European Bank
for Reconstruction and Development

The Italian Investment Special Fund

Annual Financial Report
31 December 2015

The Italian Investment Special Fund

Contents

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Statement of comprehensive income

For the year ended 31 December 2015	Note	Year to 31 December 2015 € 000	Year to 31 December 2014 € 000
Interest			
From loans	3	**417**	537
From credit institutions		**(9)**	-
Net interest		**408**	537
Fee income		**-**	2
Dividend income		**11**	11
Net losses from share investments	4	**(171)**	(145)
Write-off of loans		**(60)**	-
Net losses from loans at fair value through profit or loss	9	**(1,110)**	(94)
Financial guarantees movement	5	**(302)**	595
Foreign exchange movement		**(19)**	57
Other operating expenses	6	**(8)**	(7)
Impairment charge on loan investments	7	**(402)**	(262)
Net (loss)/profit and comprehensive (expense)/income for the year		**(1,653)**	694
Attributable to:			
Contributor		**(1,653)**	694

Balance sheet

At 31 December 2015	Note	31 December 2015 € 000	31 December 2015 € 000	31 December 2014 € 000	31 December 2014 € 000
Assets					
Placements with credit institutions			**11,208**		8,982
Interest receivable on loans			**69**		96
Loan investments					
Loans at amortised cost	8	**3,951**		5,641	
Less: Provisions for impairment	7	**(1,819)**		(1,428)	
Loans at fair value through profit or loss	9	**764**		2,279	
			2,896		6,492
Share investments	10		**436**		1,522
Total assets			**14,609**		17,092
Liabilities and contributor's resources					
Other financial liabilities	11		**445**		1,488
Financial guarantee liabilities	12		**1,633**		1,420
Total liabilities			**2,078**		2,908
Contributions			**19,524**		19,524
Reserves and accumulated loss			**(6,993)**		(5,340)
Total contributor's resources			**12,531**		14,184
Total liabilities and contributor's resources			**14,609**		17,092
Memorandum items					
Guarantees	13		**3,449**		9,874

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Statement of changes in contributor's resources

For the year ended 31 December 2015	Contributions	Accumulated loss	Total
	€ 000	€ 000	€ 000
At 31 December 2013	19,524	(6,034)	13,490
Total comprehensive income for the year	-	694	694
At 31 December 2014	19,524	(5,340)	14,184
Total comprehensive expense for the year	-	(1,653)	(1,653)
At 31 December 2015	**19,524**	**(6,993)**	**12,531**

Statement of cash flows

For the year ended 31 December 2015		Year to 31 December 2015		Year to 31 December 2014
	€ 000	€ 000	€ 000	€ 000
Cash flows from operating activities				
Net (loss)/profit for the year	(1,653)		694	
Adjustment for:				
Net interest	(408)		(537)	
Net losses from share investments	171		145	
Write-off of loans	60		-	
Net losses from loans at fair value through profit or loss	1,110		94	
Foreign exchange movement	19		(57)	
Financial guarantees movement	302		(595)	
Impairment charge on loan investments	402		262	
	3		6	
Net interest received	327		419	
(Increase)/decrease in operating assets:				
Proceeds from repayment of loan investments	2,105		1,413	
Funds advanced for loans investments	-		(994)	
Proceeds from sale of share investments	431		414	
Funds advanced for share guarantee payments	(430)		(308)	
Funds advanced for share investments	(130)		(24)	
Funds advanced for loan guarantee payments	(79)		-	
Increase in operating liabilities				
Audit fees payable	1		-	
Net cash from operating activities		2,228		926
Net increase in cash and cash equivalents		2,228		926
Cash and cash equivalents at the beginning of the year		8,982		8,044
Effect of foreign exchange rate changes		(2)		12
Cash and cash equivalents at 31 December		11,208		8,982

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Accounting policies

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

A. Basis of preparation

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

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the policies of the Italian Investment Special Fund (“the Fund”). 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.

New and amended IFRS mandatorily effective for the current reporting period

There are no new or amended standards for the current reporting period.

IFRS not yet mandatorily effective but adopted early

IFRS 9: Financial Instruments is the IASB’s replacement project for IAS 39. The Standard has developed in phases and was completed in July 2014 with a mandatory application date for annual reporting periods beginning on or after 1 January 2018. The Fund adopted the first phase ‘recognition and measurement of financial assets’ (November 2009) in its 2010 financial statements. See the accounting policy for financial assets for more details.

