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

STRATEGY IMPLEMENTATION PLAN 2017 - 2019

As approved by the Board of Directors at its Meeting on 14 December 2016

STRATEGY IMPLEMENTATION PLAN 2017 -2019

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ABBREVIATIONS

ABI	Annual Bank Investment
AMI	Annual Mobilised Investment
BP	Business Plan
BAAC	Budget and Administrative Affairs
CA	Central Asia
CAP	Capital Adequacy Policy
CEB	Central Europe and the Baltics
COP	Conference of the Parties
CPA	Composite Performance Assessment
CRR	Capital Resources Review
EEC	Eastern Europe and the Caucasus
EITI	Extractive Industries Transparency
EPG	Economics, Policy and Governance
ESD	Environment and Social Department
ETC	Early Transition Country
ETI	Expected Transition Impact
FV	Fair Value
GCF	Green Climate Fund
GET	Green Economy Transition
IFC	International Finance Corporation
IPO	Initial Public Offering
IRR	Internal Rate of Return
LC2	Local Currency and Capital Markets
MSME	Micro, Small and Medium-sized Enterprise
MDB	Multilateral Development Bank
NPL	Non-Performing Loan
OCCO	Office of Chief Compliance Officer
OE&E	Operational Effectiveness and Efficiency
PPP	Public Private Partnership
PTI	Portfolio Transition Impact
RAROC	Risk Adjusted Return on Capital
RoRC	Return on Required Capital
RO	Resident Office
SBI	Small Business Initiative
SBS	Small Business Support
SCF	Strategic and Capital Framework
SEFF	Sustainable Energy Financing Facilities
SEE	South East Europe
SEMED	Southern and Eastern Mediterranean
SIP	Strategy Implementation Plan
SME	Small and Medium-sized Enterprises
SPM	Strategic Portfolio Management
SSF	Shareholder Special Fund
TC	Technical Cooperation
TFP	Trade Facilitation Programme
VP3	Vice Presidency, Policy and Partnerships
WAPD	Weighted Average Probability of Default
WTO	World Trade Organisation

EXECUTIVE SUMMARY

The Board of Governors - in the Strategic and Capital Framework (SCF) 2016 to 2020 - called on the Bank to help re-energise the process of transition to well-functioning market economies. The Bank has been active and successful in the pursuit of this goal through the first year of the SCF. This second Strategy Implementation Plan (SIP) presents how the Bank intends to continue this delivery over the period 2017 to 2019. It also presents requests for budgetary resources for consideration and approval by the Board of Directors.

Progress in 2016

The Strategy Implementation Plan 2016 to 2018 (SIP2016-18) showed that the Bank would re-energise transition by increasing both the quality and quantity of its work. To this end, it was proposed to invest in three priority areas: the policy and investment activity needed to support the Green Economy Transition and support delivery of the objectives internationally agreed at COP21; strengthening the Bank's policy analysis and delivery capability; and reinforcing its control functions in a more challenging environment. It also proposed that the Bank would target higher and stronger levels of impact through increased levels of investment, with Annual Bank Investment rising over the three years to 2018, while maintaining cost restraint and increasing efficiency.

Progress has been made in these areas in 2016. Over the course of the year, the transition quality of the portfolio – the Bank's primary goal – has been maintained at very high levels. And with Annual Bank Investment anticipated to be at, or above, the top of the Bank's range, quantity and quality have gone hand in hand with no deterioration in the risk profile of the portfolio. Institutionally, the foundations have been laid for strengthened policy engagement with the first joint policy objectives between Banking and Policy set and pursued. As this SIP shows, risk considerations have been more fully reflected in the Bank's processes through the use of the Bank Wide Stress Test. Finally, the Bank has launched a thorough Operational Effectiveness and Efficiency (OE&E) Programme whose results underpin the value for money consciousness which is the foundation of this SIP.

In addition, the concept of transition, which is fundamental to the Bank's operational objectives and guides its strategic approach, has been revised. The revised concept casts the Bank's objective in terms of the quality of a well-functioning market economy, rather than its supporting structures. This wider operational view allows the Bank to bring its expertise in mobilising private sector finance to bear on a broader set of transition concerns. Overall, this revision is a natural refinement reflecting contemporary realities and positions the Bank well to contribute to achievement of the Sustainable Development Goals and to address the changing challenges facing countries of operation a generation after the Bank's foundation.

The SIP 2017 to 2019 (SIP2017-19) builds on these foundations. For example, it reasserts the Bank's strong commitment to gender equality and mainstreaming gender objectives, both operationally and internally, and in this respect reports on a growing level of delivery as well as progress in building our organisational capacity. The Plan also reflects the flexibility embedded in the reformed planning process at EBRD to refine the Bank's objectives in key areas in the light of developments over the past year. Three themes have particularly the shaped plan presented here.

Achieving Transition 2017 - 2019

The past year has been a one of widespread global, regional and national uncertainty. Two major geopolitical issues directly influence the plan. First, the continued guidance of Directors on Russia which means for planning purposes that no new projects are projected to be undertaken in that country. Second, the ongoing humanitarian tragedy of displacement caused by the conflict in Syria creates economic strains in a significant part of the Bank's region. The Bank will continue to contribute where it has the expertise to do so. Economic challenges range from the region's continued low growth and low levels of investment, the fragility of banking systems across the Bank's region to the spillovers from commodity price weakness. Political uncertainty is equally pervasive with the value of globalisation questioned together with the trade and financial liberalisation which has been associated with it. Democracy itself has become increasingly questioned.

In this context, the Bank's work is more needed than ever, but its objectives are more challenging to achieve. The uncertainty also makes planning more difficult. Over half of the Bank's investment in each of the last three years has taken place in five countries - Egypt, Kazakhstan, Poland, Turkey and Ukraine. This concentration makes the Bank's activity very sensitive to changes in economic and political sentiment in these countries. The Bank can only pursue its objectives successfully when it has willing partners, both as investors and policy makers. For different reasons, the confidence that the Bank will be able to invest as fully as expected in each country is reduced. There are also prudential reasons for slowing investment to avoid excessive concentrations in the portfolio.

The challenging environment validates the decision to use the Bank's policy and investment instruments together to increase the prospects of achieving sustainable change. This insight has also motivated the reorganisation of the Bank's Top Management through which policy and banking activities will be structurally integrated under the First Vice President and Head of Client Services Group. The uncertainties also lead to the proposal within this SIP to moderate the projected growth of Annual Bank Investment, especially from 2018 onwards relative to the levels set out in the previous SIP (whilst still preserving high levels of investment).

Financial Sustainability

The Bank is financially strong and has recently had its stable AAA credit rating reaffirmed by all the rating agencies. Nevertheless, the period covered by the SIP will see a renewed focus on the Bank's income generation. To pursue its prime objective of supporting transition to the greatest possible extent, the Bank needs financial health and sustainable capital growth.

The projected trends in the Bank's cost to income ratio have highlighted the challenge. The current projection for 2017 is that the level will be just below the ceiling set in the Strategic and Capital Framework. The projection for the second and third years covered by the plan is for the level to be exceeded. Although costs are at the committed levels, the cause of this movement is a lower projection of the Bank's realised income, specifically minimal expected income from sale of equities and the continued lack of return on capital from the low global interest rate environment. This structural trend needs to be addressed. Some of the tools are in place, for example, better measurement of investment returns and an increased focus on profitability. Significant efforts are being made to strengthen the Bank's equity performance under the Enhanced Equity Approach. Management will continue to explore further options for enhancing income generation, consistent with the delivery of the Bank's transition objectives.

