**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

REPORT OF THE BOARD OF DIRECTORS TO THE BOARD OF GOVERNORS

2015 ANNUAL MEETING

STRATEGIC AND CAPITAL FRAMEWORK 2016-2020

As approved by the Board of Directors at its Meeting on 8 April 2015

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Acronyms

AEB	Agreement Establishing the Bank
BP&B	Business Plan and Budget
CEB	Central Europe and the Baltic States
CO2	Carbon Dioxide
COP	Conference of the Parties
CRR	Capital Resources Review
CSRF	Country Strategy Results Framework
EBRD	European Bank for Reconstruction and Development
EFSI	European Fund for Strategic Investments
EIB	European Investment Bank
ETCI	Early Transition Countries Initiative
ETI	Expected Transition Impact
EU	European Union
EUR	Euros (currency)
EURIBOR	Euro Interbank Offered Rate
FAO	Food and Agriculture Organisation of the United Nations
FDI	Foreign Direct Investment
FfD	Financing for Development
GEF	Global Environment Facility
GIF	Global Infrastructure Facility
ICGI	Investment Climate and Governance Initiative
IFC	International Finance Corporation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IIP	Institutional Investment Partnership
IMF	International Monetary Fund
IPPF	Infrastructure Project Preparation Facility
IsDB	Islamic Development Bank
IT	Information Technology
KEI	Knowledge Economy Initiative
LC2	Local Currency and Capital Markets Initiative
MDB	Multilateral Development Bank
MOU	Memorandum of Understanding
MSME	Micro, Small and Medium Enterprise
MTD	Medium-term Directions
PBC	Performance Based Compensation
PPP	Public-Private Partnership
PTI	Portfolio Transition Impact
RUB	Rouble (currency)
SBI	Small Business Initiative
SCF	Strategic and Capital Framework
SDG	Sustainable Development Goal

SEE	South-eastern Europe
SEI	Sustainable Energy Initiative
SEMED	Southern and Eastern Mediterranean
SIP	Strategy Implementation Plan
SME	Small and Medium Enterprise
SRI	Sustainable Resource Initiative
SSF	Shareholder Special Fund
TC	Technical Cooperation
TI	Transition Impact
TIMS	Transition Impact Monitoring System
UNFCC	United Nations Framework Convention on Climate Change
USD	US Dollar (currency)
WTO	World Trade Organization

1. Introduction

1. Article 5.3 of the Agreement Establishing the Bank (the 'AEB') stipulates that the Board of Governors shall review the capital stock of the Bank at intervals of not more than five years.

2. In line with this stipulation, the first Capital Resources Review (CRR1) was approved at the Annual Meeting in Sofia in April 1996. The second, third and fourth Capital Resources Reviews (CRR2, CRR3 and CRR4) were approved by the Board of Governors respectively at the 2001, 2006 and 2010 Annual Meetings.

3. These Capital Resources Review documents went significantly beyond the requirement in the AEB to review the Bank's capital stock and included prescriptive figures on operations, financial results and resources as well as a capital adequacy analysis. Acknowledging the limitations of five-year projections in a dynamic operating environment and in order to establish a certain level of flexibility for the Bank to respond to the needs of its region, the reform of the Bank's planning process was noted by the Board of Governors at the Bank's 2014 Annual Meeting in Warsaw. The new planning process consists of the following documents:

- a five-year Strategic and Capital Framework (SCF) to be approved by the Board of Governors; and
- a rolling three-year Strategy Implementation Plan (SIP) to be approved by the Board of Directors.

4. Each SCF sets the Bank's high level strategic orientations through the Medium-Term Directions, reviews the Bank's capital capacity to pursue its priorities and sets a control framework for implementation. In the SCF, the Board of Directors reports to the Board of Governors on the adequacy of the Bank's capital base. The extent to which there is a surplus or shortfall of capital is assessed through a quantitative and qualitative analysis by management. On this basis, the SCF can also include proposals for a potential capital increase or decrease. This is without prejudice to the general powers of the Board of Governors to make decisions on the Bank's capital at any time.

5. Each SCF is cast into quantitative frameworks in SIPs which include: (i) a three-year rolling business plan including operational, financial and capital projections as well as a resource framework, taking account of the economic and risk environment; and (ii) the corporate scorecard and budget for the first year of each SIP period. SIPs allow the Board of Directors to assess the capital situation of the Bank on an annual basis and consider the planned capital utilisation levels for the following three years. This analysis will also inform the capital reviews in future SCFs.

6. The orientations of this SCF document for the period 2016-2020 will be implemented against a backdrop of significant uncertainty. The repercussions from the global financial crisis continue to be felt and have been exacerbated by extreme market volatility, a weak outlook for economic growth in the Bank's region and its main trading partners, soft commodity prices and major geopolitical risks such as those associated with events in Ukraine and developments in the Middle East and North Africa. Notwithstanding the Bank's successful operations during the CRR4 period, a great deal remains to be done as the pace of transition has slowed in many countries. In order to re-energise transition, the Bank will focus

on supporting its countries in building reform resilience, further integrating into regional and global markets and dealing with common global and regional challenges such as climate change and food security. The Bank will also consider how it can further contribute, by investing in its region and by sharing knowledge, to the advancement of international efforts in the fight against climate change and in addressing the new Sustainable Development Goals that will come online in 2016.

7. This SCF document is structured as follows to cover the range of these topics:

- Section 2 contains a summary of the Bank's record against the CRR4 objectives and the developments outside the CRR4 framework, based on actual results from 2011 to 2014. It also takes stock of **developments in transition** including progress made and remaining challenges;
- Section 3 sets the **medium-term directions and strategic orientations** which would guide the Bank's activities for the 2016-2020 period and is based on "Re-energising Transition: Medium-Term Directions for the Bank" (BDS14-098/F) which was discussed at the Governors Roundtable at the Bank's 2014 Annual Meeting in Warsaw;
- Section 4 **reviews the Bank's capital** and provides an indication of possible capital capacity under certain assumptions for the implementation of the Bank's medium-term directions for the 2016-2020 period; and
- Section 5 sets the **strategic control parameters** with respect to transition, capital and resource efficiency which provide the framework within which the medium-term directions will be implemented. In this context, it is worth highlighting that the Bank's capital policies will continue to ensure that the Bank is managed in a manner consistent with the preservation of its triple-A credit rating.

8. Annex 1 contains a detailed analysis of the Bank's record to date in the CRR4 period, Annex 2 covers the assumptions on the growth of members' equity used for the capital capacity analysis in Section 4 and Annex 3 includes the draft resolution of the Board of Governors on the SCF.

2. Taking Stock

2.1. The Bank's record to date in the CRR4 period

9. The CRR4 set out the Bank's strategy in the wake of the global financial crisis for the period 2011 to 2015. This section provides a summary of the Bank's record in implementing CRR4 based on actual results through 2014 and its response to developments beyond CRR4, notably the extension of the Bank's operations to the southern and eastern Mediterranean (SEMED) region. A detailed review of all these elements is presented in Annex 1.

10. Since 2009, the Bank has responded to the global financial crisis and the difficult global and regional environment that continued during the CRR4 period, and promoted post-crisis recovery while supporting economic transition. At the same time, it maintained a strong focus on the quality of operations, in line with its mandate, and on financial soundness. The Bank's credit rating from the main agencies has been solidly AAA throughout the period.

11. **The Bank continued to focus on delivering strong transition impact through its operations.** The share of new projects rated 'good' and 'excellent' for transition impact has been consistently around 90 per cent during the period 2011 to 2014 and the average expected transition impact (ETI) and portfolio transition impact (PTI) were above 60 and 65 respectively.

12. **The Bank's operational performance between 2011 and 2014 was consistent with CRR4, with certain deviations**. Cumulative annual Bank investment (ABI) for 2011-2014 was at 96 per cent of the CRR4 envelope. At the end of 2014, the Bank's portfolio and operating assets were lower than CRR4 projections due to lower than projected disbursements and higher than projected reflows. The geographic composition of the portfolio at the end of 2014 somewhat deviated from CRR4 projections, with the shares of Central Asia and Eastern Europe and Caucasus in line with projections, the share of Russia lower than projections and the shares of South Eastern Europe, Central Europe and the Baltics and Turkey higher than projections.

13. **The Bank displayed a strong financial performance over the period but recorded a financial loss in 2014 due to the volatile operating environment.** The Bank's realised profit[1] before and after specific impairment for the period 2011-2014 was EUR4.0 billion compared to EUR4.5 billion projected in CRR4 for the same period. Despite strong performance in realised profit, the Bank recorded financial reporting losses of EUR568 million in 2014, including EUR1.03 billion unrealised reductions in equity valuations recognised through the income statement. The environment in which the Bank operates remains volatile and consequently, there is unpredictability in future financial results.

14. **Capital utilisation remained within the CRR4 envelope.** Statutory capital utilisation stood at 68 per cent compared to 80 per cent projected under CRR4 and a 92 per cent prudential threshold. Economic capital utilisation stood at 79 per cent compared to 88 per cent projected under CRR4, remaining within the 90 per cent prudential threshold.

15. **The Bank's operations were conducted within the CRR4 budgetary resource framework.** The cumulative real budget growth for operations in the CRR4 region was 9.9

[1] Excluding movements in general portfolio provisions and fair valuation of Banking investments

per cent, significantly below the CRR4 resource framework range of 13 per cent to 19 per cent.

16. **The Bank made good progress towards its qualitative objectives under the CRR4**, which include a focus on strengthening policy dialogue, building stable financial sectors and developing capital markets, diversifying economies, tackling energy efficiency, climate change and energy security, accelerating transition in infrastructure, and preserving and enhancing EBRD's operational business model by making organisational improvements, maintaining strong grant funding and reinforcing cooperation with international financial institutions (IFIs).

17. In addition to performing against its objectives under the CRR4, the Bank also responded to **additional developments beyond CRR4**:

- One of the most significant events during the CRR4 period has been the extension of the Bank's operations into the **SEMED region**. The Bank's shareholders seized a historic opportunity to support Egypt, Jordan, Morocco and Tunisia in their democratic and economic transitions, creating a special fund to launch investments in 2012 and ratifying the necessary changes to the Bank's charter. The Bank was able to rapidly establish operations and the SEMED portfolio reached EUR1.6 billion by the end of 2014.
- The Bank also extended its operations to **Cyprus** in 2014 with a limited time horizon until the end of 2020. The Bank's aim is to leverage its experience in other transition countries to address Cyprus' challenges in the structure of its markets and market institutions. Annual Bank investment reached EUR108 million during the first year of operations.
- In February 2015, the Board of Governors granted recipient country status to **Greece** with a limited time horizon until the end of 2020. The Bank's operations will aim to support the country's efforts in implementing reforms, strengthening the role of the private sector and deepening regional integration.

2.2. Developments in transition

2.2.1 Progress made

18. Much of the transition region has undergone a fundamental transformation since the fall of the Berlin wall more than 25 years ago. In many countries, the progress achieved towards the fundamental principles of the Bank – democracy, pluralism, entrepreneurship and private sector development – would have been unimaginable during the years of the Cold War. However, the pace of reform has varied considerably, both in types of reform and geographically. The reform areas where progress has been most evident are generally those that were undertaken in the early years of transition, namely, price and trade liberalisation, privatisation and banking sector reform. The reform process was most rapid in countries in central Europe and the Baltic states (CEB), where the prospect of joining the European Union provided an important anchor for reforms. The EU approximation process has also helped to orient the countries of south-eastern Europe (SEE) towards the development of full market economies, although some countries in this region still have a considerable distance to travel on this path. Elsewhere, reforms have been rather patchy, but some policy-makers have shown considerable courage and determination in tackling vested interests and pushing ahead

with liberalisation and privatisation measures. Growing trade integration has been a notable feature of the transition, and membership of the World Trade Organization (WTO) is now widespread across the region.

2.2.2 Reform developments and stagnation

19. Although many countries in the region have made great strides over the past two and a half decades, the overall pace of transition in the region has slowed significantly since the early 2000s. In part, this reflects the successful completion of first-generation reforms in much of the region. The focus in more recent years has shifted to areas where the opportunities for change were less immediate and the technical and institutional requirements for reform were greater. Progress on governance and enterprise restructuring has been more gradual and limited to fewer countries. In these areas there remain significant gaps between transition countries and advanced economies. These gaps have not declined substantially in the last decade.

20. It should be noted that, notwithstanding the difficulties facing the region since the crisis hit with full force in 2009, recent years have seen commendable progress in reforms in some of the more difficult areas. For example, the Bank's annual survey of competition authorities in countries of operations shows a slow but steady improvement since 2010 in the areas of implementation and enforcement of best practice in the area of competition policy. As a result, many firms have developed innovative processes and products, some of which are now making an impact on global markets.[2] In transport infrastructure, a number of countries have made progress in terms of adopting a more commercialised approach and developing PPPs, while in the financial sector important measures have been introduced in many countries to help build sustainable financial sectors.

21. At the same time, the prolonged economic downturn that followed the global financial crisis has made reforms more difficult. Some countries – including some of the more advanced transition countries – have suffered reform reversals in specific sectors, particularly energy, transport and pension systems. There are signs in many countries of increased state influence in these areas, as well as in the banking sector. The loss of transition momentum is also visible in cross-country indicators that seek to measure the broad quality of economic institutions, such as the rule of law, the control of corruption, regulatory quality and government effectiveness.