IFRS not yet mandatorily effective but adopted early

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

Pronouncement	Nature of change	Potential Impact
IFRS 9 Financial Instruments	Classification and measurement of financial liabilities (October 2010). Hedge accounting (November 2013). Impairment methodology and introduction of 'fair value through other comprehensive income' measurement category for financial assets represented by simple debt instruments (July 2014). IFRS 9 to be adopted in its entirety for annual reporting periods beginning on or after 1 January 2018.	The Fund is yet to assess the potential impact of adopting this standard.
Amendments to: IFRS 10: Consolidation Financial Statements and IAS 28: Investments in Associates and Joint Ventures	Provides guidance for the accounting for the loss of control of a subsidiary as a result of a transaction involving an associate or a joint venture that is accounted for using the equity method. Effective for annual reporting periods beginning on or after a date to be determined by the IASB.	The Fund is yet to assess the potential impact of adopting this standard.
Amendments to: IFRS 11: Joint Arrangements	Provides guidance on the accounting for acquisitions of interests in joint operations in which the activity constitutes a business. Effective for accounting periods beginning on or after 1 January 2016.	The Fund considers that this amendment has no applicability to its existing operations.
IFRS 15: Revenue from Contracts with Customers	Establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Effective for annual reporting periods beginning on or after 1 January 2018.	The Fund is yet to assess the potential impact of adopting this standard.
IFRS 16: Leases	Sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, ie the customer ('lessee') and the supplier ('lessor'). Effective for annual reporting periods beginning on or after 1 January 2019.	The Fund considers that this amendment has no applicability to its existing operations.
Amendments to: IAS 1: Presentation of Financial Statements	Various amendments to improve presentation and disclosure under IAS 1. Effective for annual reporting periods beginning on or after 1 January 2016.	The Fund considers that this standard will have minimal impact on the presentation of its financial statements and the disclosures therein.
Amendments to: IAS 7: Statement of Cash Flows	An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. Effective for annual reporting periods beginning on or after 1 January 2017.	This is a disclosure requirement only which the Fund will comply with in 2017.
Amendments to: IAS 16: Property, Plant and Equipment and IAS 38: Intangible Assets	Clarification of acceptable methods of depreciation and amortisation. Effective for annual reporting periods beginning on or after 1 January 2016.	The Fund considers that this amendment has no applicability to its existing operations.

B. Significant accounting policies

Financial assets - Classification and measurement

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

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

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

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

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

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

The basis of fair value for share investments that are unlisted is determined using valuation techniques appropriate to the market and industry of each investment. The primary valuation techniques used are 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 Fund's share investments are recognised on a trade date basis.

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

Derecognition of financial assets

The Fund 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..

Financial liabilities

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

All financial liabilities are measured at amortised cost, except for derivative instruments which must be measured at fair value and financial guarantees which are measured in accordance with IAS 39, as described under “Financial guarantees” below.

Impairment of financial assets

Financial assets at amortised cost
The Fund has not adopted early that part of IFRS 9 which relates to impairment and therefore still applies IAS 39: Financial Instruments.

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

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

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

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

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

Derivative financial instruments

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

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

Financial guarantees

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

Contributor's resources

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

Statement of cash flows

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

Foreign currencies

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

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

Interest, dividends and fees

Interest is recorded on an accruals basis using the effective interest method. All interest, positive and negative earned on placements with credit institutions, is recognised within ‘net interest’ in the income statement.

Interest is recognised on impaired loans through unwinding the discount used in deriving the present value of expected cash flows.

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

Loan prepayment fees are classified as income when received.

Taxation

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

C. Critical accounting estimates and judgements

Preparing financial statements in conformity with IFRS requires the Fund to make estimates and judgements that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts included in the income statement during the reporting period.

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

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

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

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

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

Portfolio provisions for the unidentified impairment of loan investments at 31 December 2015 were €17,000 (2014: €203,000).