Whatever measures are put in place to improve the Bank's income will not bear fruit to bring the cost to income ratio within the maximum permitted level by the time of consideration of the next budget. In addition, the cost to income ratio which was introduced primarily to ensure cost discipline seems too sensitive to changes in revenue patterns. Accordingly, I propose that the Board of Governors consider proposals for reviewing the cost to income ratio as a control parameter at the Bank's Annual Meeting in May 2017.

Efficiency

The SIP2016-18 committed the Bank to examine thoroughly its processes and pursue change through an Operational Effectiveness and Efficiency Programme. This major undertaking has been pursued vigorously throughout the year. Next year will see the programme move to implementation and supports delivery of the proposed flat budget, adjusted for staff compensation increases in 2017. It is foreseen that ongoing implementation will allow continuing cost control even as the Bank's activities remain challenging. As shown in this document, investment will be needed to realise savings and detailed business cases are presented in parallel. It is essential that the Board has confidence in the implementation of the programme. The use of any additional resources and progress in programme delivery will be tracked and reported, separately and quarterly, for Board consideration.

In addition to financial benefits, the simplification of processes, structural reorganisation and improved IT achieved through OE&E will increase the Bank's effectiveness by improving its offer and service to clients; its impact for shareholders and job satisfaction internally. As it moves into implementation the programme will need increased dedicated senior management time. As a result, delivery will become the responsibility of the newly established Senior Vice President, Chief Financial and Operating Officer, although I will remain the programme sponsor.

2017 – Goals and Resources

The proposed business objectives for 2017, set out in the Corporate Scorecard are:

- Expected transition impact floor for new projects set at 60;
- Portfolio transition impact floor set at 65;
- Number of operations within a range of 360 to 420
- Annual Bank Investment within a range of €8.1 to 8.9 billion;
- Annual Mobilised Investment floor set at €0.8 billion, with a floor for combined annual Bank and mobilised investment set at €8.7 billion;
- Annual disbursement range of €5.2 to 6.5 billion; and
- Realised profit before impairment range of €400 to €600 million.

The Scorecard also makes operational the revised transition concept by assessing more comprehensively the individual transition dimensions of the Bank's work through a new Composite Performance Assessment. Throughout any year, the Bank always responds to the prevailing opportunities. Should the business and transition environment prove more favourable, it may be possible to exceed these objectives.

In addition, the review of the Bank's projected liquidity requirements within this SIP document leads to a proposal for a Borrowing Programme for 2017 of €8.0 billion net new issuance. This level of funding aims to ensure that the Bank at any time meets its minimum liquidity requirements under the Liquidity Policy and retains flexibility in the execution of the Borrowing Programme. With this proposed funding, it is projected that the Bank will have liquidity to cover 111% of the next two years' net cash requirements funding at the end of 2017. Based on the assessment of the Bank's liquidity within this document it is considered that the Bank will have the ability to continue as a going concern for the next twelve months. This assessment by management will underpin the basis of preparation of the Bank's 2016 Financial Statements on a 'going concern' basis.

The Bank's total proposed Administrative expenditure for 2017 is formed of two budgets. Consistent with the commitments made in SIP2016-18, the Bank will finance its regular operations and all its IT expenditure for 2017 from an Administrative Expense Budget, excluding compensation increases which is below the baseline level. This sees the continuation of the priority investments identified in 2016 together with the delivery of the objectives set out in the SCF. The savings of the initial year of the OE&E programme allows the absorption of a set of cost pressures within this budget.

The second budget relates to the exceptional, one off expenditure required for the delivery of OE&E programme relating principally to the costs of reshaping the Bank's workforce and ensuring its successful management. Resources approved under this element of the budget can only be used for the specific purposes for which they are intended. Usage will be reported quarterly to the Board and this exceptional budget will not be incorporated in the budget baseline in future. Further, section 8.1 provides projections of the future interrelationship between the Bank's Administrative Expense Budget and OE&E investment budget and sets out the assumptions and expectation.

STRATEGY IMPLEMENTATION PLAN – 2017 to 2019

1. INTRODUCTION

The Strategic and Capital Framework 2016 to 2020 set the EBRD's high level objectives and ambitions for that period. This second Strategy Implementation Plan provides for how those aims will be pursued in practice by presenting a three year perspective for the Bank's activity and resourcing from 2017 to 2019. A more detailed set of objectives for 2017 are presented in the Corporate Scorecard and elaborated in each subsequent section together with budgets for the coming year for Board consideration and approval.

The starting point for the SIP2017-19 is the commitments made in the first Strategy Implementation Plan. The objectives for 2016 are reported to the Board and monitored regularly through the Quarterly Performance Report. Progress on the implementation of multiyear commitments and the prospects for future developments are reported in the relevant sections of this SIP.

The broad theme of the SIP2016-18 was that the Bank should aim to reenergise transition in its region by 'doing more, better' through increasing lending activity and enhancing and broadening policy work. To support these objectives the SIP set out a programme of investment in internal capability notably enhancing the approach to the Green Economy Transition; building up policy skills and activities and strengthening the Bank's control functions.

The SIP2017-19 anticipates a continuation of this overall approach. However, reflecting the advantages of the flexibility offered by the SCF, the plan is adapted to the changes in the internal and external context which the Bank faces. For the period covered by this SIP three key differences are clear:

- The projected growth of the portfolio and expected increase in Annual Bank Investment which supports it are prudently expected to be slower than was the case in the SIP2016-18. This reflects growing uncertainty about the business and transition prospects in the Bank's larger Countries of Operation, as well as the active management of increasing concentrations in the Bank's portfolio.
- The projected growth in the Bank's capital base is lower than presented in both the projections in the previous SIP and those underpinning the capital capacity analysis in the SCF. This reflects mainly the continuing disappointing performance of equity markets in the Bank's region and the Bank's portfolio within that.
- The goal of achieving a growing share of equity investment in both the Bank's annual investment and portfolio is looking more challenging. The Bank's region is in need of equity finance, but opportunities with both financial and transition potential are scarcer than had been anticipated.

The internal context for the SIP2017-19 is shaped most importantly by the development and implementation the Operational Effectiveness and Efficiency Programme. The start of this programme was signalled in the previous SIP. It is designed to benefit staff, clients and shareholders by increasing the Bank's impact, responsiveness and flexibility by directing resources to key strategic areas. Delivery of this programme is central to fulfilling the commitment made in 2016 to achieve growing impact within a flat budget, excluding compensation increases for 2017 and 2018. It is also an important part of refreshing the culture of the Bank after twenty five years.

The proposed Plan also projects that lower realised income in 2016 and subsequent years will lead to a rise in the Bank's cost to income ratio. The level will be just below the maximum permitted under the control framework agreed for the Bank in the Strategic and Capital Framework in 2017. However, the projected trend of the ratio throughout the period – which sees the control level substantially exceeded in the later years covered by the SIP - means that addressing the development of this ratio will be a key focus of the Board and Management in the first part of 2017. This is discussed in detail in the next section.

