocation and distribution of the Bank's net income and states: "No such allocation, and no distribution, shall be made until the general reserve amounts to at least ten per cent of the authorised capital stock". This figure is currently €3.0 billion (2011: €3.0 billion).

During 2011 the Board of Governors approved €190 million of net income to be allocated to the Chernobyl Projects. This amount was set aside in the Bank's restricted reserves. In 2012, this amount was reflected in the income statement, below net profit, when the grant agreement was signed.

At the 2012 Annual Meeting of the EBRD Board of Governors, the Board of Governors approved a net income allocation of €1.0 billion to the SEMED ISF pursuant to Article 36.1 of the Agreement. This amount was to enable the EBRD to conduct special operations in the SEMED region. The SEMED ISF is a EBRD Special Fund established under Article 18 of the Agreement.

The net income allocation from the Bank's ordinary capital resources to the SEMED ISF continues to be recognised, under IFRS, in the Bank's balance sheet as the Bank retains the risks and rewards associated with these funds. For the purposes of the Bank's reserves, the €1.0 billion has been ring-fenced within restricted reserves, as will any future income or expense accruing to the SEMED ISF from the use of those funds. These restricted amounts will only be transferred back to the Bank's ordinary capital resources on the entry into force of the amendment to Article 1 of the Agreement or, if the amendment to Article 1 does not become effective, through the orderly realisation of the SEMED ISF's net assets. At 31 December 2012, €241 million had been drawn-down to the SEMED ISF for signed projects and operational costs.

## 27. Undrawn commitments and guarantees

| Analysis by instrument | 2012 € million | 2011 € million |
|---|---|---|
| **Undrawn commitments** | | |
| Loans | 8,726 | 7,678 |
| Share investments | 1,642 | 1,803 |
| **At 31 December** | 10,368 | 9,481 |
| | | |
| **Guarantees** | | |
| Trade finance guarantees[45] | 473 | 465 |
| Other guarantees[46] | 154 | 88 |
| **At 31 December** | 627 | 553 |
| | | |
| **Undrawn commitments and guarantees at 31 December** | 10,995 | 10,034 |

## 28. Operating lease commitments

The Bank leases its headquarters building in London and some of its Resident Office buildings in countries of operations. These are standard operating leases and include renewal options, periodic escalation clauses and are mostly non-cancellable in the normal course of business without the Bank incurring substantial penalties. The most significant lease is that for the Bank's headquarters building. Rent payable under the terms of this lease is reviewed every five years and is based on market rates. The last review was conducted in December 2011.

Minimum future lease payments under long-term non-cancellable operating leases and payments made under such leases during the year are shown below.

| Payable | 2012 € million | 2011 € million |
|---|---|---|
| Not later than one year | 29 | 28 |
| Later than one year and not later than five years | 102 | 101 |
| Later than five years | 111 | 131 |
| **At 31 December** | 242 | 260 |
| Expenditure incurred in the current year | 26 | 23 |

The Bank has entered into sub-lease arrangements for two floors of its headquarters building. The total minimum future lease payments expected to be received under these sub-leases and income received during the year is shown below:

| Receivable | 2012 € million | 2011 € million |
|---|---|---|
| Not later than one year | 5 | 6 |
| Later than one year and not later than five years | 6 | 10 |
| Later than five years | - | - |
| **At 31 December** | 11 | 16 |
| Income received in the current year | 5 | 5 |

[45] Trade finance guarantees represent stand-by letters of credit issued in favour of confirming banks that have undertaken the payment risk of issuing banks in the Bank's countries of operations.
[46] Other guarantees include unfunded full or partial risk participations.

## 29. Staff retirement schemes

### Defined benefit scheme

A qualified actuary performs a full actuarial valuation of the defined benefit scheme at least every three years using the projected unit method. For the purposes of IAS 19: Employee Benefits, this is rolled forward annually to 31 December. The most recent valuation date was 30 June 2011. The present value of the defined benefit obligation and current service cost was calculated using the projected unit credit method.