22. The stagnation of transition has a number of causes. In some countries – particularly those with weaker political systems – reforms and the quality of economic institutions are held back by political constraints. In other countries the crisis – including knock-on effects from turmoil in the Eurozone – has eroded popular support for markets and market-supporting institutions. Vested interests have also stood in the way of new reforms, particularly in countries with abundant natural resources or large energy-intensive industrial sectors. And even when reforms were enacted at the national level, lack of transparency and accountability at the local level has often created impediments to successful reform implementation.

2.2.3 Reinvigorating reform

23. Long-term growth projections suggest that, unless the reform process can be reinvigorated, transition economies are likely to see significantly lower growth rates over the

[2] See EBRD Transition Report 2014: Innovation in Transition.

next 20 years. Countries in the transition region have achieved impressive rates of income convergence since the mid-1990s. One of the drivers was the catch-up in productivity – resulting from the collapse of inefficient sectors, first-generation reforms, and the re-orientation of trade. This phenomenon was unique to the transition region and transitory by nature, and is unlikely to support growth in the future. Future productivity growth will have to be achieved through sustained improvement in economic and political institutions, as well as better human capital and innovation.

24. Further reform will therefore be critical to sustaining convergence in the region. This includes, in particular, improving the business environment, addressing bottlenecks in infrastructure and skills, and deepening local capital markets. The precise nature of these growth-critical reforms is country-specific. Common to almost all countries, however, is the need to create an environment that makes reforms more likely and improves their implementation and resilience by targeting issues such as the control of corruption and the rule of law, where progress has often proved elusive in the past. International integration has proven to be an important driver of institutional quality, in addition to having direct benefits for growth, and should be part of any effort to get transition "unstuck".

2.2.4 Economic uncertainty and trends

25. As of early-2015, the global economy continues to face turbulence, with important implications for the Bank's countries of operations. The journey of transition, and therefore the Bank's operations with it, will be affected by the evolution of a number of factors.

- The Bank's latest *Regional Economic Prospects*, published in January 2015, points to a difficult year ahead for the region and negative growth on average (-0.3 per cent). On balance, the short-term outlook for growth has worsened significantly relative to six months earlier.
- The dramatic fall in the price of oil in late-2014/early-2015 is likely to be a "double-edged sword" for the region, bringing terms of trade benefits on the one side to oil-importers (the majority of countries in the region) but damaging prospects for oil exporters.
- The region's largest economy, Russia, in particular is facing a major recession in 2015, where the combination of the drop in oil prices and economic sanctions is compounding the ongoing effects of long-running structural problems. This is also reflected in the depreciation of the RUB, with impact on several other currencies in the region.
- Ukraine's economy is in a precarious state. International reserves have declined considerably, despite capital controls, and external financing needs are high. Government debt continues to rise rapidly, while banking sector balance sheets have been subject to deposit outflows and currency depreciation.
- Negative developments in these two economies, combined with persistent weaknesses in the Eurozone, pose significant risks for the entire region. Any deepening of the recession in Russia would, in turn, have significant contagion effects for the economies in Eastern Europe, the Caucasus and Central Asia, as seen already in December 2014, but they could also lead to a global downturn in confidence and investor sentiment.
- Major geopolitical factors, those associated with the events in Ukraine as well as the developments in the Middle East and North Africa, pose significant downside risk for economic growth and transition-related reforms in the rest of the region.

These factors can have significant impact on investments, capital flows/ foreign direct investment (FDI) and the risk environment, with negative consequences for economic growth and job creation.

26. As a result of these uncertainties, reformers in the region will continue to face an unconducive macroeconomic and investor environment for reforms to take place. There is a heightened risk that policy-makers will be drawn to short-term populist measures, for example with regard to household energy prices, rather than putting in place durable reforms that bring lasting benefits to the economy.

27. Reinvigorating transition therefore will require dealing with the remaining legacy of the financial crisis and managing a period of market volatility. In the years after the crisis, bank liquidity has been flowing out of the region and is not expected to significantly improve in the near term as the ongoing deleveraging in the European banking system still has a considerable way to go. High levels of nonperforming loans on bank and corporate balance sheets persist in much of the transition region, over-burdening managers and, coupled with tightened lending conditions, severely constraining new credit. The banks and their supervisors will also have to deal with the implementation of a wave of regulatory changes in the wake of the global crisis.

28. The crisis has led to a cyclical increase in domestic funding in most banking systems in the region, but more efforts are needed to rebalance finance in favour of home-grown sources through local capital market development. Yet, it is clear that domestic savings will not be sufficient to rekindle and maintain the desired pace of convergence growth. Over the longer term, sustainable growth will depend on a recovery of capital flows to the region, albeit not to the unsustainable levels recorded in the boom years immediately preceding the crisis. In the current environment the speed of recovery of these flows is uncertain. Without major reforms in the investment climate, it is likely that FDI to the region will remain at subdued levels for the foreseeable future.

29. Some important lessons from the crisis must be heeded. One such lesson is that the purpose for which capital is imported matters greatly for vulnerability and long-term growth. In line with global historical experience foreign direct investment proved more stable than portfolio flows, and lending by banks with a strategic commitment to the region was less volatile than funding from wholesale markets and non-strategic banks. Equally importantly, economies where investments went into tradable sectors proved much more resilient than those where capital had targeted sectors such as construction and real estate.

30. The economies in the region increasingly find themselves competing for investments with other emerging and frontier markets. During the first decade of transition, the region benefitted from rapid improvements in productivity and institutional convergence. Foreign direct investors contributed greatly to these achievements by introducing modern technologies and transferring skills, but in most cases they also contributed to improved business practices and a better investment climate. The challenge in coming years will be to attract forms of finance that can help re-energise transition.

3. Medium-term directions: Re-energising transition

31. The Bank carried out a review of its priorities in 2014, which was discussed and endorsed at the Annual Meeting Governors Roundtable in Warsaw (Re-energising Transition: Medium-Term Directions for the Bank, BDS14-098/F). This section of the Bank's Strategic and Capital Framework (SCF) sets out and, where appropriate, updates the high-level guidance received. This guidance will be cast into operational, financial and resource frameworks in the context of future Strategic Implementation Plans (SIPs).

3.1. Summary of the priorities for the medium term

3.1.1 Context

32. The transition process has stalled in recent years: progress towards well-functioning market economies has been modest in most countries in the Bank's region and there have been reversals. At the same time, as the Bank enters the SCF period 2016-2020, the considerable risks identified in the previous section create a challenging environment for both the countries of operations and the Bank. Geopolitical factors, such as those associated with events in Ukraine as well as developments in the Middle East and North Africa, pose a sustained threat to stability. In this context, the EBRD Board's guidance on operations in Russia, the Bank's largest country of operations prior to 2014, will have a significant impact on the implementation of the Bank's strategy. These risks are compounded by a weak outlook for growth in the Eurozone and the spill-over from recessions in Russia and Ukraine, as well as fragile commitments to multiparty democracy and pluralism in some of the Bank's countries. In considering the Bank's strategic directions for the SCF period, these risks, not all of which were apparent when the Medium-Term Directions were adopted in 2014, must be borne in mind. This question is further discussed below in Section 3.1.3.

3.1.2 Priorities

33. The Bank's region must re-energise transition while navigating a period of increased volatility. In this context, and given the persistently low levels of capital flows to the region since the global financial crisis, the Bank is highly additional and its mandate, skills and capital capacity are more needed than ever. Therefore, **the Bank's priority over the SCF period will be to assist its region in re-energising transition**. The Bank will step up further, through finance, technical cooperation and policy advice, and deepen its engagement to assist its countries of operation in this endeavour. Over the SCF period, the Bank has an estimated maximum cumulative investment capacity of EUR55 billion[3] from its own resources and will seek to mobilise additional funds from the markets to support its objectives.

34. In assisting its countries in re-energising transition over the SCF period, the Bank will continue to be guided by its key operating principles of **transition impact, sound banking and additionality** and give added focus to the following three key priorities:

- **Resilience**: The Bank will aim to strengthen the resilience of reforms by promoting good governance institutions, inclusiveness and robust economic structures. To this end, the Bank will build a more structured policy dialogue capacity to foster transition, including through an Investment Climate and Governance Initiative targeting country-level frameworks and through further strengthening its toolkit such

[3] As estimated in the paper "Review of the Redemption of Callable Capital (BDS15-14)"

as the Legal Transition Programme. It will further mainstream economic inclusion across its operations through measures aimed at improving the participation of marginalised groups in the market economy, and adopt a Gender Strategy to deepen the impact of the Bank's gender activities. And it will further build up its Small Business Initiative, Knowledge Economy Initiative and Local Currency and Capital Markets Initiative in support of robust economic structures.

- **Integration**: The Bank will promote further international and regional integration which is a powerful force supporting efficient markets and reinforcing reform discipline. The Bank will step up its efforts for investment mobilisation by expanding its business development activities and by developing debt and equity co-investment structures. The Bank will build up its Infrastructure Project Preparation Facility to provide assistance to national and local governments in preparing and structuring projects, including cross-regional and cross-border projects, and will consider ways of cooperating with the European Fund for Strategic Investments (EFSI) and the Global Infrastructure Facility (GIF). The Bank will continue its support for the diversification of energy sources, including through better integration of regional markets important for energy security. And it will consider the case for a further build-up of its trade finance programme.
- **Common global and regional challenges**: While markets worldwide fail to produce sustainable outcomes in these areas, the problems are especially acute in the Bank's transition region. Building on its strong track record of climate finance which now accounts for more than a third of the Bank's annual investments, the Bank will ramp up activities under its Sustainable Energy Initiative, including its strong focus on energy efficiency as a means of addressing climate change as well as competitiveness and energy security. The Bank will continue the extension of this operational concept from energy to water and material waste under its Sustainable Resource Initiative. The Bank will also further broaden its Private Sector for Food Security Initiative and give impetus to projects mitigating regional environmental impacts.

Box 1: The Bank in 2020

Based on the strategic directions of the SCF, by 2020:

<u>The Bank's operational profile will include:</u>

- An even higher proportion of activities that incorporate sustainable energy and resource efficiency components and considerably stepped-up operations in energy security
- A comprehensive suite of solutions to support SMEs, entrepreneurship and innovation
- An active and comprehensive programme of local currency and capital market development
- A strong infrastructure project preparation offer together with increased financing for sustainable infrastructure projects, within and across borders
- A wide range of products that can address the evolving transition needs of its countries and clients—notably, a higher proportion of equity investments

<u>The Bank will, across all its operations:</u>

- Have a significant, structured policy dialogue capacity, leveraging its project work and aimed at sector reform and institutional and governance improvements
- Fully mainstream inclusion and gender objectives
- Mobilise significant cross-border capital and investments from both traditional and non-traditional sources
- Further strengthen results orientation and alignment of objectives and apply lessons learned.

The priorities will be implemented through future annual Strategy Implementation Plans with continued efforts to manage both existing projects and new commitments to pursue transition impact whilst balancing, in the portfolio, risks, returns and costs to ensure financial sustainability. Over the SCF period, the Bank will maintain its strategic orientation to move progressively towards countries and regions within countries that are less advanced in transition and, by 2020, will conclude its engagement in new operations in Cyprus and Greece in accordance with Resolutions 173 and 177.

35. By the end of the SCF period, the Bank will have assisted its region in setting a course for accelerated reforms and more resilient institutional frameworks; taking measures to diversify economies with an increased role of the private sector and enhanced competitiveness; strengthening financial systems and capital markets to be able to provide financing, also in local currency, to the real economy; utilising energy and resources more efficiently; and embarking on a more rapid income convergence as well as an inclusive and sustainable growth trajectory.

36. Over the SCF period, the evolving global context will also present the Bank with demands and opportunities. In particular:

- The upcoming Conference of the Parties meeting in Paris in 2015 (COP21) will aim to reach an agreement among all parties to limit the global temperature increase to 2 degrees Celsius above pre-industrialisation levels. In this context, the Bank's approach to climate finance, as demonstrated by the success of its Sustainable Energy Initiative, is considered a strong response model.
- The UN system is formulating a new set of Sustainable Development Goals (SDGs) to replace the Millennium Development Goals expiring in 2015. The draft SDGs incorporate sustainability, economic growth and industrialisation on top of the traditional anti-poverty goals and have strong linkages to the Bank's activities especially in the areas of climate change, sustainable infrastructure and inclusion. The associated Financing for Development track gives increased prominence to private sector mobilisation which is at the core of the Bank's business model.

37. In other words, a convergence is increasingly observed between the EBRD's business model and the global development agenda. The Bank is therefore well-placed to respond and will play its part in addressing the challenges presented by COP21 and the SDGs within its transition mandate and the geographic provisions set out in the AEB.

3.1.3 Coping with uncertainty

38. The uncertainties in its operating environment create significant challenges for the Bank both for new operations and for its portfolio and financial sustainability. Russia and Ukraine are particularly important in this respect, given the size of the Bank's historical operations in these countries. The implications of geopolitical uncertainties and economic developments can significantly increase the risk level of the Bank's portfolio and impact the Bank's profitability.

39. In this context, the Bank will carry out its operations over the SCF period with prudence and give added focus to its strategic portfolio approach, managing both the stock of existing projects and the flow of new commitments to pursue transition impact whilst balancing, in the portfolio, risks, returns and costs:

- The achievement of transition impact and the implementation of the Medium-Term Directions will be assessed from the perspective of the portfolio as a whole.
- The Bank will target a balanced and diversified portfolio in terms of geographic, sector and product composition in order to ensure the Bank's financial sustainability while addressing the transition needs of its region.

- Existing projects in the portfolio will be managed, throughout their cycle, in a rigorous and entrepreneurial manner in order to support the delivery of transition impact and financial results.

