

**European Bank
for Reconstruction and Development**

The Italian Investment Special Fund

**Annual Financial Report
31 December 2016**

The Italian Investment Special Fund

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Statement of comprehensive income

For the year ended 31 December 2016		Year to 31 December 2016	Year to 31 December 2015
	Note	€ 000	€ 000
Interest income from loans	3	166	417
Dividend income		-	11
Net losses from share investments	4	(1,938)	(171)
Net gains/(losses) from loans at fair value through profit or loss	9	1,039	(1,110)
Financial guarantees movement	5	255	(302)
Foreign exchange movement		72	(19)
Other operating expenses	6	(50)	(17)
Impairment release/(charge) on loan investments	7	104	(462)
Net loss and comprehensive expense for the year		(352)	(1,653)
Attributable to:			
Contributor		(352)	(1,653)

Balance sheet

At 31 December 2016		31 December 2016		31 December 2015	
	Note	€ 000	€ 000	€ 000	€ 000
Assets					
Placements with credit institutions			12,267		11,208
Interest receivable on loans			18		69
Loan investments					
Loans at amortised cost	8	1,971		3,951	
Less: Provisions for impairment	7	(1,000)		(1,819)	
Loans at fair value through profit or loss	9	202		764	
			1,173		2,896
Share investments	10		2,483		436
Total assets			15,941		14,609
Liabilities and contributor's resources					
Other financial liabilities	11		2,480		445
Financial guarantee liabilities	12		1,282		1,633
Total liabilities			3,762		2,078
Contributions			19,524		19,524
Reserves and accumulated loss			(7,345)		(6,993)
Total contributor's resources			12,179		12,531
Total liabilities and contributor's resources			15,941		14,609
Memorandum items					
Guarantees	13		3,252		6,295

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Statement of changes in contributor's resources

For the year ended 31 December 2016

	Contributions	Accumulated loss	Total
	€ 000	€ 000	€ 000
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
Total comprehensive expense for the year	-	(352)	(352)
At 31 December 2016	19,524	(7,345)	12,179

Statement of cash flows

For the year ended 31 December 2016

	Year to 31 December 2016	Year to 31 December 2015
	€ 000	€ 000
Cash flows from operating activities		
Net loss for the year	(352)	(1,653)
Adjustment for:		
Interest from loans	(166)	(417)
Interest expense on placements	43	9
Net losses from share investments	1,938	171
Net losses from loans at fair value through profit or loss	(1,039)	1,110
Foreign exchange movement	(72)	19
Financial guarantees movement	(255)	302
Impairment charge on loan investments	(104)	462
	(7)	3
Interest received from loans	111	334
Interest paid on placements	(41)	(7)
(Increase)/decrease in operating assets:		
Proceeds from repayment of loan investments	2,960	2,105
Proceeds from sale of share investments	242	431
Funds advanced for share guarantee payments	(248)	(430)
Funds advanced for share investments	(1,945)	(130)
Funds advanced for loan guarantee payments	-	(79)
(Decrease)/increase in operating liabilities		
Audit fees payable	(1)	1
Net cash from operating activities	1,071	2,228
Net increase in cash and cash equivalents	1,071	2,228
Cash and cash equivalents at the beginning of the year	11,208	8,982
Effect of foreign exchange rate changes	(12)	(2)
Cash and cash equivalents at 31 December	12,267	11,208

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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 a number of amendments to standards effective for the current reporting period which have no or negligible impact on the Fund's financial statements, namely:

- IFRS 11: Joint Arrangements
- IAS 1: Presentation of Financial Statements
- IAS 16: Property, Plant and Equipment
- IAS 38: Intangible Assets

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 January 1, 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.

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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
Amendments to: IFRS 2: Share-based Payment	Accounting for a modification of a share-based payment transaction that changes its classification from cash-settled to equity-settled. Effective for annual reporting periods beginning on or after 1 January 2018.	The Fund considers that this standard is not applicable to its operations.
Amendments to: IFRS 4: Insurance Contracts	Provides guidance for insurers in applying IFRS 9: Financial Instruments with IFRS 4: Insurance Contracts. Effective for annual reporting periods beginning on or after 1 January 2018.	The Fund considers that this standard is not applicable to its operations.
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 January 1, 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 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 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 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.

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Amendments to: IAS 12: Income Taxes	Clarifies the requirements on recognition of deferred tax assets for unrealized losses on debt instruments measured at fair value Effective for annual reporting periods beginning on or after 1 January 2017.	The Fund is exempt from all forms of direct taxes and so this Standard is not applicable.
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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 the legal rights and obligations attaching to the instrument in accordance with IFRS.