Amounts recognised in the balance sheet are as follows:

| | 2012 € million | 2011 € million |
|---|---|---|
| Fair value of plan assets | 257 | 220 |
| Present value of the defined benefit obligation | (247) | (206) |
| | 10 | 14 |
| Unrecognised actuarial losses[47] | 60 | 56 |
| **Prepayment at 31 December** | 70 | 70 |
| | | |
| Movement in the prepayment (included in "Other assets"): | | |
| At 1 January | 70 | 65 |
| Exchange differences | 2 | 2 |
| Contributions paid[48] | 21 | 17 |
| Total expense as below | (23) | (14) |
| **At 31 December** | 70 | 70 |
| | | |
| The amounts recognised in the income statement are as follows: | | |
| Current service cost | (22) | (17) |
| Interest cost | (10) | (9) |
| Expected return on assets[49] | 11 | 13 |
| Amortisation of actuarial loss | (2) | (1) |
| **Total included in staff costs** | (23) | (14) |

Principal actuarial assumptions used:

| | 2012 | 2011 |
|---|---|---|
| Discount rate | 3.70% | 4.50% |
| Expected return on plan assets | 5.10% | 5.00% |
| Future salary increases | 3.5% | 4.25% |
| Average remaining working life of employees | 15 years | 15 years |

Actuarial gains and losses in excess of a corridor (10 per cent of the greater of assets or liabilities) are amortised over the remaining working life of employees.

| Actual asset allocation | 2012 € million | Expected return per annum | 2011 € million | Expected return per annum |
|---|---|---|---|---|
| Equities | 143 | 7.10% | 118 | 7.10% |
| Index-linked bonds | 90 | 2.60% | 82 | 2.50% |
| Commodities | 13 | 3.10% | 10 | 3.10% |
| Derivatives | 11 | 3.10% | 10 | 3.10% |
| Cash | - | 0.5% | – | 0.50% |
| **Total** | 257 | | 220 | |

[47] These unrecognised actuarial losses represent the cumulative effect of the historical differences between the actuarial assumptions used in the production of these disclosures and the actual experience of the plan. The primary historical causes of the losses are an overall lower-than-expected investment return on plan assets, and a historical decline in the discount rate used to value the plan's liabilities.

[48] Contributions for 2013 are expected to be €22 million.

[49] The actual return on assets during the year was €17 million (2011: €8 million).

The approach used to determine the expected return on assets assumption is to set an assumption for the return on each of the main asset classes and then to weight these returns linearly according to the Plan's asset allocation. In this calculation, the return for bonds is assumed to be the same as their initial yields. At 31 December 2012, this is 3.1 per cent per annum for gilts and 2.6 per cent per annum for index-linked gilts. The expected return on equities is assumed to be 4.0 per cent above the return on gilts. It has been assumed that commodities and hedge funds have the same long-term expected return as gilts.

| Changes in the present value of the defined benefit obligation | 2012 € million | 2011 € million |
|---|---|---|
| Present value of defined benefit obligation at 1 January | (206) | (162) |
| Service cost | (22) | (18) |
| Interest cost | (10) | (9) |
| Effect of exchange rate movement | (5) | (4) |
| Actuarial loss arising due to changes in assumptions | (10) | (23) |
| Benefits paid | 6 | 10 |
| Present value of defined benefit obligation at 31 December | (247) | (206) |

| Changes in the fair value of plan assets are as follows: | 2012 € million | 2011 € million |
|---|---|---|
| Opening fair value of plan assets | 220 | 199 |
| Expected return | 11 | 13 |
| Asset gain/(loss) arising during the year | 5 | (4) |
| Effect of exchange rate movement | 6 | 4 |
| Contributions paid | 21 | 18 |
| Benefits paid | (6) | (10) |
| Present value of plan assets at 31 December | 257 | 220 |

| History of experience gains and losses | 2012 € million | 2011 € million | 2010 € million | 2009 € million | 2008 € million |
|---|---|---|---|---|---|
| Defined benefit obligation | (247) | (206) | (162) | (137) | (108) |
| Plan assets | 257 | 220 | 199 | 166 | 100 |
| Surplus/(deficit) | 10 | 14 | 37 | 29 | (8) |
| Experience (losses)/gains on plan liabilities: | | | | | |
| Amount | (5) | (16) | 2 | 1 | 4 |
| Percentage of the present value of the plan liabilities | (2.2%) | (7.6%) | 1.2% | 1.1% | 3.9% |
| Actual return less expected return on plan assets: | | | | | |
| Amount | 5 | (4) | 9 | 18 | (29) |
| Percentage of the present value of the plan assets | 2.1% | (1.9%) | 4.5% | 11.0% | (29.5%) |

## Defined contribution scheme

The charge recognised under the defined contribution scheme was €12 million (2011: €10 million) and is included in "General administrative expenses".