40. Tools underpinning the strategic portfolio approach include the Bank's methods for assessing transition impact, effective risk-based allocation of capital to the portfolio, and the framework within which the Bank manages and monitors its risks. In addition to further strengthening these methods, the Bank will also develop new tools to enhance the implementation its strategic portfolio approach over the SCF period.

3.2. The Bank's business model

41. The Bank was founded to foster transition to open market economies and promote private and entrepreneurial initiative in its countries of operations. This aim, which is enshrined in the Bank's founding charter, does not target specific development outcomes but the improvement of an economic system.

42. The Bank implements this mandate as a "bank" by financing mainly private sector projects which have tangible "real economy" impact. It also supports this transactional activity by providing project-related or stand-alone technical cooperation (TC), non-TC grants and policy dialogue in support of change.

43. This business model is underpinned by the Bank's specific attributes and tools: its additionality principle which ensures that the Bank is complementary to and not competing with the private sector; its sound banking principle ensuring the Bank's financial sustainability by relying on the economic fundamentals of projects and implementing high quality standards; its private sector expertise while also having the ability to work in the public sector, therefore being able to mediate between the two while fostering private sector principles; its risk-taking capacity for both debt and equity; its global shareholder base as an MDB which provides the Bank with widespread support; and its regional knowledge and local presence which enables the Bank to identify and support local projects and to engage effectively with authorities.

44. The sum of these attributes and its transition mandate distinguish the Bank from most other institutions and instruments of public policy and enables the Bank's shareholders to achieve certain goals effectively.

3.2.1 Core competencies and strategic initiatives

45. The Bank's core competencies stem from this approach. They include structuring market-based, commercially oriented and predominantly private sector solutions by:

- in the *financial sector*, supporting the development of solid and well-governed banks and capital markets through direct investments;
- in the *corporate sector*, supporting value-added creation, innovation, competition, diversification, smaller businesses and high standards of business conduct;
- in the *energy sector*, leveraging energy efficiency across sectors, assisting the development of energy markets, fostering new technologies, supporting renewables

and low-carbon transition and investing in well-regulated energy supply and security; and,

- in *infrastructure*, developing efficient transport systems and municipal infrastructure services, through commercialisation, privatisation or an effective mix of public and private involvement including PPPs.

46. The Bank also addresses *horizontal* transition priorities through its strategic initiatives. These mobilise resources from across the Bank by combining the Bank's instruments and capabilities in a joined-up, results-oriented manner. The following initiatives, which will be ramped up further over the medium-term, are monitored in the Bank's corporate scorecard:

- the Early Transition Countries Initiative (ETCI), which aims to support transition in the less advanced market economies of the region by delivering significant investment levels, a range of tailored instruments and a dedicated donor fund;
- the Sustainable Resource Initiative (SRI), including the Sustainable Energy Initiative (SEI), which aims to make a substantial contribution to lowering carbon emissions and reducing the waste of water and other scarce resources by supporting investments in more resource efficient technologies and renewable energy;
- the Local Currency and Capital Market Development Initiative (LC2), which aims to achieve more efficient and self-sustaining financial intermediation, contributing to economic progress and fostering a more stable financial environment; and
- the Small Business Initiative (SBI), which aims to maximise the Bank's impact on the development of a strong SME sector by ensuring the most effective mix of financing, advisory support and policy dialogue at country level.

47. An integral part of these core competencies and strategic initiatives is the range of the Bank's instruments. Building on the 2014 Medium-Term Directions and in an effort to further improve these instruments, the Bank will give consideration to its risk-taking capacity at the project and portfolio level in pursuing transition impact. Recognising the strong role equity can play in achieving transition impact and its potential as a major source of earnings, the Bank will also strengthen its equity culture, organisation and skills base and improve its investment origination and value creation processes with a view to further developing its equity portfolio as appropriate. These efforts will be guided by the imperative for the Bank to manage its operations and balance sheet in a manner that aims to preserve its triple-A credit rating

48. Additionally, the Bank has made an assessment of new or enhanced opportunities for engagement to maximise transition impact in its region. This assessment resulted in the identification of a set of potential activities, including the expansion of existing activities or the launch of certain new activities. Over the SCF period, the Bank will carefully design and develop these and, with the support of the Board of Directors, build the necessary capacity to gradually roll them out. Work has already started on a number of these. For instance, following the successful pilot project in Ukraine, the Bank is working on developing renewable energy loan facilities in other countries to kick-start renewable generation markets through 'first-of-kind' projects. Under SBI, the Bank is planning to expand its existing risk sharing products to a wider range of its countries and is in the process of developing portfolio risk sharing products. The Bank has also started work on potential credit enhancements for infrastructure projects and is in dialogue with other IFIs on the development of these ideas. More generally, the Bank will continue to adapt its products and financial instruments to the evolving needs of its region over the SCF period in order to maximise its transition impact.

3.3. Priorities for the medium term

49. Over the SCF period, the Bank will implement three priorities that are key for re-energising transition in its countries of operation: building transition resilience, supporting market integration and addressing common global and regional challenges. As outlined in Section 2.2.4 and 3.1.1, the Bank's operational environment is volatile and uncertain, which will require the Bank to be flexible in adapting the implementation of these priorities to developments.

3.3.1 Building transition resilience

50. Among the lessons of recent years is that change in economic structures and institutions is not linear. Progress can be hollow unless built on solid institutional foundations, economic stability and social acceptance. Good governance and inclusive markets create the resilience for reforms to be ultimately successful – i.e. the ability to withstand political and economic stress – and will be key priorities for the Bank.

Governance and policy dialogue

51. The Bank is driving governance reforms primarily through project-level interventions. These include the choice of willing reformers as its corporate partners; due diligence in vetting clients; nomination of independent directors; guidelines on working with publicly exposed persons; integrity and corporate governance checklists; covenants on corporate governance, transparency and IFRS reporting; compliance with the Extractive Industry Transparency Initiative – even for projects in countries that are not signatories to this initiative; strict procurement policy safeguards; and engagement with other MDBs in a programme of cross-debarment.

52. The Bank complements its project-based approach with measures to assist in the establishment of institutional frameworks, including in post-conflict areas, and to achieve broader improvements in economic governance. Through its Legal Transition Programme, it works to create a predictable legal and regulatory environment and transparency. Projects with public sector counterparts often encompass regulatory dialogue. It provides advice and technical assistance on procurement policy in countries that have shown a commitment to reform. The Bank also facilitates the transfer of transition know-how by experienced policy makers and experts from more advanced to less advanced countries of operations. The Bank's strategic initiatives and integrated approaches target policy and institutional improvements through multiple channels.

53. In view of the challenge to re-energise transition, the Bank will step up still further in this area:

- The Bank is building a more structured capacity to conduct policy dialogue, in terms of its strategy, organisation, capacity in the field and skills mix. Country strategies provide the platform for high-level dialogue on the road-map for reform and pull together the Bank's efforts in a results-oriented manner.
- Success requires willing counterparts. The Bank will support committed reformers, at national, regional and local levels – including within difficult broader reform environments – in promoting sound policies and institutions. A critical mass of Bank

investments and a willingness to support private as well as public sector enterprises – where there is evidence of a commitment to reform – will often be crucial for success.

54. A focal point for the Bank's work in this area is its Investment Climate and Governance Initiative (ICGI) which aims to build country-specific institutional frameworks that will deliver lasting impact. Under ICGI, the Bank partners with selected authorities at national or regional levels that demonstrate leadership on reforms, with participation of the business community, civil society, other IFIs and international organisations – each has complementary skills. Under one umbrella, it aims to address project governance, aspects of the business climate, dispute resolution (such as ombudsman functions), procurement standards, public-private dialogue, the legal framework and process transparency. In support of the ICGI, the Bank is further strengthening its toolkit, including the Legal Transition Programme, regulatory and economic expertise and policy function.

Inclusive economic institutions

55. Inclusiveness is key to the efficiency of economic institutions, and it builds legitimacy which makes them resilient. Excluding population groups from access to labour markets, finance, information infrastructure or entrepreneurial opportunity wastes economic resources.

56. For this reason, promoting an inclusive market-based system is at the very heart of the EBRD's mandate. It also responds to the business needs of many of the Bank's clients, who are looking for ways to reach under-serviced population groups and tap under-utilised human resources.

57. The Bank has adopted a strategic gender initiative and a revised approach to inclusion which are helping the Bank to mainstream gender considerations and promote economic inclusion more systematically. Building on its experience, the Bank will prepare a gender strategy before the end of 2015 to further deepen its impact. It will do so in a way that builds on the Bank's core strengths and complements its transition mandate of focusing on systemic change. The approach does not reward projects for particular social outcomes, but for nudging the economic system in the direction of more inclusion. This is based on an analysis of the extent to which economic systems in the region succeed in offering opportunities to women and young adults, and in overcoming regional disparities.

Robust economic structures

58. Resilience is also a matter of economic structure and stability. Economies that are competitive and diverse – in terms of output, finance and ownership – and whose financial sectors are soundly managed are less prone to volatility, and their markets less fragile. There are many ways in which the Bank helps to develop more robust economic structures, sometimes purposefully though more often implicitly.

59. The Small Business Initiative promotes a less concentrated ownership structure and more competitive and "democratic" markets. The Sustainable Energy Initiative reduces dependence on volatile energy markets. The Knowledge Economy Initiative aims to diversify economic activity and strengthen productivity and competitiveness by supporting technological development and value-adding innovation, developing information systems and infrastructure, ensuring the continuity of the financing chain for small innovative companies and improving innovation policies. The Bank works to buttress financial intermediaries against future crises by developing sustainable business models, rebalancing funding, strengthening risk management and helping to tackle non-performing loans. The Local

Currency and Capital Markets Initiative aims at broadening the range of financial instruments and addressing sources of instability. Some of these are recent initiatives which are expected to develop impact in the coming years.

3.3.2 Supporting market integration

60. Economic integration is a powerful force promoting efficient markets and reform. It increases competition in product markets, widens the range of financing sources available for investment, allows countries to opt into institutional arrangements of a high standard, and more generally, acts as a discipline on governance, legal, regulatory and other institutions. The economic crisis of recent years has put some of the region's integration at risk. Helping to revitalise integration is one of the priorities for the Bank in the coming period.

61. The Bank promotes open markets and integration through cross-border financial flows and investment, trade finance, infrastructure, the promotion of skills and standards, policy dialogue and partnerships with institutional investors. It builds on its project and market-led perspective to achieve the wider goal – not a top-down, comprehensive approach for which it lacks the instruments, but concrete and effective in meeting specific challenges.

62. *Financial integration*: A rebalancing of banking systems towards local funding sources may benefit longer-term financial health and stability but should not jeopardise the benefits of integration. The Bank will contribute to a carefully managed process of change, through its leading engagement in the Vienna Initiative, by helping to reshape bank balance sheets, and working to mobilise foreign bank funding through syndication. The Bank also promotes capital market integration and transparency by acting as an anchor investor in corporate bond issues, an area in which there continues to be much scope for innovation in the region.

63. *Investment integration:* Foreign direct investment into the region continues to lag other emerging markets. Governments in the region must redouble their efforts to strengthen the investment climate. The Bank will support these efforts through stepped-up policy dialogue. The Bank will also expand its business development activities, continuing to emphasise its traditional FDI partner countries, systematically approaching potential investors from the advanced transition economies, and targeting new and dynamic markets in Asia and Pacific, the Middle East and the Americas. To this end, the Bank will open offices in 2015 in Washington and Tokyo with representatives who will engage in business development in North America and in Asia. Also in this context, shareholders will be able to provide specific financial support to the Bank for business development activities in their territories.

64. *Infrastructure integration:* Integration, inclusion and growth continue to suffer from a legacy of sub-standard infrastructure that is insufficiently aligned with opportunities and environmental challenges. The Bank will play a supportive role by financing projects and also by promoting high-quality regulation and an appropriate mix of public/private involvement as well as by addressing the need for coordination across borders. For instance, the Bank is a key player in the Western Balkans Investment Framework which coordinates the work of beneficiary governments, European Commission and IFIs in preparing and implementing infrastructure projects that support connectivity among the individual economies in the region. The Bank's recently approved Infrastructure Project Preparation Facility (IPPF) will have an important role by helping to prepare and structure projects. The EBRD will also play its part in supporting, within the parameters of its mandate and the geographic provisions set out in the AEB, the objectives of the European Fund for Strategic Investments (EFSI) and the Global Infrastructure Facility (GIF). The Bank will ramp up efforts to assist its countries in diversifying their energy sources, in particular through better

integration of regional energy markets. To this end, the Bank will support gas and electricity interconnections, gas transportation infrastructure, underground gas storage and power transmission and distribution systems.

65. *Product market integration:* Regional trade suffered sharp falls during the crisis. The Bank has few instruments to target trade directly, though the Trade Finance Programme will remain an important part of its offer. Through the facilitation of public-private dialogue on the benefits of open markets and on trade agreements, the Bank contributes to informed debate on trade-related policies. Through its revised guidelines for the assessment of investments in protected sectors, the Bank takes a stand on trade distortions and highlights the mitigating actions it should seek in order to promote the adoption of welfare enhancing trade liberalisation policies. Furthermore, through capacity building for small businesses seeking to meet technical and public health standards and expanding into foreign markets, the Bank's Small Business Support programme helps to address concrete obstacles to integration. These efforts will continue to grow.