The Plan is based on the assumption that the guidance of Directors concerning the presentation of projects in Russia remains unchanged. The Bank has the capital capacity and infrastructure to bring forward projects in Russia should that guidance change. However, depending on the scale of the Bank's activity additional budgetary resources may be needed for which Board approval would be sought. The Plan also takes the Bank's region of operation as given[1]. Generally, whilst the Bank does – and will - constantly reallocate resources amongst priorities, it may not always be possible to fully accommodate material changes within existing budgets. Nevertheless, proposals for additional expenditure made to the Board of Directors for approval will be made through business cases which would consider the costs, benefits and funding, including the reallocation of existing resources.

Overall, the Plan will increase support for transition in the Bank's region through growth in the Bank's Annual Bank Investment and portfolio. Capital utilisation will be maintained and the Bank will remain financially sustainable in the medium term and resilient in the face of stress events.

In response to feedback following the discussion of the SIP2016-18, the presentation of the plan has been changed to increase coherence and reduce repetition. Each section presents the three year plan initially before going on to highlight developments for 2017 which will be incorporated in the corporate scorecard.

The structure of the documents is as follows:

- Section 2 sets out the projected development of the SCF control parameters over the period covered by the SIP on the basis of the proposed plan. It examines questions raised by the projected level for the cost to income ratio and presents the Corporate Scorecard as a framework for the rest of the document;
- Section 3 provides a brief overview of the economic and political trends in the Bank's region which provides the backdrop to the policy and business opportunities which condition the Bank's work in the coming three years;
- Section 4 sets out the Bank's transition objectives. It highlights the revisions to the transition concept and sets out – in broad terms - the activities and priorities to be pursued in different parts of the Bank's region drawing on Country Strategies and Country Strategy Updates. The changes to the Bank's Corporate Scorecard as a result of the revision of the concept of transition are explained;
- Section 5 gives an overview of the Bank's activities to deliver its overall transition objectives. It details how the Bank's strategic directions are combined with the business and policy delivery opportunities and its financial objectives to shape its overall activity in countries. The section goes on to describe the investment and

[1] In this context, Lebanon has applied to become a shareholder of the Bank with the view to becoming a country of operations. Should Lebanon become a country of operations (subject to the relevant governance, including approval by the Board of Governors), then, if necessary, a Supplementary Budget would be proposed for the associated incremental resource requirements for Board consideration.

policy activity together with the level of anticipated grant support over the period covered by the SIP;

- Section 6 contains the financial and capital utilisation projections on the basis of the projected investment activity. It considers the financial robustness of the Bank in the face of economic stress and the Bank's profitability objective for 2017. This section also sets out the 2017 borrowing programme;
- Section 7 gives detail on the Bank's Operational Efficiency and Effectiveness programme and presents an investment budget to support the programme; and
- Section 8 presents the resourcing trends for the period covered by the SIP together with the proposed Administrative Expense Budget for 2017.

2. THE CONTROL FRAMEWORK AND CORPORATE SCORECARD

The EBRD's formal institutional management framework has two components. In addition to setting high level objectives the Strategic and Capital Framework provided a set of control parameters within which the work of the Bank was intended to be undertaken between 2016 and 2020. Progress against these measures and the future trajectory is reported in successive SIPs. As a complement, the Board of Directors approves an annual budget and objectives set out in the Corporate Scorecard in the context of a three year rolling plan. This forms the yearly compact between the Bank and its shareholders for its performance. Consistency between the different elements is a key concern for each SIP.

This section sets out the projected levels for the SCF control parameters in the period covered by this Strategy Implementation Plan. It shows on the basis of the projections presented in this document the Bank will be within all of the control parameters in 2017. For 2018 and 2019, whilst five of the six control parameters are projected to be fully met, one – the cost to income ratio – is projected to above its ceiling in that period. The section also explains in full the reasons for this development, the value of this measure as a control parameter and the next steps.

The Corporate Scorecard is also presented as a prelude to the discussion in the remainder of the document.

2.1 SCF control framework

The SCF set control parameters in three areas within which to implement the strategy. For transition, the framework set minimum levels for:

- Expected Transition Impact (ETI) measured at the time of approval of individual operations should average above 60 throughout the SCF period; and
- Portfolio Transition Impact (PTI) should average over 65

For capital, the Bank should maintain:

- Statutory capital utilisation below a 92% prudential threshold: and
- Capital adequacy utilisation under the Bank's Capital Adequacy Policy against a 90% threshold.

And for resources, the requirement is to manage the Bank to achieve a:

- Five year rolling average for the Cost to Income ratio of less than 33%; and
- Five year rolling average for the Ratio of Staff Costs to Total Costs below 70%.

Table 2.1 shows the levels for the SCF parameters for 2015, forecasts for 2016 and projected levels for each of the control parameters over the period covered by the SIP.

It shows:

- The floor levels for ETI and PTI are exceeded as at the end September 2016. Projections of the transition objectives for future years are not undertaken, but annual objectives and the Bank's internal systems gives confidence the level will be maintained (see section 4).
- Capital utilisation is well within the set prudential thresholds for both statutory capital and capital adequacy utilisation across the whole period (see section 6).
- For resourcing, the forecast for the cost to income ratio in 2016 is well within the SCF control levels before rising to just below the control limit 2017 and exceeding it in 2018 and 2019. The ratio of Staff Costs to Total Costs is projected to rise slightly but within the SCF limit.

Table 2.1: Projected SCF Control Parameters 2017 to 2019

Parameter	Limit	2015	2016 (est)	2017 (proj)	2018 (proj)	2019 (proj)
Transition						
Expected Transition Impact	>60	68.8	66.8 (Sept)	>60	>60	>60
Portfolio Transition Impact	>65	69.8	70.2 (Sept)	>65	>65	>65
Capital						
Statutory Capital Utilisation	<92%	71%	71%	73%	75%	76%
Capital Adequacy Utilisation	<90%	80%	78%	80%	81%	81%
Resources						
Cost to Income Ratio	<33%	25%	28%	33%	38%	42%
Staff Cost to Total Cost ratio[2]	<70%	67%	68%	68%	68-69%	68-69%

The plan presented in the SIP2017-19 is consistent with delivering the ambitious aims set by shareholders in the SCF and continues the course outlined in the SIP2016-18. The projections show that the Bank is expected to continue to be successful in its policy objectives; prudent in its capital management and financially sustainable. However, the projected excess of the cost to income ratio is a concern whose causes and consequences merit a full examination**.**

2.2 Evolution of the Cost to Income ratio

The projected level of the cost to income ratio in this SIP is materially different to that anticipated in the SIP2016-18 over the period covered by both SIPs. Table 2.2 shows the movements in the components of the cost to income ratio between the projections assumed within SIP2016-18 and this SIP to explain the differences and show the important features of this year's projection.

The key points from the table are:

- **The Bank's costs are under control.**

The Bank's commitment to deliver a flat budget (excluding compensation) in the SIP2016-18 is on course to be achieved. This will be mainly the result of the successful implementation of the Bank's OE&E programme.

[2] This ratio focusses on the Bank's structural staff expenditure; consequently its calculation does not include OE&E Programme Costs.