## Other long-term employee benefits

The Bank maintains a medical retirement benefit plan to provide staff retiring from the Bank, aged 50 or over and with at least seven years service, with a lump sum benefit to help purchase medical insurance cover. The total charge for the year calculated under IAS 19 was €2 million (2011: €1 million).

## 30. Related parties

The Bank has the following related parties:

### Key management personnel

Key management personnel comprise: the President and Vice Presidents; members of the Bank's Executive Committee; Director of the President's Office; Managing Directors; the Treasurer; the Controller; the Director of Human Resources; the Director, Communications; the Head of Internal Audit; and the Chief Compliance Officer.

In sterling terms, salaries and other benefits paid to key management personnel in 2012 amounted to £10 million (2011: £9 million). This comprises salary and employee benefits of £8 million (2011: £7 million) and post-employment benefits of £2 million (2011: £2 million).

One consultancy contract had been awarded in 2012 to a close family member of one of the Bank's key management personnel for a value of £30,000. This contract was concluded and settled in during the year. No new contracts were awarded nor were any balances outstanding at 31 December 2012.

### Venture capital associates

The Bank has invested in a number of venture capital associates that it accounts for at fair value through profit or loss. At 31 December 2012, according to the most recently audited financial statements (and where these are not available, the most recent unaudited management information) from the investee companies, these venture capital associates had total assets of approximately €36.0 billion (2011: €74.3 billion) and total liabilities of approximately €26.2 billion (2011: €49.3 billion). For the year ended 31 December 2012, these associates had income of €7.8 billion (2011: €23.1 billion) and made a net profit before tax of approximately €541 million (2011: €1.9 billion).

In addition, the Bank has provided €115 million (2011: €115 million) of financing to these companies on which it received €2 million (2011: €3 million) of interest income during the year.

### Special Funds

Special Funds are established in accordance with Article 18 of the Agreement Establishing the Bank and are administered under the terms of the rules and regulations for each such Special Fund. At 31 December 2012 the Bank administered 17 Special Funds (2011: 17 Funds) with aggregate pledged contributions amounting to €2.0 billion (2011: €1.0 billion).

The Bank acts as manager and administrator of the Special Funds for which it receives management and cost recovery fees. In 2012 these fees amounted to €0.3 million (2011: €0.3 million).

The Bank pays for guarantees from certain Special Funds in respect of specific exposures arising in its trade finance portfolios for which it paid €0.2 million in 2012 (2011: €0.3 million). At 31 December 2012, the Bank recognised a receivable of €4 million (2011: €4 million) to reflect a potential recovery in relation to an impaired trade finance investment.

Audit fees payable to the Bank's auditor for the 2012 audits of the Special Funds totalled €110,000 (2011: €84,000).

The financial statements of each Special Fund are approved separately by the Board of Governors at the Bank's Annual Meeting.

## 31. Other fund agreements

In addition to the Bank's ordinary operations and the Special Funds programme, the Bank administers numerous bilateral and multilateral contribution agreements to provide technical assistance and investment support grants in its countries of operations and to member countries in the SEMED region. These grants focus primarily on project preparation, project implementation (including goods and works), advisory services and training. The resources provided through these contribution agreements are held separately from the ordinary capital resources of the Bank and are subject to external audit.

The table below provides a summary of these Funds.

| | 2012 Amount per agreements € million | 2012 Contributions received € million | 2012 Cumulative No. of Funds | 2011 Amount per agreements € million | 2011 Contributions received € million | 2011 Cumulative No. of Funds |
|---|---|---|---|---|---|---|
| Technical Cooperation Funds | 2,121 | 1,910 | 240 | 1,989 | 1,769 | 229 |
| Investment Cooperation Funds | 257 | 234 | 30 | 258 | 211 | 30 |
| Carbon Fund | 231 | 147 | 3 | 231 | 153 | 3 |
| Project Specific Assignments | 61 | 57 | 92 | 61 | 57 | 92 |
| EU Pre-accession Preparation Funds | 35 | 35 | 2 | 35 | 35 | 2 |
| Total | 2,705 | 2,383 | 367 | 2,574 | 2,225 | 356 |

Following a proposal by the G-7 countries for a multilateral programme of action to improve safety in nuclear power plants in the countries of operations, the Nuclear Safety Account (NSA) was established by the Bank in March 1993. The NSA funds are in the form of grants and are used for funding safety improvement measures.