The basis of fair value for share investments that are unlisted is determined using valuation techniques appropriate to the market and industry of each investment. The primary valuation techniques used are multiples applied to net asset value and earnings-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.

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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.

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Derivative financial instruments

The Fund makes use of derivatives 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. Interest income is recognised within 'interest income' in the income statement. Interest expense is recognised in 'operating expenses' 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.

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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 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 2016 were €7,000 (2015: €17,000).

During 2016 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 revision to these estimates was:

Probability of default

- In determining the probabilities of default for each risk rating, the historical datasets used to calibrate the rates were updated to include 2015. This was carried out for both the internal and external data used to determine the final probability of default rates.
If this change to loss parameter estimates had been applied at 31 December 2015, the portfolio provisions for the unidentified impairment of loan investments would have reduced by €1,000 from €17,000 to €16,000. No estimate of the effect these changes may have on future periods has been undertaken on the grounds of impracticability.

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In addition, the sensitivity of portfolio provisions as at 31 December 2016 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 on the Bank's probability of default rating scale, this would result in a reduction of €6,000 in portfolio provisions on loan investments (2015: €13,000).
- Conversely, if all loan investments were downgraded by three 'notches' or detailed ratings on the Bank's probability of default rating scale, this would result in a charge to the income statement of €30,000 in relation to portfolio provisions for loans (2015: €85,000).

Probability of default rates

- In determining the probabilities of default for each risk rating, the relative weighting applied to external data and the Bank's own experience is reviewed annually. The 2016 general provisioning methodology applies a 67 per cent weighting to the Bank's own experience and a 33 per cent weighting to external data. 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 (2015: €1,000).

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 €5,000 (2015: €12,000).

Loss given default rates

- A change in loss given default rates by ten percentage points would lead to a change in portfolio provisions of +/- €2,000 (2015: €4,000).

With respect to specific provisions, an increase or decrease of ten percent in the level of impaired loans would have an impact of +/- €130,000 (2015: €245,000).

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 identifying and managing risks is underpinned by the Banking Vice-Presidency being the first line of defence related to debt and equity operations and an independent second line of defence control functions, including the Risk Management department, Office of the Chief Compliance Officer, Environmental and Social Department, Finance Department, Evaluations Department and other relevant units. An Internal Audit Department 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 Compliance, Chief Risk Officer (CRO) is responsible for ensuring the independent risk management of the Banking 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 falls 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 Risk and Compliance, CRO.

The Managing Director, Risk Management reports to the VP Risk and Compliance, CRO and leads the overall management of the department. Risk Management provides an independent assessment of risks associated with individual investments undertaken by the Bank, and performs an ongoing review of the portfolio to monitor credit, market and liquidity risks and to identify appropriate risk management actions. It also assesses and proposes ways to manage risks arising from correlations and concentrations within the portfolio, and ensures that adequate systems and controls are put in place for identifying and managing 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.

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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 2016 and 31 December 2015, 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 and Head of Client Services Group and its membership comprises senior managers of the Bank, including the VP Risk & Compliance, CRO and the 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 President, 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.

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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	AA+	Very Strong	
	2.0 2.3/2.5	AA AA-		
3	2.7	A+	Strong	
	3.0 3.3	A A-		
4	3.7	BBB+	Good	
	4.0 4.3	BBB BBB-		
5	4.7	BB+	Fair	Risk class 5
	5.0 5.3	BB BB-		
6	5.7	B+	Weak	Risk class 6
	6.0 6.3	B B-		
7	6.7	CCC+	Special Attention	Classified
	7.0 7.3	CCC CCC-/CC/C		
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.

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Credit risk exposures

Placements with credit institutions

The Fund's placements with credit institutions were classified in internal credit rating risk category 2 (€12.15 million), category 3 (€0.04 million) and category 5 (€0.08 million).

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		Total	Total	Portfolio provisions for unidentified impairment	Specific provisions for identified impairment	Total net of impairment	Impairment provisions
	€ 000	€ 000						
6: Weak	668	-	668	33.9	(7)	-	661	1.0
8: Non-performing	-	1,303	1,303	66.1	-	(993)	310	76.2
At 31 December 2016	668	1,303	1,971	100.0	(7)	(993)	971	50.7

Risk category	Neither past due nor impaired		Total	Total	Portfolio provisions for unidentified impairment	Specific provisions for identified impairment	Total net of impairment	Impairment provisions
	€ 000	€ 000						
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

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	Fair value
	2016	2015
	€ 000	€ 000
7: Special attention	202	764
At 31 December	202	764

At 31 December 2016 the Fund had security arrangements in place for €1.1 million of its disbursed loan investments (2015: €1.2 million).