During 2015 the Bank carried out a review of its loss parameters underpinning estimates of unidentified impairment, with the aim of better reflecting the Bank's loss experience. The review resulted in a reduction in the level of portfolio provisions. The key revisions to these estimates were:

Probability of default
- In determining the probabilities of default for each risk rating, the relative weighting applied to the Bank's own experience was increased to 67 per cent with a 33 per cent weighting to external data, which marks a change to the equal weighting applied in 2014. The external benchmark data is based on emerging markets data to more appropriately reflect the Bank's assets (with global default data previously being used). A +/- 10 percentage points change in the weighting assigned to the Bank's own experience would lead to a change in portfolio provisions of +/- €1,000 (2014: €23,000).

Loss given default
- The approach taken to assign loss given defaults has been simplified, with an overall reduction in the level of average loss given default. Internal recoveries experience did not support the existing more granular approach and a decision was taken to apply values aligned to those used within the regulatory capital framework.

As an illustration, if these changes to loss parameter estimates had been applied as at 31 December 2014, the portfolio provisions for the unidentified impairment of loan investments would have reduced by €111,000 from €203,000 to €92,000. Of the €111,000 reduction, approximately €82,000 would have resulted from changes to probability of default estimates and €29,000 would have resulted from changes to loss given default estimates.

In addition, the sensitivity of portfolio provisions as at 31 December 2015 to the key variables used in determining the level of impairment is provided below.

Risk ratings

- If all loan investments were upgraded by three ‘notches’ or detailed ratings within the Bank’s probability of default rating scale, this would result in a reduction of €13,000 in portfolio provisions on loan investments (2014: €176,000).
- Conversely, if all loan investments were downgraded by three ‘notches’ or detailed ratings within the Bank’s probability of default rating scale, this would result in a charge to the income statement of €85,000 in relation to portfolio provisions for loans (2014: €420,000).

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 €12,000 (2014: €151,000).

Loss given default rates

- A change in loss given default rates by ten percentage points would lead to a change in portfolio provisions of +/- €4,000 (2014: €34,000).

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

Specific provision

- With respect to specific provisions, an increase or decrease of ten percent in the level of impaired loans would have an impact of +/- €245,000 (2014: €162,000).

Financial guarantee liability

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

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Risk management

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

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

Risk governance

The Fund follows the Bank's risk governance procedures as below:

The Bank's overall framework for identification and management of risks is underpinned by: (i) the Banking Vice-Presidency being the "first line of defence" in identifying and managing risks related to debt and equity operations, (ii) independent "second line of defence" control functions, including Risk Management, Office of the Chief Compliance Officer, Environmental and Social Department, Procurement Department, Office of the General Counsel, Evaluations Department and other relevant units, and (iii) Internal Audit Department, which acts as "third line of defence" and independently assesses the effectiveness of the processes within the first and second lines of defence. The Vice President Risk and Chief Risk Officer (VP & CRO) is responsible for ensuring independent risk management of the Banking and Treasury exposures, including adequate processes and governance structure for independent identification, measurement, monitoring and mitigation of risks incurred by the Bank. The challenge of the control functions, review of their status and assessment of their ability to perform duties independently fall within the remit of the Audit Committee of the Board.

Matters related to Bank-wide risk and associated policies and procedures are considered by the Risk Committee. The Risk Committee is accountable to the President. It oversees all aspects of the Banking portfolio across all sectors and countries, and provides advice on Risk Management policies, measures and controls. It also approves proposals for new products submitted by Banking. The membership comprises senior managers across the Bank including representatives from Risk Management, Finance, Banking and the Office of the General Counsel.

The Risk Committee is chaired by the VP & CRO.

The Managing Director Risk Management reports directly to the VP & CRO and leads the overall management of the department. Risk Management (i) provides an independent assessment of risks associated with individual investments undertaken by the Bank, (ii) performs an ongoing review of the portfolio to monitor the risk presented by investments from inception to repayment or exit, (iii) assesses and proposes ways to manage risks arising from correlations and concentrations within the portfolio, and (iv) ensures that adequate systems and controls are put in place for identification and management of operational risks across the Bank. It develops and maintains the Risk Management policies to facilitate Banking and Treasury operations and promotes risk awareness across the Bank.