66. *Mobilisation of capital:* While cross-border banking is being held back by deleveraging and regulatory change, financial assets under management by institutional investors such as pension funds and sovereign wealth funds are expanding, as is the share allocated to emerging markets. The Bank's region, however, remains well below potential as a destination for these funds. To address this, the Bank is developing potential partnership structures through which institutional investors would be able to co-invest with the Bank in debt and equity transactions in the region. The Bank will continue seeking opportunities for mobilising long-term investment finance, a core element of the Bank's mandate, and supporting integration of the region into global markets.

3.3.3 Addressing common global and regional challenges

67. Common global and regional challenges are those to which economies contribute individually but whose impact is wider. Markets worldwide fail to produce sustainable outcomes in these areas and the problems are especially acute in the transition region. In parts of the EBRD region, the carbon and resource (energy, water, waste) intensity of output remains among the highest in the world and presents a challenge to energy security.

68. The Bank has built an effective climate change financing model under its Sustainable Energy Initiative (SEI). Under the SEI, the Bank structures client-based, market oriented and financially sound projects and leverages the private sector for financing, project development and implementation capacity as well as innovation. These efforts are supported by a disciplined use of concessional funding and include targeted policy dialogue and technical cooperation activities. With this approach, the Bank has developed a broad range of climate finance products to improve energy efficiency and develop renewable energy with a broad range of private sector clients including large local industries, large industries with foreign strategic sponsors, SMEs, commercial banks, equity funds, project developers, utilities and individual homeowners (through residential energy efficiency lines). This approach has been effectively mainstreamed within the Bank across sectors and countries of activities, and across functional areas deploying an effective mix of investment, technical skills and policy advice. This has been a key factor in scaling up financing and achieving impact. Since 2006, the Bank built an extensive track record of EUR16.4 billion of financing for over 900 climate change mitigation and adaptation projects for a total project value of EUR90 billion. The cumulative annual CO2 emission reduction to be achieved from these projects is estimated at 70 million tons CO2 which is equivalent to the annual emission of a county such as Romania.

With close to two thirds of its climate financing in the private sector, the EBRD is the largest provider of private climate finance among regional development banks.

69. As noted, the Bank's approach to climate financing may provide a compelling model in the context of COP21 and can assist in moderating energy demand and diversifying energy sources, both of which are important for energy security. A key priority of the Bank over the SCF period will therefore be contributing to the advancement of the international efforts in climate change mitigation and adaptation through (1) further ramping up its climate change finance offering in its region, including through a range of new activities both on the demand side, to reduce energy consumption, and on the supply side, to increase the efficiency of production of power generation and reduce losses in transmission and distribution networks; and (2) its knowledge sharing activities with partner institutions.

70. Building on the SEI, the Bank launched the Sustainable Resource Initiative (SRI) at the 2013 Annual Meeting as an umbrella initiative including the SEI and new components designed to promote water efficiency and waste minimisation. The Bank will continue the scaling-up of its activities under the new components during the SCF period.

71. Food security constitutes further significant global challenge, which was cast into sharp contrast by the global food price surge in recent years. In order to address this challenge, the Bank launched its Private Sector Food Security Initiative in 2011, which is implemented in partnership with the Food and Agriculture Organisation (FAO) of the United Nations. Under this initiative, the Bank will continue supporting access to finance across the agribusiness value chain through collateralisation options and credit lines via partner banks, among others, helping to improve policies through public-private platforms and fostering efficient water and energy technologies. Going forward, the Bank will give growing attention to improving food standards and ensuring accountability and traceability, which are crucial for the ability to export into more advanced markets. The Bank will continue enhancing its cooperation with its partner institutions in these activities and food security will be a growing area of focus for the Bank in the medium term.

72. In addition to challenges of a global nature, markets can fail at sub-national and regional levels to produce efficient or sustainable outcomes. This is especially true for environmental impacts on water basins and air quality. The Bank has worked in close partnership with several donor programmes, which support regionally coordinated approaches, to introduce modern environmental management and best available technology primarily through municipal projects. There is more to do, for instance in the Baltic Sea basin, parts of the Mediterranean and Central Asia, and the Bank will remain strongly engaged in this area over the medium term. The Bank will also continue promoting environmental and social standards throughout its region over the SCF period.

3.4. Geographic directions

73. The Bank will manage the level of its operations proactively but flexibly in accordance with its transition criteria, additionality and sound banking. It will take a forward-looking view of operations, with the Board periodically reviewing implementation and guiding management, as appropriate, as more information becomes available.

74. The Bank maintains its strategic orientation to move progressively towards countries and regions within countries that are less advanced in transition, taking account of commitment to the principles enshrined in Article 1 of the Agreement and recognising that

investments are sensitive to the pace and direction of reforms. In particular, the Bank will continue to strengthen its engagement in the Early Transition Countries and the Western Balkans, and it will develop its operations to full potential in the recipient countries of the southern and eastern Mediterranean region.

75. The Bank reaffirms the principle of graduation, as defined in its Graduation Policy, as well as the Post-Graduation Operational Approach. Graduation reflects a successful transition to a well-functioning and sustainable market economy. The main instrument for decision-making on graduation will be the respective country strategies, jointly agreed by the Bank and country authorities. In this light, shareholders expect that country strategies for the EU7 will continue to set the path and indicate a plausible pace of graduation for these countries within the medium term, while recognising that countries face specific circumstances and the economic and political context for transition can be volatile. As the transition becomes still more advanced, the level of activity of the Bank in a country will decrease as a consequence of the fewer market segments in which Bank investments can satisfy its operating principles (transition impact, sound banking and additionality).

3.5. Implementing the priorities

76. Over the SCF 2016-2020 period, the Bank will make enhancements in areas that are crucial for the implementation of its strategic priorities. These include further improvements to the transition impact assessment methodology and results frameworks as well as a review of the transition concept; improvements in the Bank’s internal organisation; further enhancing cooperation with other IFIs and the EU; and building a more programmatic approach to donor funds and the Shareholder Special Fund.

3.5.1 Transition impact and results frameworks

77. As a reform driven, private sector oriented and project-based bank, the EBRD’s transition impact depends on the successful implementation of its projects. For example, the fulfilment of policy covenants and financial performance are important factors in determining the ability of a project to achieve its transition impact potential. In this respect, transition impact of projects is strongly correlated with their financial performance and the transition impact quality of the Bank’s portfolio is a key element of the overall financial performance of the Bank.

78. The Bank continuously aims to enhance its methods for assessing this project-driven transition impact. In this context, the Bank recently approved a new Country Strategy Results Framework (CSRF) in order to establish country strategies as the guiding platform for all of the Bank’s activities and improve the link between these activities and the Bank’s strategic priorities. The Bank will continue strengthening the effectiveness of its results architecture to align objectives across different levels of activities (country, sector and initiative) and in particular, to reinforce the link between thematic strategic priorities in country strategies and transition impact assessment at project level.

79. More broadly, the Bank will review the concept of transition a quarter-century after the fall of the Berlin Wall and after the inauguration of the Bank. The region of operations, the understanding of the transition process and the Bank itself have evolved. Keeping this in mind, the Bank will re-assess the characteristics of an open market economy also taking into account new challenges confronting the Bank’s countries, some of which do not share a history of central planning. The linkage between transition and important public policy

objectives such as social inclusion, resource efficiency and diversification will also be explored. These and other elements will be considered and the Bank's transition methodology and results architecture will be enhanced with the support of the Board of Directors.

3.5.2 Organisational improvements

80. In preparation for new challenges, the Bank has been implementing a strategy of *internal modernisation*. The aim is to ensure that the Bank continues to deliver impact effectively and efficiently in a more complex world. Progress has already been made in areas including modernising the Bank's management culture, streamlining internal processes for greater efficiency, developing innovative products and strengthening the Bank's impact. The Bank will continue implementing this programme, delivering internal improvements in order to maximise its external impact, including reviewing its corporate planning, budget and administrative processes and fostering a cost-conscious culture to closely align resource allocation with priorities. To support this programme, the Bank will enhance its prioritisation discipline and continuously identify possible trade-offs to deploy effectively its resources to priority regions, sectors, and activities through the planning process and in the context of forthcoming SIPs. As part of this, the Bank will ensure that its human resources policies and practices are aligned with the Bank's strategic orientations.

3.5.3 Cooperation with other IFIs and the EU

81. The effectiveness of the Bank's business model depends on the scope and quality of its work with other International Financial Institutions and the European Union in pursuing common objectives.

82. Cooperation with other IFIs and the EU ranges across a broad spectrum of activities, from *operational collaboration* (including and co-investments and joint participation in grant mechanisms) to *policy and strategy* (including high-level platforms such as the Vienna Initiative or country-level coordination on sector reform) and *information exchange and coordination* through formal working groups, platforms, exchanges and consultations both at headquarters and country office levels. MoUs between the Bank and its peer institutions enshrine and give shape to many of these interactions.

83. Economic trends are shifting the development landscape in which IFIs operate. Globally, the role of the *private sector* in development is becoming more prominent with the rise of middle-income countries, which are graduating from MDB concessional lending windows and able to tap into a wider range of financial flows. Reflecting these trends, the UN system is formulating a new set of Sustainable Development Goals (SDGs) to replace the Millennium Development Goals expiring in 2015. The draft SDGs incorporate sustainability, economic growth and industrialisation on top of the traditional anti-poverty goals. The associated Financing for Development track gives increased prominence to private sector mobilisation.

84. In this context, the EBRD's comparative strengths, such as its project work with the private sector, its promotion of commercial approaches in the public sector, its direct support for SMEs as well as its unique skills in engaging the private sector in climate change mitigation, are relevant. Fellow development finance institutions are adapting their business models to enhance private sector lending capacity and new institutions for development finance are emerging.

85. In order to be able to better address the challenges its countries are facing, the Bank will work towards enhancing its cooperation and skill sharing with other institutions, in traditional as well as innovative ways, to better leverage each institution's strengths. It will seek platforms that facilitate exchanges of talent and expertise in order to ensure that these strengths can be deployed across the multilateral system.

3.5.4 Donor partnerships and Shareholder Special Fund

86. Donor support and access to grant funds is an integral part of the Bank's business model and have become crucial to achieving many of the Bank's priorities. Over a third of the Bank's investment operations are now supported by a grant component and many initiatives rely on access to grant funds. The Bank's partnership with its donors has deepened considerably over time, reflecting an alignment between donor priorities and the Bank's operations and continued donor interest in the Bank's unique private sector focused business model. The Bank's donor portfolio has also evolved with a gradual shift towards more multilateral funding in recent years.

87. The importance of donor partnerships is set to grow further. The Bank's efforts to re-energise transition over the next five years call for more upstream engagement through policy dialogue and institutional capacity-building to target relevant systemic challenges highlighted in the Bank's country and sector strategies. This will require access to even greater volumes of grant resources, through donor funds as well as the Shareholder Special Fund, on more predictable and flexible terms. At the project level, the Bank will continue to direct its use of TC and non-TC grant funds where such grant funds can add most value by intensifying transition impact.

88. In order to broaden the Bank's donor base and meet its growing grant needs, the Bank will explore new ways of working with its existing donors and reach out to potential new donors, including private sector companies, foundations and newer development actors. To foster further flexibility, the Bank will implement the CRR4 decision to work only with untied aid as of 2016, which will bring the Bank in line with international best practice and the approach of other IFIs/ MDBs.

89. The Bank will also aim to develop an efficient and effective funding architecture that can source funds in a more programmatic way towards clear transition priorities, strategic objectives and expected results. To achieve this, the Bank will gradually and over time seek to replace the current fragmented landscape of funds with fewer and larger thematic and regional multi-donor funds that can offer access to both predictable and flexible funding at scale, in support of its key priorities. Seeking an optimal mix of such funds with continued access to bilateral funding – enabling rapid, targeted and flexible solutions - will be of crucial importance.

90. The Bank will continue to reform its grant management systems and procedures to bring them into line with its planning and reporting processes and to ensure greater efficiency through more standardisation and simplification of fund rules and governance. Other reforms, such as the development of a new IT platform, will also help to increase efficiency and reduce costs. The Bank will further improve its results reporting and donor visibility to provide greater transparency and assurance that donor resources are being deployed effectively. It will also engage actively with its international peers, partners and donors in shareholder capitals as well as in its countries of operation.

91. These improvements of donor funds management will be supported by a larger and more efficient Shareholder Special Fund, which will also strive to support the Bank's activities in a more programmatic way, through multi-year allocations aligned with the Bank's budget planning process and focused on the Bank's key strategic themes and regions.

4. Capital review

92. The Board of Governors are required under Article 5.3 of the AEB to review the Bank's capital stock at least every five years. The last such capital review was within the 'Fourth Capital Resources Review 2011-2015' (BDS10-020 (Final)) ('CRR4')) that was approved by the Board of Governors in May 2010. This review of capital resources is based on an assessment of the Bank's potential capital capacity for 2016-2020 – the 'Capital Capacity Analysis' – for the implementation of the Bank's Medium-Term Directions.

93. The Capital Capacity Analysis is a top down assessment providing a range of operating assets net of accumulated specific provisions that could potentially be sustained by the Bank's capital base in the medium term. For that purpose the future accumulation of capital is projected assuming certain prudent levels of annual realised profits (after accumulated specific provisions) as a percentage of the Bank's members' equity.

94. Based on a growth in members' equity ranging between 4.0 per cent and 6.0 per cent, the Bank's available economic capital base is projected to increase from EUR15.0 billion at the end of 2014 to between EUR18-20 billion by the end of 2020. Under the same assumptions the Bank's statutory capital base, including an assumed unchanged EUR23.5 billion of callable capital and excluding accumulated specific provisions, is projected to increase to between EUR42-44 billion by the end of 2020.