At their Denver Summit in June 1997, the G-7 countries and the European Union endorsed the setting up of the Chernobyl Shelter Fund (CSF). The CSF was established on 7 November 1997, when the rules of the CSF were approved by the Board of Directors. It became operational on 8 December 1997, when the required eight contributors had entered into contribution agreements with the Bank. The objective of the CSF is to assist Ukraine in transforming the existing Chernobyl sarcophagus into a safe and environmentally stable system.

In 1999, in pursuit of their policy to accede to the European Union, Lithuania, Bulgaria and the Slovak Republic gave firm commitments to close and decommission their nuclear power plant units with RBMK and VVER 440/230 reactors by certain dates. In response to this, the European Commission announced its intention to support the decommissioning of these reactors with substantial grants over a period of 8 to 10 years, and invited the Bank to administer three International Decommissioning Support Funds (IDSFs). On 12 June 2000, the Bank's Board of Directors approved the rules of the Ignalina, Kozloduy and Bohunice IDSFs and the role of the Bank as their administrator. The funds will finance selective projects to help carry out the first phase of decommissioning the designated reactors. They will also finance measures to facilitate the necessary restructuring, upgrading and modernisation of the energy production, transmission and distribution sectors and improvements in energy efficiency that are a consequence of the closure decisions.

In 2001, the Nordic Investment Bank hosted a meeting with participants from Belgium, Finland, Sweden, the European Commission and international financial institutions with activities in the Northern Dimension Area (NDA). At this meeting, participants agreed to establish the Northern Dimension Environmental Partnership (NDEP) to strengthen and coordinate financing of important environmental projects with cross-border effects in the NDA. On 11 December 2001, the Bank's Board of Directors approved the rules of the NDEP Support Fund and the role of the Bank as fund manager.

The table below provides a summary of these funds.

| | 2012 Contributions pledged € million | 2012 No. of contributors | 2011 Contributions pledged € million | 2011 No. of contributors |
|---|---|---|---|---|
| Nuclear Safety Account | 352 | 17 | 334 | 17 |
| Chernobyl Shelter Fund | 1,125 | 26 | 1,000 | 25 |
| Ignalina IDSF | 752 | 16 | 697 | 16 |
| Kozloduy IDSF | 808 | 11 | 733 | 11 |
| Bohunice IDSF | 559 | 9 | 497 | 9 |
| NDEP | 346 | 12 | 339 | 12 |

For all of the above Funds with the exception of NDEP, pledges are calculated using the fixed exchange rate defined in the rules of the relevant Fund.

Audit fees payable to the Bank's auditor for the 2012 audits of the Technical Cooperation and Nuclear Safety Funds totaled €0.4 million (2011: €0.4 million).

## 32. Results from ordinary operations

During the year, an amendment to Article 18 of the Agreement which enables the Bank to carry out special operations in member countries of the SEMED region entered into force. To enable this work, the SEMED ISF was established by the EBRD Board of Directors. Following this, the Board of Governors approved a net income allocation of €1.0 billion for the SEMED ISF pursuant to Article 36.1 of the Agreement.

For financial reporting purposes under IFRS, the Bank retains control of any funds transferred to the SEMED ISF and accordingly such amounts are recognised in its financial statements. As such, the Bank's results include those from ordinary operations and SEMED operations. However, excluding SEMED operations, the results from ordinary operations are disclosed below:

### Income statement from ordinary operations

| For the year ended 31 December 2012 | Year to 31 December 2012 € million | Year to 31 December 2011 € million |
|---|---|---|
| Interest and similar income | | |
| From Banking loans | 1,040 | 859 |
| From fixed-income debt securities and other interest | 166 | 187 |
| Interest expense and similar charges | (155) | (145) |
| Net interest expense on derivatives | (176) | (118) |
| **Net interest income** | 875 | 783 |
| Net fee and commission income | 32 | 20 |
| Dividend income | 87 | 115 |
| Net gains/(losses) from share investments at fair value through profit or loss | 274 | (424) |
| Net gains from loans at fair value through profit or loss | 11 | 5 |
| Net gains from loans at amortised cost | 1 | 2 |
| Net losses from Treasury assets held at amortised cost | (16) | (34) |
| Net gains from Treasury activities at fair value through profit or loss and foreign exchange | 103 | 57 |
| Fair value movement on non-qualifying and ineffective hedges | 69 | (35) |
| Impairment provisions on Banking loan investments | (118) | (46) |
| General administrative expenses | (269) | (249) |
| Depreciation and amortisation | (25) | (21) |
| **Net profit for the year from continuing operations** | 1,024 | 173 |
| Transfers of net income approved by the Board of Governors | (190) | - |
| **Net profit after transfers of net income approved by the Board of Governors** | 834 | 173 |
| Attributable to: | | |
| **Equity holders** | 834 | 173 |