Credit risk in the loan portfolio

There were no distressed restructured loans¹ at 31 December 2016 (2015: €2.0 million).

Guarantees and derivative financial instrument liabilities

At 31 December 2016, the Fund's assets that may be used to guarantee future default losses incurred on related Bank's outstanding loan operating assets and share investment portfolio were €26.8 million (2015: €37.4 million). At 31 December 2016, the Fund's maximum exposure under such guarantees was €4.7 million (2015: €6.7 million), of which €2.5 million (2015: €0.4 million) is recognised as "Derivative financial instrument liabilities" and €1.3 million (2015: €1.6 million) is recognised as "Financial guarantee liabilities" on the balance sheet.

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.

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Concentration of credit risk exposure

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

	Loans 2016 € 000	Loans 2015 € 000
Albania	406	596
Bosnia and Herzegovina	-	143
Jordan	31	153
Kosovo	171	343
Montenegro	335	528
Serbia	575	2,123
Tunisia	333	441
Turkey	322	388
At 31 December	2,173	4,715

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

	Loans 2016 € 000	Loans 2015 € 000
Agribusiness	321	481
Depository credit (banks)	-	143
Information and communication technologies	-	500
Manufacturing and services	1,316	2,501
Non-depository credit (non-bank)	536	1,090
At 31 December	2,173	4,715

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 Italian Investment Special Fund

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

	Albanian lek	Euro	Jordanian dinar	Turkish lira	Total
	2016	2016	2016	2016	
	€ 000	€ 000	€ 000	€ 000	€ 000
Total assets	64	15,794	73	10	15,941
Total liabilities	-	(3,264)	-	(498)	(3,762)
Net currency position at 31 December 2016	64	12,530	73	(488)	12,179

	Albanian lek	Euro	Jordanian dinar	Turkish lira	Total
	2015	2015	2015	2015	
	€ 000	€ 000	€ 000	€ 000	€ 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

The overall potential impact on the Fund's net profit has been assessed 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 (2015: 2 per cent);
- 7 per cent strengthening or weakening in the Jordanian dinar to euro exchange rate (2015: 9 per cent) (based on a three year absolute rolling average);
- 11 per cent strengthening or weakening in the Turkish lira to euro exchange rate (2015: 11 per cent); and

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 fair value of share investments from a 9 per cent movement (2015: 13 per cent) in equity prices is €223,000 (2015: €57,000).

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.

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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 2016, 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 2016, 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.

	Carrying amount € 000	Impact on net profit in 2016	
		Favourable change € 000	Unfavourable change € 000
Assets			
Loan investments	202	8	(14)
Share investments and associated derivatives	14	94	(14)
At 31 December	216	102	(28)

	Carrying amount € 000	Impact on net profit in 2015	
		Favourable change € 000	Unfavourable change € 000
Assets			
Loan investments	764	23	(37)
Share investments and associated derivatives	1	37	(2)
8: Non-performing	765	60	(39)

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.

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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

	2016	2015
	€ 000	€ 000
Loans at amortised cost	97	291
Loans at fair value through profit or loss	69	126
Interest income from loans	166	417

4. Net losses from share investments

	2016	2015
	€ 000	€ 000
Net unrealised (losses)/gains from share investments and equity related derivatives	(1,239)	1,357
Net realised losses from share investments	(451)	(1,098)
Charge on derivative financial liability guarantee	(248)	(430)
Net losses from share investments	(1,938)	(171)

5. Financial guarantees movement

	2016	2015
	€ 000	€ 000
Amortisation of day one fair value	218	744
Release/(charge) for estimated settlement of impaired guaranteed loans	37	(1,046)
Financial guarantees movement	255	(302)

6. Other operating expenses

	2016	2015
	€ 000	€ 000
Audit fees	7	8
Interest expense on placements	43	9
At 31 December	50	445

At 31 December 2016 €6,700 (2015: €7,700) is payable to the Bank in relation to the 2016 external audit. In 2014 the Bank approved an extension of the term of appointment from four year to five with a maximum of two 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.

The fall in the fees for audit services paid to the Bank's external auditor from 2015 to 2016 is attributable to movements in the value of the pound sterling. The pound sterling equivalent of these fees was £5,800 (2015: £5,700).