95. The Bank manages its capital adequacy based on:

- statutory capital utilisation, under Article 12.1 of the AEB, within a 92 per cent prudential threshold; and
- economic capital utilisation, under the Bank's Economic Capital Policy, within a 90 per cent prudential threshold.

96. These thresholds will form the capital control parameters to be approved by the Board of Governors for the 2016-2020 strategy period, as discussed in section 5.2.

97. The Bank's statutory capital utilisation ratio has been adjusted going forward, to present both operating assets and the statutory capital base as being net of accumulated specific provisions, (with no change to the absolute amount of available headroom). This change is made to be consistent with the Capital Capacity Analysis approach described in this paper; see 'Adjustment to the Interpretation of the Gearing Ratio' (BDS15-018).

98. The Capital Capacity Analysis has been made on the basis of no redemption of the callable capital share increase approved in May 2010 pursuant to Resolution 128 of the Board of Governors; see 'Report of the Board of Directors to the Board of Governors on Callable Capital Redemption' (BDS15-14).

99. Based on the projected growth in the Bank's capital base, it is estimated that a maximum level of operating assets net of accumulated specific provisions of around EUR38-40 billion could be supported at the Bank's prudential capital thresholds by the end of 2020. This represents a potential for an increase of around 50 per cent from the actual exposure of EUR26.1 billion (net of accumulated specific provisions) at the end of 2014.

100. This indicative *maximum* level is based on a high-level set of assumptions. It is, however, important to recognise that:

- The maximum level capacity is a pure indication of possible capacity under certain assumptions and does not constitute a target, an objective or a business plan. The maximum level of operating assets within the Capital Capacity Analysis will not represent a 'cap' or limit.
- Based on the assumptions within the Capital Capacity Analysis, the maximum sustainable level of annual Bank investment is assumed to grow over the strategy period, although this is dependent on factors such as the product mix and tenor of activity, as well as the performance of the Bank's portfolio.
    - The Bank's actual capital base may increase to a higher level than the prudently projected range in the analysis.
    - Conversely, the Bank's actual capital capacity may be lower than the indicative projections. In particular, capital capacity may be reduced in the case of a significant shock or stress event leading to debt impairment and reductions in the valuations and exit prospects of the Bank's equity investments at levels higher than those built into the assumptions here.
- As of early 2015, the Bank's operating environment remains volatile. Economies globally and a number of the Bank's countries of operations continue to face turbulence which dampens growth expectations. Major geopolitical factors pose further downside risks. These factors present significant challenges both for the Bank's region and for the Bank's new operations, portfolio and financial sustainability, requiring a balanced and prudent approach to implementation consistent with the preservation of the Bank's triple-A credit rating.
- The Bank's Strategy Implementation Plans (SIPs) allow the Board of Directors to assess the adequacy of the Bank's capital base on an annual basis, consider the planned utilisation levels for the following three years and establish, if necessary projected operating asset levels that are below the maximum levels indicated by the Capital Capacity Analysis. Should circumstances change, the Bank will respond by adjusting levels of Annual Business Investment through its Strategy Implementation Plans,, for each following year, that are appropriate to face the then prevailing business and risk environment, preserve compliance with its capital policies and remain prudently within the Bank's maximum capacity.

101. In addition to the Bank's own investment in operations, the Bank will continue to pursue mobilisation of funds from other investors, leveraging its investment and supporting wider access to finance in its countries of operations. This includes, in addition to the traditional loan syndication mechanisms, potential partnership structures through which institutional investors, such as pension funds and sovereign wealth funds, can co-invest with the Bank in debt and equity transactions in the region. These activities will further supplement the Bank's capacity to pursue its mandate.

102. Based on the analysis presented in this paper, the Board of Directors considers that the Bank's projected capital stock is appropriate for the period to the end of 2020. A draft Resolution of the Board of Governors is presented in Annex 3.

103. It is recognised that the Bank's capital adequacy needs to be managed in a sustainable and prudential manner over the medium term by the Board of Directors through annual

Strategy Implementation Plans, without pre-judging any decision of the Board of Governors regarding future reviews of the Bank's capital resources.

4.1 Methodological approach

104. The Capital Capacity Analysis for 2016-2020 derives a range of operating assets net of accumulated specific provisions based on projected capital. This provides a frame within which capital adequacy projections based on operational objectives will be made in SIPs.

105. The Capital Capacity Analysis presents prudently assumed capital growth and a range of operating assets that could be sustained with this capital. This analysis is based on assumed rates of growth of members' equity over the medium term. Such assumed growth depends on the mix of products in the Bank's portfolio, the assumed financial return on those products and the ratio of potential levels of operating assets to members' equity ('leveraging' of those assets).

106. The projected range of operating assets within the Capital Capacity Analysis represents operating assets net of accumulated specific provisions. The supporting available economic capital base also excludes accumulated specific provisions (but includes general portfolio provisions). Together with assumptions regarding product mix in the Bank's portfolio, this enables the capacity for equity exposures and debt exposures not covered by specific provisions to be estimated, based on the parameters of the Economic Capital Policy as well as the statutory capital utilisation measure.

4.2 Capital utilisation and capital capacity trends

107. The development of the Bank's actual and projected operations and capital utilisation at planning rate is presented in table 4.1. Operating assets have increased from EUR18.6 billion at the end of 2009[4] to a projected EUR27.5 billion at the end of 2015[5]. Including the callable capital increase that became effective in 2011, the Bank's statutory capital base increased from EUR26.3 billion in 2009 to EUR39.9 billion projected by the end of 2015. Statutory capital utilisation is projected at 68 per cent under the revised basis at the end of 2015.

108. Economic capital utilisation has increased from 67 per cent in 2009 to a projected 79 per cent in 2015, reflecting both growth in the Bank's balance sheet and changes in the Economic Capital Policy, including the impact of the 2014 review of the Policy.

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4 At the planning rate of $/€ 1.30. This exchange rate assumption used for planning purposes is regularly reviewed by the Board of Directors.

5 Based on the middle of the range of operating assets growth in the 2015 Business Plan and Budget (BDS14-286 (Final).

Table 4.1: Operational and capital utilisation trends 2009-2015

At planning rate €billion (other than percentages)	2009 Actual	2010 Actual	2011 Actual	2012 Actual	2013 Actual	2014 Actual	2015 Proj'n
Annual Bank investment	8.2	9.1	9.0	9.0	8.7	8.7	8.3
Portfolio	26.5	30.9	34.8	37.7	38.4	38.1	39.4
Operating assets at cost (prior to accumulated specific provisions)	18.6	21.5	24.7	26.6	26.8	26.7	27.5
Statutory capital:							
Prior to specific provisions	26.1	27.1	35.3	37.4	38.4	38.5	38.9
Accumulated specific provisions	0.2	0.2	0.3	0.3	0.4	0.6	1.0
Total statutory capital	**26.3**	**27.3**	**35.5**	**37.7**	**38.8**	**39.1**	**39.9**
Statutory capital utilisation:							
- As reported	71%	79%	70%	71%	69%	68%	n/a
- Revised basis (1)	70%	78%	69%	70%	69%	68%	68%
Economic capital:							
Required economic capital	7.7	8.6	9.9	10.4	10.9	11.8	12.2
Available economic capital	11.5	12.5	13.1	14.0	15.0	15.1	15.4
Economic capital utilisation (2)	67%	69%	76%	74%	73%	79%	79%

(1) Based on both operating assets and statutory capital net of accumulated specific provisions (See 'Review of the Gearing Ratio Interpretation' (BDS15-018)).
(2) Economic Capital Policy was introduced in 2009 (see BDS09-219 (Final)) and reviewed in 2013 (see BDS13-143) and in 2014 (see BDS14-267).

4.3 Indicative capital growth

109. The Capital Capacity Analysis is based on assumed realised returns (in line with the established planning approach), excluding potential variations in equity fair values. Such assumptions incorporate reasonable levels of prudence regarding prospects for capital growth over the medium term.

110. A range of growth of members' equity is assumed between 4.0 per cent and 6.0 per cent for 2016-20. In addition, assumptions are made regarding net income allocations to the EBRD Shareholder Special Fund (SSF). The 4.0 per cent represents a prudent basecase, whereas the 6.0 per cent assumption illustrates the potential for returns exceeding the prudent basecase (see Annex 2).

111. For the Capital Capacity Analysis period 2016-2020, the projected aggregated growth in the realised income after specific impairment (before net income allocations) based on the above range is EUR3.3 billion and EUR5.2 billion. This compares to actual capital growth on the same basis of EUR5.0 billion in the CRR3 period (2006-2010) and EUR3.7 billion in the CRR4 period (2011-2015). The assumptions on capital growth are examined in Annex 2. Furthermore, it should be noted that equity returns are sensitive to the exchange rates underpinning equity valuations compared to the Bank's capital base in euro.

112. Based on the assumed range of growth of members' equity and assumed net income allocations to the SSF over the period, table 4.2 presents the projected statutory and economic capital bases growing to around EUR42-44 billion and around EUR18-20 billion respectively by 2020.

Table 4.2: Statutory and economic capital bases

€ billion	2013 Actual	2014 Actual	2015 Budget	2016 Indicative	2017 Indicative	2018 Indicative	2019 Indicative	2020 Indicative
Statutory capital base (1)								
4.0% growth - base case assumption								
Available economic capital	**14.9**	**15.1**	**15.4**	**15.9**	**16.4**	**17.0**	**17.6**	**18.2**
Callable capital (2)	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5
Statutory capital	**38.4**	**38.5**	**38.9**	**39.4**	**39.9**	**40.5**	**41.0**	**41.7**
6.0% growth - upside sensitivities								
Available economic capital	**14.9**	**15.1**	**15.4**	**16.2**	**17.1**	**18.0**	**19.0**	**20.0**
Callable capital (2)	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5
Statutory capital	**38.4**	**38.5**	**38.9**	**39.7**	**40.5**	**41.5**	**42.4**	**43.5**

(1) Excludes accumulated specific debt provisions.

(2) €8.9 billion out of the €9.0 billion callable capital has been subscribed as at end 2014.

4.4 Capital capacity

113. The Bank’s illustrative capital capacity over the period 2016-2020 is assessed based on the projected range of capital and the prudential thresholds for statutory and economic capital utilisation. Either of these capital utilisation limits may provide the effective constraint to the Bank’s exposure at any point in time.

114. *Statutory capital capacity* is less sensitive to the growth in the Bank’s reserves:

- Given the 1:1 gearing in the statutory capital limit and the 92 per cent prudential threshold, each EUR1 billion of additional reserves would support EUR0.92 billion of additional net operating assets.
- Any growth in reserves has a relatively low proportionate impact on statutory capital given the EUR23.5 billion of callable capital.

115. The statutory capital utilisation ratio reflects both operating assets and capital base net of accumulated specific provisions and is ‘invariant’ in the short term to changes in impairment levels. The potential increase in impairment and therefore the specific provisions has no impact on the available headroom in absolute terms as both operating assets (numerator) and capital base (denominator) would be reduced by the accumulated specific provisions; reflecting that ‘100 per cent capital’ has already been set aside. The resulting impairment would initially lower reflows and eventual write offs lower capital with an impact on the potential new business activity that the Bank could support.

116. *Economic capital capacity* is more sensitive to the level of the Bank’s reserves, supporting strong potential growth in operating assets, but it is also more sensitive to shocks/ stresses. For example, based on the current operational product mix, every EUR1 billion increase in reserves could support around an additional EUR2.3 billion in net operating assets (compared to the additional EUR0.92 billion operating assets under the statutory capital constraint).

117. The analysis of the economic capital capacity is based on a pro rata scale up of the 2014 balance sheet in terms of product mix and level of undrawn commitments. Actual equity share of total operating assets was 23 per cent as at the end of 2014. This share has reduced slightly from 25 per cent in the earlier years 2009 to 2012, and 24 per cent in 2013.

118. The Bank's capital capacity is sensitive to a number of key operational and financial variables which will be reviewed in the SIP documents. One of the variables that could have a significant impact on the capital capacity is the product mix. In this regard, given the uncertain economic environment in the region and the Bank's equity share reducing in the last two years, the Capital Capacity Analysis presents economic capital utilisation with a sensitivity analysis based on the equity stock at 20 per cent of total operating assets and exposure to other products being proportionately scaled up.

4.5 Overall capital capacity

119. Table 4.3 presents capital capacity in terms of maximum operating assets net of accumulated specific provisions based on the statutory and economic capital utilisation thresholds.

Table 4.3: Capital capacity under statutory and economic capital utilisation bases

€ billion	2013 Actual	2014 Actual	2015 Budget	2016 Indicative	2017 Indicative	2018 Indicative	2019 Indicative	2020 Indicative
Statutory capital basis (at 92% threshold)								
4.0% capital growth - base case assumption								
Implied maximum Banking operating assets*	35.3	35.4	35.8	36.2	36.7	37.2	37.8	38.3
6.0% capital growth - upside sensitivities								
Implied maximum Banking operating assets*	35.3	35.4	35.8	36.5	37.3	38.1	39.1	40.0
Available economic capital basis (at 90% threshold)								
4.0% capital growth - base case assumption								
Implied maximum Banking operating assets*:								
- Equity at 23% of operating assets (current mix)	30.8	31.0	31.8	32.9	34.2	35.4	36.7	38.1
- Equity at 20% of operating assets				35.1	36.4	37.8	39.2	40.7
6.0% capital growth - upside sensitivities								
Implied maximum Banking operating assets*								
- Equity at 23% of operating assets (current mix)	30.8	31.0	31.8	33.6	35.6	37.7	40.0	42.3
- Equity at 20% of operating assets				35.9	38.0	40.3	42.6	45.2

** Presented as net of accumulated specific provisions.*

120. Statutory capital capacity in terms of maximum Banking assets is based on the projected capital base growth (range of 4.0 per cent to 6.0 per cent) and a limit of 92 per cent statutory capital utilisation, resulting in a range of around EUR38 to EUR40 billion of maximum net operating assets by end 2020.