Table 2.2: Cost to income ratio SIP2017-19 compared to SIP2016-18

Realised basis		SIP 2017-2019				SIP 2016-2018				
	Forecast	Proj.	Proj.	Proj.	Aggregate	BP	Proj.	Proj.	Aggregate	Variance
€ billion	2016	2017	2018	2019	2016-2018	2016	2017	2018	2016-2018	2016-2018
Debt return before impairment	0.77	0.76	0.73	0.74	2.26	0.78	0.80	0.80	2.38	(0.12)
Realised equity (incl. dividends)	0.10	0.09	0.10	0.20	0.29	0.33	0.38	0.41	1.12	(0.84)
Treasury operating income	0.17	0.09	0.08	0.08	0.33	0.08	0.09	0.09	0.26	0.07
Return on capital	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.08	0.11	(0.11)
Total gross income	1.04	0.94	0.90	1.01	2.88	1.20	1.29	1.38	3.87	(1.00)
Debt impairment charge	(0.11)	(0.21)	(0.22)	(0.22)	(0.54)	(0.22)	(0.22)	(0.23)	(0.67)	0.13
Administrative expenses (incl. depreciation)	(0.43)	(0.43)	(0.44)	(0.45)	(1.31)	(0.46)	(0.47)	(0.47)	(1.40)	0.10
OE&E 'Invest to Save'	0.00	(0.03)	(0.01)	(0.00)	(0.04)	0.00	0.00	0.00	0.00	(0.04)
Total administrative expenses (€1.25:£)	(0.43)	(0.46)	(0.45)	(0.45)	(1.34)	(0.46)	(0.47)	(0.47)	(1.40)	0.06
Growth in capital	0.49	0.26	0.24	0.35	0.99	0.52	0.60	0.68	1.80	(0.81)
(before indicative NIA assumptions)										
Cost-to-income ratio all administrative costs										
Cost-income ratio (spot basis)	42%	49%	50%	45%		38%	36%	34%		
5 year rolling basis	28%	33%	38%	42%		28%	30%	33%		

- **Income expectations are lower.**

The Bank's gross income is projected to be broadly stable over the period covered by this SIP with a positive level of return from the Bank's loan portfolio and treasury operations consistent with previous plans. However, relative to SIP2016-18 overall realised income in the period from 2016 to 2018 is expected to be €1.0 billion lower than had been anticipated in the first Strategy Implementation Plan.

Of this, €0.84 billion is related to the lower projected equity earnings. Although dividend income is expected to be stable, following a small €7 million gain in 2016 no net gains are expected to be realised from equity investments relative to their historic cost in 2017 and 2018. A modest realised gain of €100 million, significantly lower than the past average, is projected for 2019 (see section 6.2.2).

The remainder of the variance is related to somewhat lower than anticipated interest margins on the Bank's lending and an extension of the expected period of ultra-low interest rates reducing the projected return on the Bank's capital (see section 6.2.1).

Clearly, the lower income projections in this SIP are the main reason for the worsening of the Bank's cost to income ratio.

- **Equity weakness**

The more prudent projections of equity income reflect the period of slow growth which has affected much of the Bank's region since the financial crisis in 2008 and which has been accompanied by both low levels of investment and limited stock market returns. Specific recent developments in the Russian economy - where a disproportionate amount of the Bank's equity is invested, including lower commodity prices, slower overall growth and adverse exchange rate movements have reduced returns. In general, the Bank's region has proved unattractive to institutional investors implying limited returns and restricted scale.

The new projections also reflect structural changes in the Bank's equity holdings. The Bank has enjoyed over many years the benefit of the exceptional returns that were possible due to the unique circumstances of the initial move from central planning to the market economy in the Bank's region. By definition, these returns were exceptional and unrepeatable. To some extent, this over-performance of a few investments has compensated for less strong performance of the rest of the portfolio, particularly those made in the decade from 2005. Naturally, the share of high yielding equities in the Bank's portfolio has fallen over time. It is also to be expected that with the Bank's objective to deliver transition, maximising returns is not the primary focus.

Further, the lower level of overall realised income reflects a strengthening of the Bank's equity culture. In the past, the focus on realised income as the main measure of the Bank's financial health has encouraged the holding of underperforming assets beyond the time when it is reasonable to expect a price recovery. Following the decision to establish a dedicated equity group in the Bank in 2014 efforts have been made to undertake a necessary restructuring of the portfolio on a more realistic basis. This leads to a greater focus on the level of potential exits against fair value, rather than historic cost. The impact is to secure the best current value for the Bank and to free up capital for more profitable investment elsewhere.

2.3 Limitations of the parameter

The cost to income ratio was chosen as a control parameter since it combined measures of cost control and financial sustainability. It is also a standard measure of comparison in the banking industry. The deterioration in the projected level over the period covered by this SIP usefully highlights the need for the Bank to consider further ways in which its income generating capacity can be increased and its financial stability supported. However, whilst the information which the ratio contains is both useful and necessary for Management and Board reflection, its instability in the face of movements in income makes it less useful as a means of control. In retrospect, the relative stability of the Bank's realised income over a long period of time meant that the vulnerability of the ratio to exogenous movements in income was neglected when the parameter was calibrated. Other MDBs are facing rising cost to income ratios driven by the same underlying trends. Unlike the EBRD, these are not used a control parameters.

In addition, the focus on realised income in this context can mislead. In addition to inducing counterproductive management of the equity portfolio, realised income provides only a partial view of the Bank's financial position. As a result, it is not a good indicator of potential capital growth.

2.4 Implications and next steps

The Strategy Implementation Plan provides the context for the Board of Directors' consideration and formal approval of the 2017 budgets. The SIP itself is not approved by Directors and the projections for the second and third years of the rolling plan are only indicative. As a result, the projected rise of the cost to income ratio above its maximum permitted level in 2018 and 2019 does not prevent approval of 2017 budgets during which time the parameter is projected to be below its ceiling level. Each year there is some level of risk that when the actual ratio is assessed at the end of the year the control level will be exceeded. It is inevitable that in each year the actual cost to income ratio will not be the same as that projected.

Beyond this formal position, action will need to be taken to address the development of the cost to income ratio. Several steps are being taken to address both parts of the ratio and tackle the underlying causes of its deterioration:

- The OE&E programme is being pursued vigorously and will contain costs so that the Bank's medium term growth ambitions can be realised within a flat budget for at least the period of the SIP2016-18.
- Instruments to strengthen the measurement and management of income have been introduced: tracking of the return on required capital in the Corporate Scorecard and a new Investment Profitability model from September 2016 with profitability monitored systematically at the portfolio level.
- The Enhanced Equity Approach will be implemented rigorously. Box 1 contains more details about the approach and prospects for a stronger equity portfolio.

The Board and Management will consider in the first quarter of 2017 the evolution of the cost to income ratio and what supplementary measures – in particular with regards to increasing income – might be needed to address the challenges in the medium term.

The implementation of any additional efforts will only realise their full benefits in the medium term and are unlikely to lower future projections for 2018 and 2019 below the ceiling. As a result, Governors should consider the issue at the next Annual Meeting in Nicosia. With a well-established commitment to cost constraint in place, it will be particularly important to focus on avenues to increase revenue and the nature, definition and usage of the control parameter itself.

Box 1: Strengthening the Bank's equity approach

The Bank's Equity Group has been restructured to: improve the quality of the pipeline; the quality of new equity deals and the results for the existing equity portfolio.

This has seen the Equity Group move from an advisory to front line function, engaging directly with clients. To strengthen the quality of decisions, an equity lead is allocated to each equity transaction. This lead is drawn from an Equity Network formed of experienced and motivated bankers from across the Bank and the Equity Team. The effect is to increase consistency and raise standards. This effort has been supplemented by creation of a dedicated Equity Risk Team which has proved a pragmatic and responsive counterpart to the Equity Team; monitoring and advising on all decisions on equity transactions from pipeline to exit stage.