In exercising its responsibilities, Risk Management is guided by its mission to:

- Provide assurance to stakeholders that risk decision-making in the Bank is balanced and within agreed appetite, and that control processes are rigorously designed and applied; and
- Support the Bank's business strategy including the maximisation of transition impact through provision of efficient and effective delivery of risk management advice, challenge and decision making.

A. Credit risk

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

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

The carrying amounts of financial assets presented on the balance sheet, together with the undrawn loan commitments and guarantees as shown under memorandum items, best represents the Fund's maximum exposure to credit risk at 31 December 2015 and 31 December 2014, without taking account of any collateral held or other credit enhancements.

Credit risk management and measurement

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

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

Individual projects
The Operations Committee reviews all Banking projects prior to their submission for Board approval. The Committee is chaired by the First Vice President Banking and its membership comprises senior managers of the Bank, including the VP & CRO and Managing Director Risk Management. A number of frameworks for smaller projects are considered by the Small Business Investment Committee or by senior management under a delegated authority framework supervised by the Operations Committee. The project approval process is designed to ensure compliance with the Bank's criteria for sound banking, transition impact and additionality. It operates within the authority delegated by the Board, via the Executive Committee, to approve projects within Board-approved framework operations. The Operations Committee is also responsible for approving significant changes to existing operations.

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

Risk Management 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. It also reviews the fair value of equity investments.

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

To identify emerging risk and enable appropriate risk mitigating actions Risk Management also conducts regular Bank-wide (top-down) and country level (bottom-up) stress testing exercises and comprehensive reviews of its investment portfolios. The Bank recognises that any resulting risk mitigation is constrained by the limited geographical space within which the Bank operates.

EBRD internal ratings

Probability of default (PD)
The Bank assigns its internal risk ratings to all counterparties, including borrowers, investee companies, guarantors and sovereigns in the Banking portfolio. Risk ratings reflect the financial strength of the counterparty as well as consideration of any implicit support, for example from a major shareholder. The sovereign rating takes into consideration the ratings assigned by external rating agencies. For non-sovereign operations, probability of default ratings are normally capped by the sovereign rating, except where the Bank has recourse to a guarantor from outside the country which may have a better rating than the local sovereign rating.

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

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

Loss given default (LGD)
The Bank assigns loss given default percentages on a scale of 0 to 100 determined by the seniority of the instrument in which the Bank invested.

Non-performing loans (NPL)

NPL definition
An asset is designated as non-performing when either the borrower is more than 90 days past due on payment to any material creditor, or when Risk Management considers that the counterparty is unlikely to pay its credit obligations in full without recourse by the Bank to actions such as realising security, if held.

Provisioning methodology
A specific provision is raised on all NPLs accounted for at amortised cost. The provision represents the amount of expected loss, being the difference between the outstanding amount from the client and the expected recovery amount. The expected recovery amount is equal to the present value of the estimated future cash flows discounted at the loan's original effective interest rate.

General portfolio provisions
In the performing portfolio, provisions are held against losses incurred but not identified at the balance sheet date. These amounts are based on the PD rates associated with the rating assigned to each counterparty, the LGD parameters reflecting product seniority and the Exposure at Default (EAD). EAD is calculated based on outstanding operating assets and the expected disbursement of committed but not yet drawn amounts.

Credit risk exposures

Placements with credit institutions
The Fund's placements with credit institutions were classified in internal credit rating risk category 2 (€10.6 million), category 3 (€0.2 million), category 5 (€0.2 million) and category 6 (€0.2 million) (approximately AA+ to B- in terms of the S&P equivalent).

Derivative financial assets
Derivative financial assets represent option contracts to provide potential exit routes for the Fund on its unlisted equity investments. All derivative financial assets are currently valued at nil.

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

Risk category	Neither past due nor impaired € 000	Impaired € 000	Total € 000	Total %	Portfolio provisions for unidentified impairment € 000	Specific provisions for identified impairment € 000	Total net of impairment € 000	Impairment provisions %
6: Weak	1,497	-	1,497	37.9	(17)	-	1,480	1.1
8: Non-performing	-	2,454	2,454	62.1	-	(1,802)	652	73.4
At 31 December 2015	**1,497**	**2,454**	**3,951**	**100.0**	**(17)**	**(1,802)**	**2,132**	**46.0**