121. By contrast, economic capital capacity could support a potential EUR38-42 billion of operating assets by end 2020, increasing to EUR41-45 billion based on an illustrative decrease in the share of equity operating assets to 20 per cent.

122. Regardless of which policy provides the lowest boundary at any point in time, the Bank has capacity to deliver on its Medium-Term Directions, barring very significant stress events in which case the Bank would respond by adjusting its business plans in SIPs.

4.6 Sensitivity analysis

123. As illustrated above, the capital capacity is sensitive to the assumption on growth of members' equity and product mix (including the level of disbursed assets relative to undrawn commitments). Also, the Capital Capacity Analysis is an illustration at a high level, with operational, financial and capital planning detail being developed in the SIP documents.

4.6.1 Capital sensitivity

124. It is important to recognise that the capital base of the Bank remains at risk from a potential shock or stress that could significantly reduce the Bank's capital capacity, primarily in economic capital terms. A potential capital loss of EUR1 billion, which is broadly equivalent to around 7 per cent of the Bank's current available economic capital base, has been taken into account for illustration purposes. The assumed growth of members' equity of 4.0 per cent in the five year period 2016 to 2020 is equivalent to EUR3.3 billion. Based on this assumption, a loss to capital of EUR1 billion would be equivalent to reducing the growth in members' equity assumption to 2.8 per cent.

125. The maximum net operating asset capacity projected for 2015 is EUR35.8 billion under the statutory capital basis with available headroom of EUR8.3 billion compared to the 2015 net operating asset projection of EUR27.5 billion (net of accumulated specific provisions). By reducing the capital base by EUR1 billion in 2015 as a result of the illustrative one-off shock, the available headroom to the prudential threshold would reduce by EUR0.9 billion to EUR7.4 billion when compared to the 2015 net operating asset projection.

126. Similarly, a one-off reduction of EUR1 billion in the Bank's capital base would significantly decrease capital capacity under the economic capital basis. In this case, the projected available capital capacity headroom of EUR4.3 billion in 2015 would be reduced by EUR2.3 billion to EUR2.0 billion when compared to the 2015 projection of EUR27.5 billion. Capital capacity under the economic capital basis[6] would be lower than the capital capacity under the statutory capital utilisation basis throughout the five year period from 2016 to 2020, with illustrative maximum net operating assets of EUR35.3 billion by the end of 2020. In addition, the Bank is facing volatility in fluctuations of equity valuations in any given year.

127. In conclusion, while the assumptions on capital accumulation during the SCF period are important, the maximum Operating Assets capacity would not change materially, even in the event of a stressed assumption of 2.8 per cent annual growth in members' equity.

[6] Based on end 2014 portfolio mix.

4.6.2 Exchange rate sensitivity

128. The planning rate reflects a constant exchange rate assumption for the planning period to provide a consistent basis for projections and analysis of historic trends of the Bank's portfolio, capital utilisation and headroom. The appropriateness of the planning rate is reviewed on an annual basis under the governance of the Board of Directors. The Bank originally introduced the planning rate in 2003 based on an exchange rate of EUR/ USD1.15. The planning rate was subsequently adjusted to EUR/ USD1.30 in the context of the 2008 Business Plan and Budget (BDS07-206 (Final)). There have been temporary fluctuations of the actual rate from the planning rate since 2008; however the planning rate remains at EUR/ USD1.30.

129. The Bank's overall balance sheet is hedged, with the Banking portfolio being matched by Treasury in terms of currency. However for the purposes of calculating the capital utilisation ratios, Banking exposure (in currencies) is managed against the Bank's capital base (in euro) and so the Banking exposure is unhedged in this instance. Any temporary exchange rate fluctuations from the planning rate are absorbed within the prudential buffer inherent in the capital utilisation thresholds.

130. The capital capacity is presented in euros. To the extent that the Bank's planning rate is adjusted from the current level of EUR/ USD1.30, this would mean that a higher or lower level of equivalent loan investments denominated in US dollars could be supported by the Bank's capital. As such, the planning rate does not affect the net operating asset capacity presented. However, in practice the strengthening of the US dollar reflected in the planning rate would have a negative impact on the capital utilisation ratios and headroom to the prudential thresholds.

131. To illustrate this sensitivity, potential impact of exchange rate fluctuation is based on the actual operating assets of EUR26.7 billion at the end of 2014 and based on the current share denominated in US dollars in the Bank's operating assets (based on 2014 portfolio mix).

- A depreciation of euro against US dollar from EUR/ USD1.30 to EUR/ USD1.20, for example, is estimated to result in an increase of around 3 per cent on the current level of operating assets.
- A further shift of the rate to EUR/ USD1.10 would represent a 6 per cent increase of operating assets.

5. Control framework parameters

132. The control framework of the SCF consists of parameters for transition, capital and resource efficiency. These control parameters focus on the mandate of the Bank and its financial sustainability and provide the framework within which the strategic orientations of the SCF will be implemented. Accordingly, these parameters in the SCF will be interpreted by the Board of Directors in the context of the annual Strategic Implementation Plans.

5.1. Transition control parameters

133. In order to improve incentives for maximising expected transition impact and increasing the focus on the post-investment success of projects, the Bank replaced the threshold for "good" and "excellent" rated projects with an Expected Transition Impact (ETI) measure and the floor level for the average rating under the transition impact monitoring system (TIMS) with a Portfolio Transition Impact (PTI) measure. The 2014 Business Plan and Budget (BDS13-244) approved by the Board of Directors in December 2013 formally set, for the first time, floor levels for the new indicators of transition impact: ETI and PTI.

134. As the Bank's projects will remain the key building blocks of its transition activity, the SCF transition control parameters are based on these two measures. The SCF sets the floors levels for ETI and PTI with an aim to strike the right balance between the transition quality of projects and the size of the Bank's engagement necessary for impact. Keeping these minimum levels in mind, the Bank will nevertheless maintain a high level of ambition for its transition impact over the SCF period, as it has done in the past, and reflect its level of ambition in the ETI and PTI floor levels which will be set in the context of the annual corporate scorecards in SIPs.

135. Additionally, during the SCF period, the Bank will track the success ratio of technical cooperation projects, the level of which will be set in the context of the annual corporate scorecards in SIPs, and the performance of its strategic initiatives included in the corporate scorecard.

5.1.1 Expected Transition Impact

136. Expected Transition Impact (ETI) includes both the transition impact potential and the risk of not achieving that potential as a combined score to better reflect the available information at each point in time on the likely ultimate transition impact of a project.

137. 2014 and 2015 Business Plan and Budget established a floor value of 60 for the average ETI of new projects approved during the year. The ETI of the Bank's new projects since 2009 has been within a range of 61 to 65 and stood at 65.3 at the end of 2014 (preliminary results).

138. To maintain the same high standards for project quality-at-entry, the ETI floor level for the SCF 2016-20 period is set at 60.

5.1.2 Portfolio Transition Impact

139. Portfolio Transition Impact (PTI) is the average ETI score of the active portfolio, defined as the stock of rated projects as of 1 January of the year and including projects that exit the portfolio during the year. It excludes the new inflow of projects signed during the year as these are covered by the ETI inflow measure.

140. Portfolio transition impact potential is a less volatile measure than ETI due to stock effect, since the risk to transition impact potential decreases in time as projects are implemented and as transition benchmarks are achieved.

141. The 2014 and 2015 Business Plan and Budget established a floor value of 65 for the PTI of the active portfolio. The PTI since 2009 has been within a range of 66 and 71 and stood at 66.5 at the end of 2014.

142. The PTI floor level for the SCF 2016-20 period is set at 65.

5.1.3 Strategic initiatives

143. Strategic initiatives are those covered in the Bank's corporate scorecard and encompass cross-cutting activities of the Bank spanning various sectors and addressing specific but significant transition gaps. They include projects as well as strong policy dialogue and capacity building elements. While projects falling under these initiatives will continue to be included in ETI and PTI assessments individually, operational parameters and, where relevant, outcome and impact parameters of these initiatives are covered under their dedicated performance frameworks.

144. The progress of the Bank's strategic initiatives will be monitored within the context of the Bank's corporate scorecard and institutional performance reports. These strategic initiatives are expected to be on track against their respective performance frameworks during the SCF period.

5.1.4 Technical cooperation

145. Technical cooperation (TC) is an important element of the Bank's activities and is a significant contributor to transition impact. As of July 2013, a matrix specifying results in terms of outputs and outcomes is required for all TC projects. The results matrix is used to monitor implementation progress at least annually and assess achievement of results at completion. This approach permits aggregation of individual TC results into an overall TC success ratio, which was first introduced in the 2014 Business Plan and Budget. During the SCF period, the Bank will track the progress of the TC success ratio, the level of which will be set in the context of the annual corporate scorecards in SIPs.

5.2. Capital control parameters

146. The Bank manages its medium-term capital adequacy based on:

- statutory capital utilisation (ratio of net operating assets divided by statutory capital); and

- economic capital utilisation (required economic capital divided by available economic capital).

147. The maximum levels of these established metrics are set at prudential thresholds under the Bank's financial policies and these thresholds are maintained for the SCF period:

- 92 per cent for the statutory capital utilisation; and
- 90 per cent for economic capital utilisation.

148. Section 4.2 reviews actual trends in statutory and economic capital utilisation.

149. The Bank's Economic Capital Policy is reviewed annually by the Board of Directors. The Policy aims to ensure that the Bank's capital is managed in a way consistent with AAA principles, preventing a need to call capital. The policy establishes a methodology for estimating required economic capital for each of the risks the Bank bears and captures external factors (rating agency approaches and capitalisation standards in the market).

150. The assessment of the medium-term capital sustainability of operational plans, including the annual Business Plan, will be included in the SIPs. If, in the third year of any SIP, capital utilisation is projected to be very close to one of the SCF capital utilisation thresholds, it will be appropriate to make a high level roll forward assessment of indicative capital utilisation beyond the three year planning horizon to better assess the dynamics of the portfolio and capital needs.

5.3. Resources

151. Recognising the need for flexibility in resource management to be able to respond to a highly dynamic operating environment, the SCF introduces relative parameters that establish a resource control framework rather than a specific resource allocation plan (based on absolute resource parameters (maximum headcount and real budget growth):

- Cost to Income ratio
- Staff Cost to Total Cost ratio

152. The objective of these control parameters is to ensure financial sustainability by supporting long term profitability before impairments while supporting the Bank's underlying strategy of transition and financial flexibility by limiting the portion of the more rigid staff costs to total costs.

5.3.1 Cost to Income ratio

153. The Cost to Income ratio is a commonly used industry standard metric, which provides an understanding of how efficient the cost base of an organisation is relative to its income stream.

154. The components of the ratio are:

- costs as the numerator, representing total operating expenses, retirement plan costs and depreciation
- gross income (realised profit before impairment, excluding movements in the fair value of Banking investments, and prior to costs) as the denominator.

155. Impairment is excluded from the denominator to preserve consistency with industry best practice and is in line with the corporate scorecard and the methodology for deriving the size of the performance based compensation (PBC) pool. In addition, including impairment could be counterproductive in a situation of heightened risk when debt recovery and risk management capabilities could increase, hence requiring more funding in a scenario of higher impairments.

156. The Cost to Income ratio is calculated using a five year rolling average for both the numerator and denominator. This methodology aims at reducing the volatility of the ratio and not discouraging investments in activities that have a time lag to generate income.

5.3.2 Staff Cost to Total Cost ratio

157. The Staff Costs to Total Costs ratio is a derivation of a commonly used industry standard known as the 'compensation ratio'. This ratio provides the highest level of transparency by reporting all staff costs (irrespective of contractual basis), therefore eliminating any ambiguity surrounding the definition of 'headcount'. The numerator, staff costs, includes all:

- salaries
- benefits
- short term contractor or agency staff costs
- performance based compensation costs.

158. In the denominator, the total costs definition is consistent with the treatment in the Cost to Income ratio. The Staff Costs to Total Cost ratio is also calculated using a five year rolling average for both the numerator and denominator.

159. Both Cost to Income and Staff Costs to Total Cost parameters are useful in isolation but become even more powerful when considered together as they establish linkages among different types of costs (namely the right balance between staff costs which are rigid by nature and the overall cost base of the Bank) and the financial sustainability of the Bank. Together, these parameters will promote a culture focused on efficiency while still enabling the delivery of the Bank's mandate.

160. It should be noted that costs include the impact of inflation. This is a development from the way costs have been governed historically (in real terms growth) and will further tighten the scrutiny over costs increases.

161. The recommendation to use these two parameters was reached after extensive analysis to understand how the Bank would have performed by:

- applying shocks to income and costs to understand how the Bank would have performed under these scenarios;
- understanding how the Bank performed relative to a peer group; and
- considerations for how these metrics could impact decision making to support the Bank's strategy.

162. On the basis of this analysis and the Bank's current business model, strategy and activities, the prudential resource efficiency control parameters are set at the following levels for the period of 2016 – 2020:

- Cost to Income ratio at a maximum of 33 per cent on the basis of a five year rolling average
- Staff Cost to Total Cost ratio at a maximum of 70 per cent on the basis of a five year rolling average.