A number of steps have been made to actively manage the portfolio. There is a greater focus on value creation with Equity Leads in place for each transaction to ensure that an exit strategy and a value creation plan are in place. In addition, the Equity Committee has been restructured to focus on the Bank's equity portfolio and a process for earlier initial testing of possible transactions has been put in place on a pilot basis to ensure effort is concentrated on the best prospects.

Standards are also supported by the creation of a dedicated due diligence budget for the Bank's third party expenses and the establishment of the Equity Participation Fund (EPF). The EPF necessitates high standards of professionalism and provide the Bank with fee income which partly goes towards strengthening the Bank's equity business.

Early signs are encouraging, but equity is a long term business and future success will depend on a continuous and consistent focus on implementing these enhancements and following these principles.

Proactive management of the portfolio in recent years has seen exits from large loss making transactions, but more remains to be done before the effect will be shown in the performance of the legacy portfolio.

Looking forward, the focus is on improving the quality of deals as a necessary precondition for any increase in levels of investment. This will be supported by strengthening further the Bank's capability to originate equity transactions through actively promoting equity as an alternative to debt. It will also be supported through more actively identifying more opportunities for equity through using Equity Network bankers in ROs to identify local opportunities; co-investing with the Bank's private equity partners and exploring opportunities with potential new and existing local and international partners.

2.5 Corporate Scorecard

The Corporate Scorecard is presented here as its structure is reflected in the remainder of this document.

As in previous years, the scorecard contains transition, operational, financial and resourcing objectives for 2017. The proposed levels are explained in detail in each of the following sections.

Two changes have been made from 2016:

- The measurement of transition in the scorecard has been updated to reflect the changes brought by the revision of the transition concept. As a result, the scorecard contains an assessment of the Bank's performance in delivering results against each of the six qualities of transition which form the building blocks of the revised concept. This provides a more comprehensive view of the Bank's work than the previous approach of tracking individual strategic initiatives. More details on the selection of indicators are presented in section 4.
- The level of fungibility between Annual Mobilised Investment (AMI) and Annual Bank Investment (ABI) is proposed to be substantially increased (from €0.4 billion to €0.7 billion) as long as the minimum level of AMI has been achieved. The purpose is to reduce the disincentive to pursuing mobilisation.

This scorecard is the apex of a performance management system with corporate objectives cascaded through Management and Departmental scorecards to individuals. In addition, the results frameworks Country Strategies and the Country Strategy Updates, along with the performance monitoring frameworks of individual strategies and initiatives allow deeper regular reporting to Senior Management and the Board about the Bank's operations and provide a means of ensuring ongoing accountability for results.

Corporate Scorecard – 2017

	2017 BP and Budget	30/09/2016 Actual	2016 BP and Budget	2015 Actual
TRANSITION IMPACT				
Expected Transition Impact	**Min 60**	66.8	Min 60	66.8
Portfolio Transition Impact	**Min 65**	70.2	Min 65	69.6
Transition Qualities				
Competitive, innovative economies	**CPA***	**Very Good / Good / Requires Attention**		
Well-governed economies and firms	**CPA**	-		
Environmentally sustainable, green economies	**CPA**	-		
Inclusive, Gender-equal economies	**CPA**	-		
Resilient economies and firms	**CPA**	-		
Well-integrated, connected markets	**CPA**	**-**		
OPERATIONAL PERFORMANCE				
Number of operations	**360-420**	226	360-420	381
Annual Bank investment (€ billion)	**8.1-8.9****	5.9	8.1-8.8	9.4
Annual mobilised investment (€ billion)	**Min 0.8**	0.7	Min 0.8	2.3
Disbursements (€ billion)	**5.2-6.5**	5.4	5.0-6.3	6.5
FINANCIAL PERFORMANCE				
Realised profit before impairment (€ million)	**400-600**	426	660-860	949
Return on Required Capital (3 year rolling average)	**tracked**	2.2%	Tracked	3.8%
Non-Performing Loan ratio (non-sovereign) (%)	**tracked**	6.8%	Tracked	6.8%
ORGANISATIONAL PERFORMANCE				
Productivity (number of operations based)	**1.7-1.9**	-	1.7-1.9	1.8
Staff Engagement Ratio	**tracked**	-	Tracked	-
RESOURCE FRAMEWORK				
EXPENDITURE				
Administrative Expense Budget				
Euro (million)	**401.4**	322	462.5	431
Pound Sterling (million)	**346.0**	237	345.7	326
Operational Effectiveness and Efficiency Investment				
Euro (million)	**27.8**			
Pound Sterling (million)	**24**			

* Composite Performance Assessment
** Up to €0.7 billion in BP2017 fungibility possible once minimum Annual Mobilised Investment is achieved.

3. THE TRANSITION CONTEXT

The challenges to which the Bank should respond – and its ability to do so – are shaped by the economic and political context. This section considers the economic outlook in the short and medium term; the particular financing needs facing the Bank's region and the conditions for reform.

3.1 Economic trends

Short-term outlook

The immediate economic outlook for the Bank's region remains challenging. The average annual growth rate has declined for five consecutive years to 0.5% in 2015. Growth is expected to pick up modestly reaching 1.5% in 2016 and rising to 2.5% in subsequent years.

Low commodity prices and the continued recession in Russia weigh on the economic performance of both Central Asia and Eastern Europe and the Caucasus. However, declines in the cost of energy imports benefit the economies of central and south-eastern Europe, where growth momentum has been sustained. Those economies have also benefited from accommodative policies in the Eurozone. Declining revenue from tourism, partly owing to security concerns, has negatively affected the outlook for Turkey and countries in the southern and eastern Mediterranean.

Medium-term trends and challenges

Growth prospects in the longer term are uncertain given the slowdown in structural reform, slower growth of international trade, lower expected growth in the advanced economies and continued weakness of investment (discussed in greater detail in the Transition Report 2015-16). In addition, a sharp deceleration in China's growth could further exacerbate investors' loss of confidence and amplify volatility in global markets. Geopolitical tensions in and around the region are a major source of risk to the medium-term economic outlook.

3.2 Financing needs

Capital flows to emerging markets overall, and to the EBRD region specifically, have recovered somewhat from the lows seen in 2015, in part due to a reassessment of the trajectories of interest rates in advanced economies. In the medium term, however, capital flows to emerging markets, including the EBRD countries of operation, are expected to remain significantly below pre-crisis levels and probably below levels seen in 2010-14, as interest rates are gradually increased in the advanced economies and foreign banks continue to adjust their funding models.

Credit growth has remained subdued throughout the region reflecting a combination of diminished external capital inflows and stagnant domestic savings. In a number of countries in Eastern Europe and the Caucasus (EEC) and Central Asia the economic slowdown revealed major weaknesses in the banking sector. The analysis in the 2015-16 Transition Report shows that in virtually all countries SMEs were more credit constrained in 2012-14 than before the financial crisis.

3.3 Prospects for reform

Recent years have been challenging for reformers across the Bank's region and reform reversals remain common, as reflected in the latest sector transition indicators published in the Transition Reform 2016-17. Many of the factors identified in earlier Bank analysis[3] as deterring market-oriented reforms – such as weak or negative growth, global and regional turbulence and instability, and weak state and public administrations – continue to be present. The picture is not uniform. Some countries have shown a commitment to improving governance and fostering a better business environment. Others are increasingly recognising the important role the private sector can play in traditionally public-dominated sectors such as infrastructure and energy. But many countries remain reluctant to undertake reform and face major challenges.