Risk category	Neither past due nor impaired € 000	Impaired € 000	Total € 000	Total %	Portfolio provisions for unidentified impairment € 000	Specific provisions for identified impairment € 000	Total net of impairment € 000	Impairment provisions %
6: Weak	2,901	-	2,901	51.4	(91)	-	2,810	3.1
7: Special attention	1,115	-	1,115	19.8	(112)	-	1,003	10.0
8: Non-performing	-	1,625	1,625	28.8	-	(1,225)	400	75.4
At 31 December 2014	4,016	1,625	5,641	100.0	(203)	(1,225)	4,213	25.3

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

Risk rating	**Fair value 2015 € 000**	Fair value 2014 € 000
6: Weak	**-**	14
7: Special attention	**764**	2,265
At 31 December	**764**	2,279

At 31 December 2015 the Fund had security arrangements in place for €1.2 million of its disbursed loan investments (2014: €2.8 million).

Credit risk in the loan portfolio
Distressed restructured loans[1] represent €2.0 million of disbursed loan investments at 31 December 2015 (2014: €2.4 million).

Guarantees and derivative financial instrument liabilities
At 31 December 2015, the Fund's resources may be used to guarantee future default losses incurred on the Bank's outstanding loan operating assets and share investment portfolio of €37.4 million (2014: €52.7 million). At 31 December 2015, the Fund's maximum exposure under such guarantees was €6.7 million (2014: €9.8 million), of which €0.4 million (2014: €1.5 million) is recognised as "Derivative financial

[1] 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 likely have become an impaired loan.

instrument liabilities” and €1.6 million (2014: €1.4 million) is recognised as “Financial guarantee liabilities” on the balance sheet.

Concentration of credit risk exposure

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

	Loans 2015 € 000	Loans 2014 € 000
Albania	**596**	804
Bosnia and Herzegovina	**143**	286
Bulgaria	**-**	550
Jordan	**153**	246
Kosovo	**343**	932
Montenegro	**528**	693
Serbia	**2,123**	3,275
Tunisia	**441**	500
Turkey	**388**	634
At 31 December	**4,715**	7,920

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

	Loans 2015 € 000	Loans 2014 € 000
Agribusiness	**481**	1,224
Depository Credit (banks)	**143**	286
Information and Communication Technologies	**500**	2,200
Manufacturing and Services	**2,501**	2,602
Non-depository Credit (non-bank)	**1,090**	1,608
At 31 December	**4,715**	7,920

B. Market risk

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

Market risk management and measurement

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

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

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

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

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

	Albanian lek 2015 € 000	Euro 2015 € 000	Jordanian dinar 2015 € 000	Turkish lira 2015 € 000	United States dollar 2015 € 000	Total € 000
Total assets	385	13,316	299	609	-	**14,609**
Total liabilities	(9)	(1,419)	(1)	(649)	-	**(2,078)**
Net currency position at 31 December 2015	**376**	**11,897**	**298**	**(40)**	**-**	**12,531**

	Albanian lek 2014 € 000	Euro 2014 € 000	Jordanian dinar 2014 € 000	Turkish lira 2014 € 000	United States dollar 2014 € 000	Total € 000
Total assets	555	15,262	247	1,028	-	17,092
Total liabilities	(15)	(2,777)	-	(114)	(2)	(2,908)
Net currency position at 31 December 2014	540	12,485	247	914	(2)	14,184

The overall potential impact on the Fund's net profit is considered to be minimal based on the average five year absolute rolling average movement in the below currencies:

- 2 per cent strengthening or weakening in the Albanian lek to euro exchange rate (2014: 2 per cent);
- 9 per cent strengthening or weakening in the Jordanian dinar to euro exchange rate (2014: 8 per cent) (based on a three year absolute rolling average);
- 11 per cent strengthening or weakening in the Turkish lira to euro exchange rate (2014: 11 per cent); and
- 5 per cent strengthening or weakening in the United States dollar to euro exchange rate (2014: 5 per cent).

Equity price risk

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

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

Based on the five year rolling average movement in the Stoxx EU Enlarged TMI index, the potential impact on the Fund's net profit from a 13 per cent movement (2014: 13 per cent) in equity prices is €57,000 (2014: €198,000).