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7. Provision for impairment of loan investments

	2016	2015
	€ 000	€ 000
Release/(charge) for the year		
Portfolio provisions for the unidentified impairment of loan investments	10	186
Specific provisions for the identified impairment of loan investments	94	(648)
Provisions for impairment of loan investments	104	(462)
Movement in provisions		
At 1 January	(1,819)	(1,428)
Release/(charge) for the year to the income statement	104	(462)
Release against amounts written off	651	60
Unwinding discount relating to the identified impairment of assets	19	12
Foreign exchange adjustments	45	(1)
At 31 December	(1,000)	(1,819)
Analysed between		
Portfolio provisions for the unidentified impairment of loan investments	(7)	(17)
Specific provisions for the identified impairment of loan investments	(993)	(1,802)
At 31 December	(1,000)	(1,819)

8. Loan investments at amortised cost

	2016	2015
	€ 000	€ 000
At 1 January	3,951	5,641
Repayments	(1,271)	(1,604)
Capitalised interest	-	2
Foreign exchange movement	(58)	(28)
Written off	(651)	(60)
At 31 December	1,971	3,951
Impairment at 31 December	(1,000)	(1,819)
Total loan investments net of impairment at 31 December	971	2,132

9. Loan investments at fair value through profit or loss

	2016	2015
	€ 000	€ 000
At 1 January	764	2,279
Repayments	(1,689)	(501)
Capitalised interest	88	96
Movement in fair value revaluation	1,039	(1,110)
Fair value at 31 December	202	764

The Italian Investment Special Fund

10. Share investments

	2016	2015
	€ 000	€ 000
Outstanding disbursements		
At 1 January	3,652	5,051
Disbursements	1,945	130
Disposals	(692)	(1,529)
At 31 December	4,905	3,652
Fair value adjustment		
At 1 January	(3,216)	(3,529)
Movement in fair value revaluation	794	313
At 31 December	(2,422)	(3,216)
Fair value at 31 December	2,483	436

11. Other financial liabilities

	2016	2015
	€ 000	€ 000
Fair value of equity related derivatives	2,469	435
Audit fees payable	7	8
Interest payable	4	2
At 31 December	2,480	445

12. Financial guarantee liabilities

	2016	2015
	€ 000	€ 000
At 1 January	1,633	1,420
Financial guarantee movement	(255)	302
Foreign exchange movement	(96)	(89)
At 31 December	1,282	1,633
Represented by:		
Unamortised balance of day one fair value	138	355
Estimated settlement of impaired guaranteed loans	1,144	1,278
At 31 December	1,282	1,633

13. Undrawn commitments and guarantees

	2016	2015
	€ 000	€ 000
Guarantees	735	3,449
Undrawn share commitments	2,517	2,846
Undrawn commitments and guarantees at 31 December	3,252	6,295

The Italian Investment Special Fund

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
	2016	2016	2016	2015	2015	2015
	€ 000	€ 000	€ 000	€ 000	€ 000	€ 000
Assets						
Placements with credit institutions	12,267	-	12,267	11,208	-	11,208
Interest receivable on loans	18	-	18	69	-	69
Loan investments at amortised cost	362	1,609	1,971	845	3,106	3,951
Provisions for impairment	(4)	(996)	(1,000)	(7)	(1,812)	(1,819)
Loan investments at fair value through profit or loss	70	132	202	577	187	764
Share investments	-	2,483	2,483	-	436	436
Total assets	12,713	3,228	15,941	12,692	1,917	14,609
Liabilities						
Derivative financial instruments	-	2,469	2,469	-	435	435
Other financial liabilities	11	-	11	10	-	10
Financial guarantee liabilities	1,282	-	1,282	1,633	-	1,633
Total liabilities	1,293	2,469	3,762	1,643	435	2,078

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 2016, there were no management fees paid by the Fund to the Bank (2015: nil) and there was no accrued management fee payable by the Fund to the Bank at 31 December 2016 (2015: 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

Opinion

We have audited the financial statements of Italian Investment Special Fund ("the Fund") for the year ended 31 December 2016 which comprise the statement of comprehensive income, the balance sheet, the statement of changes in contributors' resources, the statement of cash flows, the accounting policies, the risk management statement and the related notes 1 to 16.

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 2016 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 (IASB).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Fund in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together the ethical requirements that are relevant to our audit of the financial statements in the United Kingdom, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

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.

In preparing the financial statements, the President is responsible for assessing the Fund's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Fund or to cease operations, or has no realistic alternative but to do so.

The President is responsible for overseeing the Fund's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Fund's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the President.
- Conclude on the appropriateness of the President's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Fund's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate,

to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Fund to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on other legal and regulatory requirements

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
5 April 2017