The political context for reform remains difficult across the Bank's region of operation. Over the past year, a number of countries have experienced external and internal challenges, including open conflicts, terrorist attacks, irregular migration, widening social polarisation and military threats to democratic order. These developments have often threatened political stability and adversely affected the economic situation. On the other hand, a focus on achieving political stability itself has not always created an enabling environment for reform.

Domestic populist and authoritarian tendencies combined with erosion of trust in the institutions represent another serious challenge, undermining democratic credentials and readiness for further democratic reform. Respect for the rule of law and capacity of public administration remain among the key weaknesses in many countries of operations. These trends are unlikely to be reversed soon. Most of the Bank's largest countries in terms of business volume are affected by some of these challenges with consequent risks to the pace and direction of the Bank's activities.

4. TRANSITION

The Bank's purpose is to support its countries of operation in achieving the transition to a fully-functioning market economy. Recognising that the world of 2016 is different from the world of 1990, the Bank has undertaken a full review of how the concept of transition should be defined, measured and pursued with a view to strengthening further its ability to support countries achieve their goals.

This section begins with a brief summary of the nature of the revised concept and its relationship to the Bank's existing planning processes, particularly country strategies. It goes on to provide a high level regional view of the Bank's overall transition objectives and activities. A final section details how the transition objectives will be tracked in the Corporate Scorecard.

4.1 Transition concept

The concept of transition is fundamental to the Bank's operations. During 2016 the Bank adopted a revised concept of transition, which describes the objectives of transition in terms of the qualities of a well-functioning market economy: competitive, well-governed, green, inclusive, resilient and integrated with country strategies defining transition priorities at the operational level. This revision implies changes across the Bank's strategic planning, including the formulation of country strategies and the corporate scorecard.

These six transition qualities form the organising principle of this section. Moreover, further efforts have been made this year to align the Country Strategy process with these qualities. Once all country strategies have been prepared in the new format it will be

[3] EBRD (2013): *Stuck in Transition*: Transition Report 2013

possible to aggregate a high-level thematic view of the transition challenges facing the Bank's countries of operations, and the Bank's planned operational responses, directly from the Country Strategies and Strategy Updates themselves. While most of the Strategies still remain in the previous format, this section attempts a high-level overview drawn from a review of existing work in this area.

4.2 Summary of transition challenges

The following sections provide a summary per quality of the transition priorities and activities across the Bank's countries of operation, drawn from Country Strategies.

Competitive

Support for development of a **competitive** market economy is a strategic priority for the Bank in all regions. At an institutional level, the Bank's Small Business, Knowledge Economy and Early Transition Countries (ETC) initiatives, which had a significant focus on competition issues, are being mainstreamed into banking operations.

Box 2: Early Transition Countries Initiative

The Bank's Early Transition Countries Initiative started in 2004 with the objective of increasing the Bank's `impact and reach' in its then poorest countries of operation. The initiative looked to raise the number of projects in these countries through the Bank taking more risk, increasing resources and systematically accessing donor funding.

The initiative has been a success. The number of operations has risen from 43 in 2004 to over 100 for each of the last six years, accounting for between a quarter and third of the Bank's total operations. As an indication of the degree of focus on ETCs, Bank investment levels relative to country GDP in ETC countries (excluding Uzbekistan) now stand at 250% of the portfolio average.

The Bank is delivering on the priorities in the latest ETC Operational Plan which runs until the end of the year. The predominant part of the investment activity is through the support provided for SMEs, this has included both providing wholesale financing to partner banks and innovative approaches to local currency lending specifically for SMEs. The Bank has extensive policy dialogue activities in the ETCs, both on specific issues such as supporting commercialisation in the municipal sector and supporting improvements in business climate, notably through Investment Councils. The strongest indicator of the success of the initiative is activity in ETCs fully mainstreamed in the Bank's SME; Investment Climate and Governance; and Financial Institutions work.

The Bank remains fully committed to maintaining and enhancing its impact in these countries, consistent with the objectives set in the Strategic and Capital Framework. In common with the other Strategic Initiatives, the ETC initiative will no longer be reported separately in the Corporate Scorecard following the approval of the revised Transition Concept and its implementation. However, the initiative will continue to be tracked in the Quarterly Performance report. The full integration of activity in these countries, especially through the Bank's support for SMEs, means that the Bank's impact will continue to grow.

Inefficient or inadequate public and municipal utilities are a common challenge across the regions. In response, the Bank will focus on supporting commercialisation of utilities with co-ordinated investments and policy dialogue, promoting PPPs where appropriate. **Innovation** is a key priority in Central Europe and the Baltics (CEB) and Turkey, supported by investments in venture capital and private equity plus specific investment and advice targeting innovation improvements in corporates in Turkey. **Access to finance**, especially for **SMEs**, is a challenge in Eastern Europe and the Caucasus (EEC), Sothern and Eastern Mediterranean (SEMED), Greece and Turkey. The Bank is responding with direct and indirect investment financing for corporates and SMEs, together with support for SMEs from the Advice for Small Business (ASB) programme.

In the SEE region, a **lagging private sector with limited skills** and capacity for expansion requires support. The Bank will invest in projects promoting higher value added, new technologies and skills transfer. State domination of the economy is a major issue for Central Asia, and the Bank will focus on helping rebalance the region's economies with policy dialogue and investment in privatisation and commercialisation of state enterprises, supporting private corporates, and providing finance and advice to SMEs with the aim of helping them to scale up.

The SEMED region faces a **weakness in productivity, operating standards and skills**. The Bank will assist private corporates, with a focus on improving operating standards. Finally, **corporate restructuring** is a priority for Greece and Cyprus, and the Bank will seek to facilitate this process with selective investments.

Well-governed

Promotion of **good governance** at the institutional and corporate levels is a priority in countries spread across the EEC (Azerbaijan, Moldova, Ukraine), SEE (Albania, Serbia), Central Asia (Mongolia, Turkmenistan) and SEMED (Egypt) regions. The main vehicle for developing and co-ordinating the Bank's response to governance challenges through policy dialogue at the institutional level is the Investment Climate and Governance Initiative (ICGI), while high standards of corporate governance are promoted as part of the Bank's investments and related advisory work.

In the EEC region, **barriers to entry** and **dominance by privileged businesses** are obstacles to transition. The Bank will assist in addressing corruption, enhancing competition and cutting red tape, including through the Investor Councils. A **weak business environment** and **ineffective management of companies** are challenges facing the SEE region, where the Bank will engage in policy dialogue through ICGI, and advise companies on improving corporate governance.

For Central Asia, **governance of natural monopolies and state-owned utilities**, **transparency in the extractives sector** and the **predictability and quality of the business environment** all need improvement. The Bank will provide technical support to implement EITI requirements and promote improvement of public procurement regulation for the public sector; and will advise on investment climate reform (including through Investment Councils). In Egypt, **shortcomings in governance and transparency** limit private sector financing options and the level of service and economic efficiency of public utilities, while **regulatory enforcement** remains weak. The Bank's response will include direct investments in the private sector and public utilities, accompanied by corporate governance programmes, ASB and policy dialogue; and judicial, competition and policy delivery capacity building.

Green

Reflecting the corporate strategic priority on **environmental sustainability** in its region of operation, the Bank is well positioned to scale up its transition impact and environmental financing activity through the Green Economy Transition (GET) approach by increasing existing activities, promoting innovation, expanding into new environmental dimensions and deepening relevant policy dialogue engagements.