C. Liquidity risk

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

The Fund's Rules and Regulations require that loan investments, equity investments and guarantees are financed from the resources of the Fund, which comprise contributions received and investment income. Accordingly, the Fund cannot commit more than the available resources and cannot borrow funds to finance operations. The Fund's guarantees are limited to the proceeds recoverable on the Fund's parallel investment. The Fund also recognises contributions received as equity, which will only be returned to the contributor as part of the residual assets upon termination of the Fund. As a result, the Fund's exposure to liquidity risk is considered to be minimal.

D. Fair value of financial assets and liabilities

IFRS 13 specifies classification of fair values on the basis of a three-level hierarchy of valuation methodologies. The classifications are determined based on whether the inputs used in the measurement of fair values are observable or unobservable. These inputs have created the following fair value hierarchy:

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

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

At 31 December 2015, the Fund's balance sheet approximates to the fair value of all financial assets and liabilities.

Level 3 - sensitivity analysis
The table below presents the Level 3 financial instruments carried at fair value at 31 December 2015, main valuation models/techniques used in the valuation of these financial instruments and reasonably possible increases or decreases in fair value based on reasonably possible alternative assumptions.

		Impact on net profit in 2015	
	Carrying amount	**Favourable change**	**Unfavourable change**
Assets	**€ 000**	**€ 000**	**€ 000**
Loan investments	**764**	**23**	**(37)**
Share investments and associated derivatives	**1**	**37**	**(2)**
At 31 December	**765**	**60**	**(39)**

		Impact on net profit in 2014	
	Carrying amount	Favourable change	Unfavourable change
Assets	€ 000	€ 000	€ 000
Loan investments	2,279	106	(111)
Share investments and associated derivatives	41	232	(33)
At 31 December 2014	2,320	338	(144)

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

Loan investments

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

Share investments and associated derivatives

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

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

The Italian Investment Special Fund

Notes to the financial statements

1. Creation of the Special Fund

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

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

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

2. President's responsibilities

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

3. Interest income from loans

	2015	2014
	€ 000	€ 000
Loans at amortised cost	**291**	386
Loans at fair value through profit or loss	**126**	151
Interest income from loans	**417**	537

4. Net losses from share investments

	2015	2014
	€ 000	€ 000
Net unrealised gains from share investments and equity related derivatives	**1,357**	292
Net realised losses from share investments	**(1,098)**	(129)
Charge on derivative financial liability guarantee	**(430)**	(308)
Net losses from share investments	**(171)**	(145)

5. Financial guarantees movement

	2015	2014
	€ 000	€ 000
Financial guarantees issued	**-**	102
Amortisation of day one fair value	**(744)**	(699)
Charge for estimated settlement of impaired guaranteed loans	**1,046**	2
Financial guarantees movement	**302**	(595)

6. Other operating expenses

Other operating expenses represent external auditor's remuneration of €7,700 (2014: €7,200). At 31 December 2015 €7,700 (2014: €7,200) is payable to the Bank in relation to the 2015 external audit. In 2014 the Bank approved an extension of the term of appointment from four years to five with a maximum consecutive terms. Deloitte LLP (UK) completed its first four-year term in 2014 and has been re-appointed for the five year period 2015-2019.

7. Provision for impairment of loan investments

	2015	2014
Release/(charge) for the year	**€ 000**	€ 000
Portfolio provisions for the unidentified impairment of loan investments	**186**	57
Specific provisions for the identified impairment of loan investments	**(588)**	(319)
Provisions for impairment of loan investments	**(402)**	(262)
Movement in provisions		
At 1 January	**(1,428)**	(1,177)
Charge for the year to the income statement	**(402)**	(262)
Unwinding discount relating to the identified impairment of assets	**12**	12
Foreign exchange adjustments	**(1)**	(1)
At 31 December	**(1,819)**	(1,428)
Analysed between		
Portfolio provisions for the unidentified impairment of loan investments	**(17)**	(203)
Specific provisions for the identified impairment of loan investments	**(1,802)**	(1,225)
At 31 December	**(1,819)**	(1,428)

8. Loan investments at amortised cost

	2015	2014
	€ 000	€ 000
At 1 January	**5,641**	5,975
Disbursements	**-**	869
Repayments	**(1,604)**	(1,263)
Capitalised interest	**2**	3
Foreign exchange movement	**(28)**	57
Written off	**(60)**	-
At 31 December	**3,951**	5,641
Impairment at 31 December	**(1,819)**	(1,428)
Total loan investments net of impairment at 31 December	**2,132**	4,213