**Balance sheet related to ordinary operations**

| At 31 December 2012 | € million | 31 December 2012 € million | € million | 31 December 2011 € million |
|---|---|---|---|---|
| **Assets** | | | | |
| Placements with and advances to credit institutions | 7,279 | | 5,172 | |
| Debt securities | | | | |
| At fair value through profit or loss | 175 | | 411 | |
| At amortised cost | 12,243 | | 11,161 | |
| Less: Provisions for impairment | (8) | | (34) | |
| | 12,410 | | 11,538 | |
| Collateralised placements | 600 | | 851 | |
| | | 20,289 | | 17,561 |
| Other financial assets | | | | |
| Derivative financial instruments | 4,671 | | 5,111 | |
| Other financial assets | 355 | | 517 | |
| | | 5,026 | | 5,628 |
| Loan investments | | | | |
| *Banking portfolio:* | | | | |
| Loans at amortised cost | 19,333 | | 18,088 | |
| Less: Provisions for impairment | (734) | | (672) | |
| Loans at fair value through profit or loss | 247 | | 239 | |
| | | 18,846 | | 17,655 |
| Share investments | | | | |
| *Banking portfolio:* | | | | |
| At fair value through profit or loss | 6,645 | | 6,037 | |
| *Treasury portfolio:* | | | | |
| Share investments at fair value through other comprehensive income | 64 | | 58 | |
| | | 6,709 | | 6,095 |
| Intangible assets | | 41 | | 44 |
| Property, technology and office equipment | | 42 | | 38 |
| Paid-in capital receivable | | 12 | | 15 |
| **Total assets** | | **50,965** | | **47,036** |
| **Liabilities** | | | | |
| Borrowings | | | | |
| Amounts owed to credit institutions | 3,086 | | 2,610 | |
| Debts evidenced by certificates | 31,824 | | 29,195 | |
| | | 34,910 | | 31,805 |
| Other financial liabilities | | | | |
| Derivative financial instruments | 1,752 | | 1,643 | |
| Other financial liabilities | 530 | | 415 | |
| | | 2,282 | | 2,058 |
| **Total liabilities** | | **37,192** | | **33,863** |
| Members' equity attributable to equity holders | | | | |
| Paid-in capital | | 6,202 | | 6,199 |
| Reserves and retained earnings | | 7,571 | | 6,974 |
| Total members' equity | | 13,773 | | 13,173 |
| **Total liabilities and members' equity** | | **50,965** | | **47,036** |
| Memorandum items | | | | |
| Undrawn commitments | | 10,866 | | 10,034 |

## 33. Post-balance sheet events

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

# Responsibility for external financial reporting

## Management's responsibility

### Management's report regarding the effectiveness of internal controls over external financial reporting

The management of the European Bank for Reconstruction and Development (the Bank) is responsible for the preparation, integrity, and fair presentation of its published financial statements and associated disclosures presented in this Financial Report. The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board.

The financial statements have been audited by an independent accounting firm, which has been 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 external auditor during its audit were valid and appropriate. The external auditor's 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 IFRS. 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 and testing by management and internal audit, and are revised as considered necessary – support the integrity and reliability of the financial statements.

There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and the circumvention of overriding controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statements. Furthermore, the effectiveness of an internal control system can change with circumstances.

The Bank's Board of Directors has appointed an Audit Committee, which assists the Board in its responsibility to ensure the soundness of the Bank's accounting practices and the effective implementation of the internal controls that management has established relating to finance and accounting matters. The Audit Committee is comprised entirely of members of the Board of Directors. The Audit Committee meets periodically with management in order to review and monitor the financial, accounting and auditing procedures of the Bank and related financial reports. The external auditor and the internal auditor regularly meet with the Audit Committee, with and without other members of management being present, to discuss the adequacy of internal controls over financial reporting and any other matters that they believe should be brought to the attention of the Audit Committee.