The **scaling-up** of **energy and resource efficiency** activities remains a priority across the region in particular in the Caucasus, Central and Eastern Europe and the Baltics, SEMED and Turkey. There is potential for increased **renewable energy** financing, in particular in the Caucasus, parts of Central Asia and SEMED, where the Bank can play an important role in supporting both the transition to a lower carbon economy and a higher share of private sector power generation. Scaling up financing for **sustainable buildings** is also a priority with further investment in residential, commercial and public sectors planned throughout the region.

The Bank will also promote **innovation** with a focussed **environmental technology transfer** approach to stimulate demand and bring suppliers of such technologies and equipment into new markets, in particular in ETC countries, Ukraine and SEMED. In water stressed countries, the optimisation of water use in the agriculture sector is key to improving the resilience of water systems.

The Bank is developing its **environmental policy and investment activity** to improve the resilience of water supply, groundwater and surface water resources, sustainable agriculture, local air quality and the environmental remediation of contaminated sites. Water and soil pollution will be prioritised in the Western Balkans and the Caucasus.

The EBRD is also deepening its **GET policy dialogue** engagement to enhance the positive impact of regulation and legislation. Priorities include: (i) targeted sustainable resource related legislative and regulatory reform (such as buildings energy efficiency in the Western Balkans and Ukraine, support on Intended Nationally Determined Contribution (INDC) in Kazakhstan, waste management in Turkey and Ukraine, national energy efficiency action plans in Western Balkans); (ii) policy roadmaps and provision of market assessments to outline alternative development paths for specific industry sectors (for example, cement in Egypt); and (iii) sustainability action plans at city level (such as, Green City Action Plans in the Caucasus).

Inclusive

As a relatively recent area of attention for the Bank, economic **inclusion** has been recognised as a strategic priority in Turkey and the SEMED region. Core components of the institutional response are the Strategy for the Promotion of Gender Equality (adopted at the end of 2015 with progress detailed in Box 2 below), which mainstreams gender objectives in the Bank's operations; and a broader Inclusion Strategy, due for consideration in 2017.

In SEMED, **persistent regional disparities, high youth unemployment** and **low** female workforce participation restrict growth potential. The Bank will respond through the Women in Business programme and the promotion of skills transfer by vocational and technical training, while remaining alert to bankable investment opportunities in the outlying regions.

Regional disparities in accessibility of employment opportunities, finance, health, education and municipal services, obstacles to **economic opportunities for women**, and **youth unemployment** are the principal challenges facing Turkey. The Bank's response includes direct and indirect investment in key sectors in underserved regions; business advice for SMEs; the Women in Business programme, promotion of improved transport and utility services for women; and training partnerships for clients.[4]

[4] The Bank is also responding to the needs of refugees in both Turkey and SEMED (Jordan) by mobilising grant funding for relief projects.

Box 3: Implementing the Strategy for the Promotion of Gender Equality

The EBRD's first Strategy for the Promotion of Gender Equality (SPGE) was approved by the Board of Directors in December 2015. This is an instrument for delivering the SCF objective of mainstreaming gender and inclusion. External delivery in this area is tracked through the Country Strategy Results frameworks. Both this and the objective of strengthening the institutional capacity for gender mainstreaming will be incorporated in the management, and departmental, scorecards and reported through the Quarterly Performance Report, based on the indicators set out in the SPGE's Monitoring Framework. The outcomes of the Bank's work in this area are tracked through the Country Strategy Results framework, but some highlights of the Bank's extensive work in this area are:

- Within the EBRD, awareness of gender issues has been raised through training on strategy implementation with four sector teams; three country offices and Evaluation Department to date. Four further country training courses will be provided by year end; gender has been incorporated into guidelines to implement the Environmental and Social Policy (2014) and practical tools for mainstreaming gender in specific sectors have been developed. The first banker to act as a Gender Focal Point is currently being trained with the Gender Team.
- Progress in mainstreaming gender into other key Bank initiatives, in particular EBRD's work on climate change and energy efficiency. For example, the EBRD bid to the Green Climate Fund for Sustainable Energy Facilities included a $2 million allocation for gender work. All Bank projects have been screened for gender impact since 2014. The first country strategy with gender as a mainstreamed priority was due for Board approval in December.
- Several knowledge management products have been produced and disseminated, including toolkits for safer transport and district heating (with the Climate Investment Fund).
- Fifteen gender projects signed by the end of September 2016, up 15% on the same period in 2015, showing the increased institutional capacity to address gender equality concerns. Of these, eight addressed Access to employment and skills; six Access to finance and one Access to services. This brings the total of projects with a gender component to 71;
- All projects with gender Key Performance Indicators in Environmental and Social Action Plans are on track
- A range of TC assignments have been undertaken with donor and SSF support, including support for actions to support gender equality in the Bank's refugee response and a TC framework has been established to support the provision of gender advisory services;
- Stand-alone policy engagements have been carried out to support governments in improving the enabling environment for addressing gender imbalance including supporting for Kazakhstan's National Family and Gender Strategy at the request of the government.
- The Bank has collaborated strongly with a range of other institutions including the innovative programme with the WTO and others to establish a Government Procurement Gender Working Group and raising awareness.
- Data provision for formulating country and project level indicators has been strengthened and further development is planned in 2017 and beyond.

Resilient

Building economic **resilience** is a strategic priority across the regions, with particular prominence in EEC, CEB, Turkey, Greece and Cyprus. At the institutional level, the Financial Sector Strategy adopted in January 2016 makes resilience a priority, with a core role for direct equity investments in banks, supported by policy dialogue. The Local Currency and Capital Markets Development team continues to be a central component of the Bank's **financial resilience** response with the provision of local currency mainstreamed in all the Bank's countries. The SME Local Currency programme, approved in January 2016, extends the former ETC Local Currency approach into new countries including Tunisia and Ukraine. Of the remaining aspects of resilience, **food and energy security** issues are considerations for the Agribusiness and Power & Energy teams, with a clear overlap with GET priorities; while **economic diversification** is a cross-cutting strategic concern.

The EEC region faces a **lack of diversification in energy sources**, **limited local currency liquidity** and **underdeveloped capital markets**. Stability and transparency of the banking sector remains a significant challenge in Moldova. The Bank will stimulate local currency lending through credit lines and bond issuances, provide advice on banking sector stabilization, and invest in sustainable energy and modernisation of regional transmission networks alongside energy policy dialogue. **Low liquidity** and **development of capital markets instruments**, a **slowdown in bank lending** due to the weight of **non-performing loans (NPLs)**, and **fragmented, uncompetitive regional gas markets** are challenges for CEB. Here the Bank will respond with support for NPL resolution, work to create a Bond Framework in Poland focusing on an improved legal and regulatory framework and market structure for covered (mortgage) bonds; and integration between gas markets.

In Greece and Cyprus, **credit constraints**, **inadequate bank governance**, a lack of **financial instrument diversification** and **sustainable energy provision** are all concerns. The Bank will participate in bank restructurings and privatisations, bond issuance and the development of other instruments. It will also support energy privatisations in Greece; and credit lines for energy and resource efficiency in Cyprus.

Incomplete **energy market liberalisation**, **immature local currency and capital markets** and **equity markets dominated by a small number of stocks** are challenges for Turkey. The Bank will finance privatisation and modernisation of state energy companies, promote new financial instruments and structures, support IPOs and engage in policy dialogue to open up equity markets.