9. Loan investments at fair value through profit or loss

	2015	2014
	€ 000	€ 000
At 1 January	**2,279**	2,302
Disbursements	**-**	125
Repayments	**(501)**	(151)
Capitalised interest	**96**	97
Movement in fair value revaluation	**(1,110)**	(94)
Fair value at 31 December	**764**	2,279

10. Share investments

	2015	2014
	€ 000	€ 000
Outstanding disbursements		
At 1 January	**5,051**	5,570
Disbursements	**130**	24
Disposals	**(1,529)**	(543)
At 31 December	**3,652**	5,051
Fair value adjustment		
At 1 January	**(3,529)**	(3,178)
Movement in fair value revaluation	**313**	(351)
At 31 December	**(3,216)**	(3,529)
Fair value at 31 December	**436**	1,522

11. Other financial liabilities

	2015	2014
	€ 000	€ 000
Fair value of equity related derivatives	**435**	1,481
Audit fees payable	**8**	7
Interest payable	**2**	-
At 31 December	**445**	1,488

12. Financial guarantee liabilities

	2015	2014
	€ 000	€ 000
Unamortised balance of day one fair value	**355**	1,111
Estimated settlement of impaired guaranteed loans	**1,278**	309
At 31 December	**1,633**	1,420

13. Undrawn commitments and guarantees

	2015	2014
	€ 000	€ 000
Guarantees	**3,449**	9,874
Memorandum items at 31 December	**3,449**	9,874
Undrawn share commitments	**2,846**	2,976
Undrawn commitments and guarantees at 31 December	**6,295**	12,850

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

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

	Current	**Non-current**	**Total**	Current	Non-current	Total
	2015	**2015**	**2015**	2014	2014	2014
Assets	**€ 000**	**€ 000**	**€ 000**	€ 000	€ 000	€ 000
Placements with credit institutions	**11,208**	**-**	**11,208**	8,982	-	8,982
Interest receivable on loans	**69**	**-**	**69**	96	-	96
Loan investments at amortised cost	**845**	**3,106**	**3,951**	1,168	4,473	5,641
Provisions for impairment	**(7)**	**(1,812)**	**(1,819)**	(59)	(1,369)	(1,428)
Loan investments at fair value through profit or loss	**577**	**187**	**764**	89	2,190	2,279
Share investments	**-**	**436**	**436**	-	1,522	1,522
Total assets	**12,692**	**1,917**	**14,609**	10,276	6,816	17,092
Liabilities						
Derivative financial instruments	**-**	**435**	**435**	-	1,481	1,481
Other financial liabilities	**10**	**-**	**10**	7	-	7
Financial guarantee liabilities	**1,633**	**-**	**1,633**	1,420	-	1,420
Total liabilities	**1,643**	**435**	**2,078**	1,427	1,481	2,908

15. Events after the reporting period

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

16. Related parties

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

The Bank is entitled to charge the Fund a management fee of an amount equal to 1.5 per cent of contributions received. As there were no contributions received in 2015, there were no management fees paid by the Fund to the Bank (2014: nil) and there was no accrued management fee payable by the Fund to the Bank at 31 December 2015 (2014: nil). Guarantees issued by the Fund to the Bank are disclosed under credit risk exposures.

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

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

Report on the financial statements

We have audited the financial statements of the Italian Investment Special Fund ("the Fund") for the year ended 31 December 2015 which comprise the statement of comprehensive income, the balance sheet, the statement of changes in contributor's resources, the statement of cash flows for the year then ended together with the accounting policies, the risk management statement and the related notes 1 to 16. The financial reporting framework that has been applied in their preparation is the International Financial Reporting Standards as issued by the International Accounting Standards Board.

President's responsibility for the financial statements

The President is responsible for the preparation and fair presentation of the Financial Statements in accordance with 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 Italian Investment Special Fund as at 31 December 2015 and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board.

Other reporting responsibilities

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

Other matters

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

Deloitte LLP

Deloitte LLP
Chartered Accountants
London, United Kingdom
6 April 2016