The Bank has assessed its internal controls over external financial reporting for 2012. Management's assessment includes the Special Funds and other fund agreements referred to in notes 30 and 31 of the *Financial Report 2012*, and the retirement plans. However, the nature of the assessment is restricted to the controls over the reporting and disclosure of these funds/plans within the Bank's financial statements, rather than the operational, accounting and administration controls in place for each fund.

The Bank's assessment was based on the criteria for effective internal controls over financial reporting described in the "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organisations of the Treadway Commission. Based upon this assessment, management asserts that at 31 December 2012 the Bank maintained effective internal controls over its financial reporting as contained in the *Financial Report 2012*.

The Bank's external auditor has provided an audit opinion on the fairness of the financial statements presented within the *Financial Report 2012*. In addition, it has issued an attestation report on management's assessment of the Bank's internal control over financial reporting, as set out on page 77.

**Suma Chakrabarti**
President

**Manfred Schepers**
Vice President and Chief Financial Officer

European Bank for Reconstruction and Development
London
26 February, 2013

# Report of the independent auditor

## To the Governors of the European Bank for Reconstruction and Development

We have examined management's assessment that the European Bank for Reconstruction and Development (the Bank) maintained effective internal controls over financial reporting as contained in the Bank's *Financial Report 2012*, based on the criteria for effective internal controls over financial reporting described in the "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organisations of the Treadway Commission. Management is responsible for maintaining effective internal controls over financial reporting and for the assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion over the effectiveness of the Bank's internal control over financial reporting, based on our examination.

We conducted our examination in accordance with the International Standard on Assurance Engagements (ISAE) 3000. Our examination included obtaining an understanding of internal control over financial reporting, evaluating management's assessment and performing such other procedures as we considered necessary in the circumstances. We believe that our work provides a reasonable basis for our opinion.

A bank's internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A bank's internal controls over financial reporting include those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the bank; (2) provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the bank are being made only in accordance with the authorisation of the bank's management; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the bank's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness 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 and procedures may deteriorate.

In our opinion, management's assertion that the Bank maintained effective internal control over financial reporting, included within the Responsibility for external financial reporting section of the Bank's *Financial Report 2012* is fairly stated, in all material respects, based on the criteria for effective internal controls over financial reporting described in the "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organisations of the Treadway Commission.

This report, including the opinion, has been prepared for, and only for, the Board of Governors as a body in connection with management's attestation for maintaining effective internal controls over financial reporting 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
26 February 2013

# Independent auditor's report to the Governors of the European Bank for Reconstruction and Development

## Report on the financial statements

We have audited the financial statements of the European Bank for Reconstruction and Development (the Bank) for the year ended 31 December 2012 which comprise the income statement, the statement of comprehensive income, the balance sheet, the statement of changes in equity, the statement of cash flows, the accounting policies, the related notes 1 to 33 and the risk management statement. The financial reporting framework that has been applied in their preparation is International Financial Reporting Standards (IFRS) 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 the 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 Bank at 31 December 2012 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 results section of the *Financial Report 2012* is not consistent with the Financial Statements, if the proper accounting records for the Bank have not been kept, or if we have not received all the information and explanations we require for our audit.

We read the other information contained in the *Financial Report 2012* and consider whether it is consistent with the financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

We have nothing to report to you in connection with these matters.

## Other matters

This Report, including the opinion, has been prepared for, and only for, the Board of Governors as a body in accordance with Article 24 of the Agreement Establishing the Bank dated 29 May 1990, 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
26 February 2013

# Notes

# Notes

**Controllers office**
Nigel Kerby
Joyce Hossinger

**Editorial production**
Lucy Plaskett
Amanda Railson
Jane Ross

**Design and print management**
Daniel Kelly

**European Bank for Reconstruction and Development**
One Exchange Square
London EC2A 2JN
United Kingdom
Switchboard/central contact
Tel: +44 20 7388 6000
Fax: +44 20 7338 6100

**Information requests**
For information requests and general enquiries, please use the information request form at www.ebrd.com/inforequest

**Project enquiries**
Tel: +44 20 7338 7168
Fax: +44 20 7338 7380
Email: projectenquiries@ebrd.com

**EBRD publications**
Tel: +44 20 7338 7553
Fax: +44 20 7338 6102
Email: pubsdesk@ebrd.com

**Web site**
www.ebrd.com

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European Bank for Reconstruction and Development
One Exchange Square London EC2A 2JN United Kingdom
Tel: +44 20 7338 6000 Fax: +44 20 7338 6100
Requests for publications: pubsdesk@ebrd.com

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