163. This resource control framework will support the pursuit of cost efficiency, while not dis-incentivising investments that generate revenues with a time lag and activities such as policy dialogue or technical cooperation.

164. Actual decisions on resource levels and allocation will be made in SIPs with details for the first year and higher level orientations for the remaining two years.

165. The Bank will ensure that its human resource policies and practices will enable it to apply the above ratios and will report over the SCF period as necessary on developing trends.

Annex 1: Further details on the Bank's record to date in the CRR4 period

A1.1 Transition and operational assessment

166. The focus on quality during the CRR4 period is reflected in the high level of transition impact of new projects and the project portfolio. The share of new projects rated 'good' and 'excellent' for transition impact has been consistently around 90 per cent during the period 2011 to 2014. Reflecting the complex operating environment post-crisis, the share of new projects with high risk to transition impact varied between 76 per cent and 79 per cent during this period. The expected transition impact (ETI) of the Bank's new projects averaged 64 and the portfolio transition impact (PTI) averaged 67 between 2011 and 2014. The consistently high PTI demonstrates the resilience of the impact achieved during implementation in spite of the risks.

Table A1.1: Transition impact 2011-2014

	2011	**2012**	**2013**	**2014**	***2011-2014 avg***
New projects					
ETI	64.7	63.7	63.2	65.3	*64.2*
Share of Good/Excellent TI	91%	92%	91%	89%	*91%*
Share of High TI risks	76%	78%	79%	76%	*77%*
Portfolio					
PTI (start-year)	67.6	66.5	66.5	66.5	*66.8*
PTI (end-year)	67.2	67.2	67.0	67.8	*67.3*

167. The following operational results were achieved in the CRR4 region during the period 2011 to 2014:

- Cumulative annual Bank investment of EUR33.6 billion or 96 per cent of the EUR35 billion CRR4 envelope;
- 1,788 portfolio operations by end-2014 compared with the CRR4 projection of 1,784;
- Cumulative disbursements of EUR24.3 billion or 89 per cent of projected disbursements for the CRR4 region;
- Cumulative reflows, including repayments, divestments and prepayments, of EUR21.8 billion compared to the CRR4 projection of EUR20 billion;
- A CRR4 region portfolio of EUR36.3 billion compared to the CRR4 projection of EUR42.9 billion due to lower than projected disbursements and higher than projected reflows;
- Operating assets of EUR26 billion compared to the projected level of EUR31.1 billion, for the same reasons;
- In terms of the geographic composition of the portfolio at end-2014:
  - the shares of Central Asia and Eastern Europe and Caucasus were in line with the projected CRR4 share;
  - the share of Russia was lower than projected reflecting slowing economic growth in recent years, high reflows in the period 2010 to 2013 and the impact of Board guidance on new operations in July 2014;

- the share of South Eastern Europe, Central Europe and the Baltics was higher than projected reflecting the support needed in the advanced transition economies as the fragility of some of the earlier reforms was revealed by the crisis;
- the share of Turkey was also higher than projected given the strong build-up of the Bank's operations in the country as annual Bank investment increased 57 per cent from EUR900 million in 2011 to EUR1.4 billion in 2014.

- In terms of sector composition, the share of operating assets in the financial sector decreased from 32 per cent at end-2010 to 28 per cent at end-2014 while the share of the corporate sector increased from 30 per cent to 31 per cent during the same period, both in line with the CRR4 orientations.

Table A1.2: Portfolio composition 2011-2014

	2011		2012		2013		2014		2015	
	Act.	**CRR4**	**Act.**	**CRR4**	**Act.**	**CRR4**	**Act.**	**CRR4**	**BP**	**CRR4**
Central Asia	8%	8%	8%	8%	8%	9%	8%	9%	8%	10%
Eastern Europe and Caucasus	19%	19%	19%	20%	19%	20%	21%	21%	20%	21%
South-Eastern Europe	24%	22%	24%	21%	24%	20%	24%	19%	23%	19%
Central Europe and Baltics	18%	17%	17%	15%	17%	13%	17%	11%	16%	10%
Russia	27%	31%	27%	31%	24%	32%	19%	32%	19%	32%
Turkey	4%	4%	7%	5%	9%	7%	11%	8%	14%	9%

A1.2 Financial assessment, capital utilisation and resource framework implementation

168. Table A1.3 presents the Bank's realised profit[7] before and after specific impairment for the period 2011-2014 compared to CRR4 projections. The aggregate realised profit before impairment for the period 2011-2014 was EUR4.0 billion compared to EUR4.5 billion projected in CRR4 for the same period. After taking specific impairment of EUR0.6 billion into consideration for the same period, aggregate realised income was EUR3.4 billion, or EUR0.4 billion lower than the EUR3.8 billion projected in CRR4. Within this, lower realised equity returns of around EUR0.7 billion were offset by EUR0.7 billion higher Banking debt returns. Overall, the lower than projected net income was driven by lower interest returns on the Bank's capital, partially offset by higher Treasury operating income.

Table A1.3: Realised profit[7] before and after specific impairment relative to CRR4 period

€ billion	2011	2012	2013	2014	Aggregate 2011-2014
Realised profit before specific impairment					
Actual	0.9	1.0	1.2	0.9	**4.0**
CRR4	0.8	1.2	1.3	1.2	**4.5**
Realised profit after specific impairment					
Actual	0.9	0.9	1.0	0.6	**3.4**
CRR4	0.5	1.0	1.2	1.1	**3.8**

169. The Bank recorded financial reporting losses of EUR568 million in 2014, including EUR1.03 billion unrealised reductions in equity valuations recognised through the income statement. The environment in which the Bank operates remains volatile and consequently, there is unpredictability in future financial results.

[7] Excluding movements in general portfolio provisions and fair valuation of Banking investments

170. Statutory capital utilisation was 68 per cent at the planning rate at end-2014 compared to 80 per cent projected under CRR4 by end-2014, and within the prudential threshold of 92 per cent.

171. In turn, economic capital utilisation – the ratio of required economic capital to available economic capital – reached 79 per cent at planning rate compared to 88 per cent projected under CRR4 by end-2014, and within the 90 per cent prudential threshold.

172. The recently approved 2015 Business Plan and Budget (BDS14-286) demonstrates a strong track record of sound cost management, with a real budget growth of 9.9 per cent for the full five years of CRR4 (2011-15) which is below the low end of the CRR4 budget range of 13 per cent to 19 per cent. Staff levels for the CRR4 region have also been managed within the CRR4 resource framework which set a range for additional staff positions between 100 and 170.

A1.3 Progress on the qualitative objectives of CRR4

173. During the period 2011 to 2014, the Bank made good progress towards its qualitative objectives under the CRR4, which include a focus on strengthening policy dialogue, building stable financial sectors and developing capital markets, diversifying economies, tackling energy efficiency, climate change and energy security, accelerating transition in infrastructure, and preserving and enhancing EBRD's operational business model by making organisational improvements, maintaining strong grant funding and reinforcing cooperation with international financial institutions (IFIs).

Strengthening institutions through enhanced policy dialogue

174. The Bank established a Vice Presidency for Policy in 2013 to coordinate the Bank's policy activities to enhance transition impact. The Bank revised the incentives and processes for its integrated approaches in 2013 in order to ensure better implementation and broaden the Bank's sector-wide impact in its countries. At the end of 2014, the Bank was implementing 12 integrated approaches. The Bank also continued its policy dialogue activities under its strategic and cross-cutting initiatives. The Bank's Legal Transition Programme has been strengthened to support these efforts. Since the endorsement of the 2014 Medium-Term Directions by the Board of Governors in the Bank's Annual Meeting in Warsaw, the Bank has been working towards establishing country strategies as the guiding platform for all of the Bank's activities in a country, including policy dialogue. The Bank also launched an Investment Climate and Governance Initiative (ICGI) to build country-specific approaches that will improve the resilience of institutional frameworks. Under the ICGI, the Bank launched an Anti-Corruption Initiative in Ukraine and signed Memoranda of Understanding (MoUs) with Albania, Moldova and Serbia.

Support for financial sector stability

175. The Bank's region was especially hard hit by the global financial crisis, and the Bank's first priority during the CRR4 period was to act counter-cyclically by raising its level of investments and to help stabilise the banking sector. Together with other IFIs, the Bank provided capital and liquidity support to systemically important banks, helping ensure a continued flow of funds to the real economy. Between 2011-2014, the Bank invested EUR11 billion in the financial sector, in local and foreign currencies and including through key programmes such as trade finance, MSME and energy efficiency lending. In order to

promote sustainable local currency funding and develop domestic capital markets, the Bank established a Local Currency and Capital Markets (LC2) Initiative. Between 2011-2014, the Bank made EUR6.3 billion local currency debt investments (accounting for 21 per cent of the Bank's total debt investments during the period) in 341 transactions and EUR2.1 billion investments in 68 local capital market transactions across 17 countries, in addition to investments on regional levels. The Bank played a leading role in the launch of the Vienna Initiative 2.0, a forum for regulatory coordination, and has been active in its policy dialogue efforts.

Diversification of economies

176. Supporting the diversification of the real economy, the Bank put strong emphasis on industry, commerce and agribusiness with the creation of a dedicated operational team and invested EUR10 billion in the corporate sector between 2011-2014. In order to boost innovation and productivity, the Bank launched a Knowledge Economy Initiative (KEI) and committed EUR196 million across 10 related transactions between July 2014, when the initiative became effective, and December 2014. In 2013, the Bank approved a Small Business Initiative (SBI) aiming to maximise impact through organisational and administrative changes and country level coordination. In 2014, the Bank invested EUR1.39 billion in 126 projects under SBI. Small Business Support Programme, one of the pillars of SBI, carried out 6,390 projects between 2011-2014 connecting industry and local expertise with SMEs. The Bank launched its Private Sector for Food Security Initiative in 2011, promoting investments along the whole food value chain and facilitating policy dialogue. Between 2011-2014, the EBRD invested EUR3.6 billion in over 220 agribusiness projects and utilised EUR11 million in donor funding. In 2013, the Bank incorporated inclusion, in areas of gender, youth unemployment and regional differences, into its project selection and design criteria. The Bank also adopted a Strategic Gender Initiative in 2013 to have a more structured approach to gender considerations in the Bank's operations. Since then, the Bank invested in 13 projects that seek to achieve regional inclusion impact and 8 that create improved training and job opportunities for youth. Since the initial Gender Action Plan in 2009, the Bank invested in 30 projects with gender components, 10 of which included specific gender-related transition benchmarks. Since the endorsement of the 2014 Medium-Term Directions, the Bank started work on strengthening its equity organisation by establishing a dedicated business group and creating links with sector teams with a view to further developing its equity portfolio. In order to mobilise investments into the Bank's region, the Bank has also been developing potential partnership structures through which investors can co-invest with the Bank in debt and equity transactions.

Shift towards an energy efficient low carbon economy

177. In line with CRR4, the Bank continued building a strong track record in energy efficiency and sustainable energy financing under its Sustainable Energy Initiative (SEI). Between 2011 and 2014, cumulative EBRD SEI financing reached EUR10.3 billion for 773 projects with a total project value of EUR57.6 billion. In addition to increased activity in established areas such as industrial energy efficiency or renewable energy financing, the Bank developed new products aimed, for example, at residential energy efficiency or private sector adaptation financing. Building on this experience, the Bank launched its Sustainable Resource Initiative (SRI) which, in addition to energy, includes water efficiency focused on demand-side water management and materials efficiency targeting waste minimisation. During the first 18 months of SRI, the Bank financed 72 projects with an SRI component, including an innovative glass recycling project and the first sustainable resource credit line in Turkey. In response to growing external interest in its

experience, particularly in energy efficiency financing, the Bank engaged in various knowledge sharing activities to support global scaling up of energy efficiency financing. An example of this is the Sustainable Energy Finance Knowledge Sharing Platform, funded by the Global Environment Facility (GEF), where the Bank shares its experience with a number of IFIs and countries outside its regions.

Accelerating transition in infrastructure

178. In order to address the significant transition gaps the Bank's region is facing, the Bank maintained its strong engagement in the infrastructure sector and invested EUR7.3 billion in transport and municipal infrastructure projects. The Bank also continued its policy dialogue activities, prioritising the development of public-private partnerships (PPPs) as well as key reform areas for infrastructure – decentralisation, commercial reforms in district heating, market and private sector friendly use of grants from the European Union (EU), reforms in the rail and port sector. Since the endorsement of the 2014 Medium-Term Directions, the Bank launched an Infrastructure Project Preparation Facility (IPPF) which aims to provide assistance to national/local governments in preparing and structuring projects and in building solid regulatory frameworks.

Organisational improvements

179. In order to ensure effective and efficient delivery of its impact, the Bank has been implementing an internal modernisation strategy. Under this 'One Bank' change programme, more than 400 staff volunteers from all levels of the Bank looked at all aspects of how the bank operates and made recommendations on what should be done differently under four broad themes: modernising the Bank's management culture, streamlining internal processes for greater efficiency, developing innovative products and maximising the Bank's impact in a challenging environment. The Bank made progress in areas of increasing the Bank's accountability framework through a new corporate scorecard; improving the Bank's management culture through the establishment of a management committee on strategy and policy and the introduction of new performance frameworks; developing innovative products such as the Knowledge Economy Initiative (KEI) and SBI; and strengthening the Bank's impact and expanding its criteria for project selection to include gender/ inclusion. The Bank will aim to conclude this programme at the end of 2015 by which time the remaining items, including streamlining internal processes for greater efficiency, delegating further management authority with right checks and balances, reviewing budget and administrative processes and fostering a cost culture, will have been implemented. These remaining organisational improvements will take account of the need to upgrade existing human resources policies and practices to reflect the longer term orientations of the Bank and ensure that the Bank maintains a strong talent base and staff from a wide geographical area. Following the conclusion of this change programme, the Bank will move into a continuous review and improvement mode.

Maintenance of strong grant funding

180. During CRR4, the Bank benefitted from strong support from donor partnerships for technical cooperation and grant co-financing. Donor contributions enabled the Bank to deliver transition impact through policy dialogue, institutional and legal reforms as well as through the design and delivery of projects. Between 2011-2014, the cumulative amount of funds contributed by donors reached EUR1.4 billion. The strength of donor partnerships and funding have been driven by the growing importance of climate funds and a range of EU instruments.

Reinforced IFI cooperation

181. The Bank further strengthened its cooperation with other IFIs during the CRR4 period in the context of co-investments, grant and funding mechanisms, pipeline exchanges, high level platforms, information exchanges, working groups and Memoranda of Understanding (MoUs). Particularly notable cooperation efforts included the Joint-IFI Action Plan for Growth in Central and South Eastern Europe with the involvement of the European Investment Bank (EIB), EBRD, and the World Bank; the Vienna 2.0 initiative, headed by the EBRD, International Monetary Fund (IMF), World Bank and European Commission; the joint-IFI Senior Forum on Local Currency and Capital Market Development spearheaded by the International Finance Corporation (IFC) and EBRD and including other regional banks, the World Bank, and bilateral European Development Finance Institutions; and the Deauville Partnership for the SEMED region involving six Multilateral Development Banks (MDBs) and four regional IFIs. In 2014, the Bank, along with the World Bank Group, the Asian Development Bank (ADB), EIB and Islamic Development Bank (IsDB), became a signatory to the Global Infrastructure Facility (GIF) which aims to address the global infrastructure gap and is an open platform focusing on the design, preparation and financial structuring of infrastructure investments with commercial potential. To better facilitate its dialogue with other institutions, the Bank established an External Policy Coordination team and to better coordinate the extensive operational relations between the Bank and the EU institutions, the Bank opened the EBRD Operational Coordination Office in Brussels.

A1.4 Additional developments beyond CRR4

182. One of the most significant events during the CRR4 period has been the extension of the Bank's operations into the SEMED region. The Bank's shareholders seized a historic opportunity to support Egypt, Jordan, Morocco and Tunisia in their democratic and economic transitions, creating a special fund to launch investments in 2012 and ratifying the necessary changes to the Bank's charter. Since then, Jordan, Morocco and Tunisia became countries of operation of the Bank while investments in Egypt are being funded through the special fund. Despite continuing instability in parts of the region, the Bank became operational rapidly with annual Bank investments rising from EUR181 million in 2012 to EUR1,070 million in 2014. As a result, the EBRD portfolio in SEMED reached EUR1.6 billion by end 2014.

183. The Bank extended its operations to Cyprus in 2014 with a view to leveraging its experience in other transition countries to address the country's challenges in the structure of its markets and market institutions. The Bank's engagement in Cyprus is envisaged to have a limited time horizon until 2020, during which time the Bank will focus on complementing the work of European Commission, European Central Bank and International Monetary Fund. Annual Bank investment reached EUR108 million during the first year of operations.

184. In February 2015, the Board of Governors granted recipient country status to Greece with a limited time horizon until 2020. As a result, the Bank will extend its operations to Greece and will complement the work of other international institutions and IFIs, notably the ones included in the Economic Adjustment Programme, the EIB Group, the World Bank Group as well as the Council of Europe Development Bank and the Black Sea Trade and Development Bank where relevant. The Bank's operations will aim to support the country's efforts in implementing reforms, strengthening the role of the private sector and deepening regional integration.

A1.5 Additional data on CRR4 results

Table A1.4: Annual Bank Investment 2011-2014
€ billion at planning rate

	2011	2012	2013	2014
CRR4 envelope	9.0	9.0	8.5	8.5
Actual CRR4 Region	9.0	8.8	8.2	7.5
SEMED and Cyprus	-	0.2	0.5	1.1
Total	9.0	9.0	8.7	8.7

Table A1.5: Annual Bank investment geographic composition in the CRR4 region 2011-2014

	2011		2012		2013		2014	
	Act.	CRR4	Act.	CRR4	Act.	CRR4	Act.	CRR4
Central Asia	5%	9%	10%	9%	7%	10%	10%	11%
Eastern Europe and Caucasus	20%	20%	17%	21%	19%	22%	27%	22%
South-Eastern Europe	17%	18%	17%	18%	20%	17%	22%	17%
Central Europe and Baltics	15%	12%	14%	8%	20%	6%	14%	4%
Russia	32%	33%	30%	33%	23%	33%	8%	34%
Turkey	10%	9%	12%	11%	12%	12%	18%	13%

Table A1.6: Operating assets development 2011-2014
€ billion at planning rate

	2011	2012	2013	2014
CRR4	25.1	27.7	29.6	31.1
Actual (all regions)	24.7	26.6	26.8	26.7

Annex 2: Assumptions for growth of members' equity

A2.1 Overview

185. The Capital Capacity Analysis presented in Section 4 is based on a range of assumed growth in members' equity over the period 2016-2020 of between a 4.0 per cent basecase assumption and a 6.0 per cent 'upside sensitivities' assumption. This represents annual growth in realised profit after specific impairment[8], being equivalent to the growth in available economic capital and also in the statutory capital base.

186. For the Capital Capacity Analysis period 2016-2020, the resulting projected aggregated growth in the realised income after specific impairment (before net income allocations) is in a range of EUR3.3 billion to EUR5.2 billion.

187. These overall assumptions are based on a bottom up analysis for each major component of the Bank's income, as discussed is Section A2.2 below. Resulting assumptions are close to actual results expected for the CRR4 period as discussed below.

188. The assumed range of capital growth for 2016-2020 compares to returns implicit in the planning documents for the CRR3[9] and CRR4[10] periods of 5.8 per cent and 4.3 per cent respectively. Table A2.1 illustrates that the actual returns in these strategic periods were higher, in particular in the CRR3 period.

Table A2.1: Assumed and actual returns[11] across capital review periods

	CRR3 2006-2010	CRR4 2011-2015*	CCA period 2016-2020
Growth of members' equity (%)			**Range**
Assumed	5.8%	4.3%	4.0% - 6.0%
Actual	**9.3%**	**5.1%**	**n/a**
Equivalent aggregate growth in realised income (€ billion)**			**Range**
Assumed	2.6	2.7	3.3 - 5.2
Actual	**5.0**	**3.7**	**n/a**

* 2015 based on 2015 Business Plan & Budget objective.

** Before net income allocations.

189. For the CRR3 period, actual annual realised return on members' equity was 9.3 per cent or equivalent to an actual aggregated growth in members' equity of EUR5.0 billion. This was primarily the result of very strong equity returns achieved in this period, accounting for EUR2.6 billion (or 52 per cent) of total realised income.

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8 Excluding fair value movements on Banking investments and prior to movements in general portfolio provisions.
9 Report of the Board of Directors to the Board of Governors on the Capital Resources Review 3 (BDS06-021).
10 Capital Resources Review 4: 2011-2015 (BDS10-020 (Final)).
11 Returns and equivalent realised income in absolute terms are before net income allocations.

190. Projected annual realised growth rate over the CRR4 is estimated at 5.1 per cent, equivalent to an aggregated growth of members' equity of EUR3.7 billion, with debt performance being the main contributor to the Bank's overall realised income.

191. Actual returns have primarily exceeded planned levels as debt impairment levels have been lower than expected loss levels. In addition, actual equity returns provided upside in the CRR3 period. However, the volatility of the fair value of the Bank's equity portfolio emphasises the need for prudence in capital planning.

192. Table A2.2 presents detail of the components of the Bank's actual realised growth of members' equity for these capital review periods.

Table A2.2: Financial performance by key component across capital review periods

	Historic performance	
	CRR3	**CRR4**
€ billion	**2006-2010**	**2011-2015***
Debt return (incl. fees) before impairment	1.7	3.6
Specific debt impairment	(0.3)	(1.0)
Debt return after impairment	**1.4**	**2.6**
Equity return (incl. dividend income)	3.1	1.9
Equity cost of funds	(0.5)	(0.2)
Equity after cost of funds	**2.6**	**1.7**
Other income streams:		
Treasury income (incl. sub-Libor benefit)	0.6	0.8
Administrative costs	(1.2)	(1.7)
Return on capital	1.6	0.3
Net realised income after specific impairment	**5.0**	**3.7**
Capital base (period average)	**10.8**	**14.4**
Equivalent growth of members' equity (%)	**9.3%**	**5.1%**

* 2015 projection based on 2015 Business Plan & Budget.

A2.2 Detailed assumptions

193. The Capital Capacity Analysis is established based on a range of assumed growth of members' equity[12]:

- A 'headline' basecase growth of members' equity assumption of 4.0 per cent based on a prudent approach to assumptions such as equity return and debt impairment. Whilst there remains potential for uncertainty (namely on impairments and equity valuations) this approach is in line with the Bank's long established prudent approach to medium term capital planning.

[12] Before net income allocation decisions.

- An illustrative 'upside sensitivities' assumption of 6.0 per cent, where the resulting returns may exceed the prudent assumptions made from the basecase. The upsides may occur independently or together with other upside sensitivities. This analysis reflects that actual capital growth may exceed prudent capital planning assumptions, as has been experienced by the Bank in previous strategy periods. An example of an upside sensitivity is the interest base rate (EURIBOR) which may in the medium term increase from current levels, increasing the growth of members' equity[13], but which the Bank would not take into account in its capital planning. The 6.0 per cent 'headline' growth of members' equity assumption is a judgement regarding the overall result of how a combination of upside sensitivity factors occurring may increase overall growth of members' equity.

194. The basecase assumptions by Banking product and other components of the income statement are discussed below:

195. Assumptions regarding return from Banking assets:

- *Assumed leverage of members' equity:* If the size of the Bank's operating assets increases as a proportion of members' equity, then the Bank's overall growth of members' equity increases (for the same average asset returns). The basecase assumption of operating assets relative to members' equity is equal to the leverage at end 2014. The ratio of debt to equity within overall operating assets is also based on the share of assets at end 2014. Debt and equity returns described below are returns on asset base implied by projected capital, assumed leverage and product mix.
- *Debt return* (overall 2.4 per cent after specific impairment):
    - Assumed return before impairment of 3.6 per cent based on margins of 3.0 per cent and fees at an average of 0.6 per cent of debt operating assets (2010-2014: actual fees 0.8 per cent of debt operating assets).
    - Debt impairment: 1.2 per cent assumption represents average annual expected loss of the Bank's debt portfolio at mid-2014. Note that if the risks of new business increased or decreased, the margins and expected loss data would, to an extent, be expected to move 'together'. In practice the Bank's debt impairment levels have been lower than implied by ratings and default assumptions. The potential for lower impairment is therefore one of the upside sensitivities that may occur.
- *Equity return* (overall 6.5 per cent after cost of funds):
    - Realised profit on equity exits assumed at 4.0 per cent gains on exits on a realised basis as a proportion of operating assets (and so is on a different basis to long term IRR expectations). A high proportion of the projected gains in the strategy period would be from the existing portfolio at end 2014, with some exits from new business generated during the 2016-2020 period. The basecase assumption is based on annual divestment at 12 per cent of equity operating assets at cost (close to average in last three years) and an average equity multiple of around 1.35.
    - Dividends are assumed at 1.5 per cent of equity assets, broadly equivalent to the average return over the last five years.
    - Equity cost of funds: Assumed at 0.5 per cent, consistent with the assumption for the Bank's return on capital (see below).

[13] This is an illustration; the Bank has no specific view on this issue.

196. Other components of growth of members' equity:

- *Treasury income including sub-Libor benefit:* Assumed at 0.5 per cent reflecting current budgeted operating income and adjusting for a broadly fixed income compared to a projected increasing capital base.
- *Administrative costs:* Estimated based on an assumed cost-income ratio of 30 per cent.
- *Return on capital:* Assumed at 0.5 per cent. If base rates increase, any resulting increase in return on capital is partly offset by higher equity cost of funds.

Annex 3: Draft Resolution of the Board of Governors: 2016-2020 Capital Review, Strategic and Capital Framework (2016-2020)

THE BOARD OF GOVERNORS:

Noting the uncertain regional and global economic outlook and the sustained demand for the specific attributes and tools of the Bank's business model;

Recognising the strong role the Bank can play, within its transition mandate and the geographic provisions set out in the AEB, in re-energising transition and in supporting global efforts in fighting climate change and responding to the new Sustainable Development Goals;

Noting further Article 5.3 of the Agreement Establishing the Bank which specifies that "the Board of Governors shall at intervals of not more than five (5) years review the capital stock of the Bank" and previous such reviews that took place in 1996, 2001, 2006 and 2010;

Having considered the report of the Board of Directors to the Board of Governors "Strategic and Capital Framework 2016-2020 (BDS15-13)" (the "Report");

RESOLVES THAT:

The Bank will foster the transition towards open market-oriented economies and promote private and entrepreneurial initiative during the 2016-2020 period guided by the medium-term directions outlined in the Report and within the set control parameters;

The Bank's projected capital stock is appropriate for the 2016-2020 period.