Integrated

Greater **integration** of economies into global and regional markets is a strategic priority for countries concentrated in the EEC, SEE, Central Asia and Greece & Cyprus regions. At an institutional level, both the Infrastructure Project Preparation Facility (IPPF) and Trade Facilitation Programme (TFP) continue to support and promote integration through infrastructure and trade links.

Within EEC, **inadequate transport infrastructure** and **burdensome border and customs procedures** are challenges for Georgia and Moldova. The Bank will invest in key infrastructure (including through participation in well-structured PPPs); and use policy dialogue to encourage reform of border procedures and customs administration.

In the SEE region, **cross-border infrastructure is underdeveloped**, and the **energy sector is not well integrated** into the larger regional market. The Bank will respond with investments in regional transport and energy links, accompanied by advice and dialogue on prioritisation and sustainable transport.

Limited international trade and investment flows and **underdeveloped transport infrastructure** are integration challenges within Central Asia. Finance for cross-border expansion by private investors and TFP will feature in the Bank's response, along with blended financing for regional infrastructure accompanied by policy dialogue on transport reforms.

4.3 Transition and the Corporate Scorecard

The transition section of the 2016 scorecard reports average Expected and Portfolio Transition Impact (ETI, PTI), tracks the five Strategic Initiatives (ETC, GET, LC2, SBI and Gender) and also reports the TC Success Ratio.

For 2017, it is proposed that the Bank again sets the high level transition objective of an average level of ETI on new business above 60 and an average PTI of above 65. These levels have been exceeded in recent years, including 2016, but important changes are taking place to the systems through which Transition Impact is assessed. It is proposed that at the end of the first half of 2017 the appropriateness of the level of the annual floor will be reviewed in consultation with the Board in the light of experience with the new systems. The review will also consider how incentives can be strengthened to promote high transition ambition, for example through the use of ranges or targets as the basis for assessing overall transition performance.

It is also proposed to replace the Strategic Initiatives with a set of performance indicators grouped by the six qualities of the revised transition concept. This aligns measurement with the structure of the new concept; recognises the mainstreaming of the Initiatives into the Bank's work and provides a more comprehensive picture of the Bank's activities, since the six qualities cover a broader range of transition objectives.

The choice of indicators for each quality aims to achieve balanced coverage across the whole transition dimension while avoiding a proliferation of metrics that would cause both confusion of direction and excessive reporting burdens.

The 2017 scorecard will provide a Composite Performance Assessment (CPA) for each transition quality which will reflect a broader range of indicators including: a single quantitative target or floor indicator; 2-4 other quantitative indicators; and a qualitative summary of achievements focusing on policy dialogue and advisory work under that quality. The CPA framework will include:

- Each indicator will be assessed against its target where applicable, as 'strong' (exceeding the target or floor), 'fair' (within 75-95% of target/floor level), or 'weak' otherwise
- Tracked quantitative indicators will be assessed similarly against a three-year rolling average.
- Qualitative indicators will also be assessed by comparison with the achievements of previous years, as 'strong', 'fair' or 'weak'.

The overall CPA of Very Good, Good or Needs Attention will be derived by combining the assessments above.

The choice of target/floor indicators is influenced by the need to balance *ex ante* (linked to project transition assessment) and *ex post* (linked to project performance) measures. The average ETI measure, which will remain in place, provides an ex ante target for the *ambition* of the Bank's operations. Therefore it is **proposed to make the percentage of operations (investments and policy engagements) rated 'on track' for transition performance the main indicator for ex-post targeting**. An equal floor will be applied to each quality to ensure balance. Separate reporting of the TC success ratio would be discontinued.

The rating of operations as 'on track' or not, feeds directly into the PTI assessment; so there is a close relationship with PTI; but the 'on-track' measure is a purer indicator of performance. It also provides a strong incentive for *realism*: over-promising of impact, resulting in later downgrades, would be exposed by on-track percentages at team level; whereas aggregate PTI tends to mask these effects. Targeting of average PTI will continue. However, since elements of the PTI measure also feed into the 'on-track' percentage rating, its retention in the scorecard should be revisited in 2017.

The specific **reporting indicators** for each quality are:

- **Competitive, innovative economies:** a hard floor of 75% for successful implementation of operations (both investments and engagements) targeting this transition quality; tracking indicators capturing the number of: projects with a Competitive objective; financing to SMEs through intermediaries and the impact of ASB operations; and an account of qualitative achievements.
- **Well-governed economies and firms:** a hard floor of 75% for successful implementation of operations (both investments and engagements) targeting this transition quality; tracking indicators capturing the number of operations with a Well-Governed objective; and an account of qualitative achievements. It is intended that develop further indicators for this quality during the next year.
- **Environmentally sustainable, green economies:** a hard floor of 75% for successful implementation of operations (both investments and engagements) targeting this transition quality. In line with the strategic objective to reach a ratio of GET financing of 40% by 2020, the Bank will seek to achieve an indicative increase of 2% per year from a 2017 GET ABI ratio of 34% relative to the Business Plan range. Further measures are; tracking indicators capturing the number of operations with climate adaptation, water and/or waste minimisation components; estimated annual CO_2 emissions reduction and the number of sub-loans financed by SEFFs; and qualitative achievements focusing on policy dialogue and advisory work.
- **Inclusive, gender-equal economies:** a hard floor of 75% for successful implementation of operations (both investments and engagements) targeting this transition quality; tracking indicators capturing the number of: new investments with either a gender component or focus; MSME sub-loans under Women in Business programmes; SBS operations with women-owned companies; operations with an Inclusive objective; new investments with a youth or regional inclusion focus or component and an account of qualitative achievements.
- **Resilient economies and firms** a hard floor of 75% for successful implementation of operations (both investments and engagements) targeting this transition quality; tracking indicators capturing the number of: operations with a Resilience objective; transactions contributing to local capital market development; the proportion of debt investments in local currency and the changes in the capital adequacy ratio of partner banks and an account of qualitative achievements.
- **Well-integrated, connected markets:** a hard floor of 75% for successful implementation of operations (both investments and engagements) targeting this transition quality; a tracking indicator capturing the number of projects with an Integration objective; and a qualitative account of results focusing on policy dialogue and advisory work.

5. BANK ACTIVITY

The previous section described the Bank's objectives and the broad set of approaches and instruments with which those objectives would be pursued. This chapter presents how the Bank will respond to the challenges faced in its region through the combination of investment and policy engagement and the extent to which each will be supported by grants and concessional finance.

The sections are linked:

- Section 5.1 describes how the Bank's overarching strategic objectives are combined with the need for financial sustainability and matched to eligible demand to produce an overall direction for the Bank's portfolio;
- Section 5.2 presents the distribution of investment activities over the period covered by the SIP together with the business objectives reflected in the Corporate Scorecard for 2017;
- Section 5.3 outlines to progress made in building the Bank's policy capability and major directions for future progress; and
- Section 5.4 summarises the grant and concessional financing needs for the period covered by the SIP to support the activities with a particular emphasis on 2017.

5.1 Foundations

This section integrates the guidance from the SCF – summarised in Box 4 - with broader operational concerns by means of an enhanced Strategic Portfolio Management (SPM) analysis. This analysis aims to inform the direction of the Bank's business over 2017 to 2019, considering three factors:

- Strategic directions of the SCF described in the box;
- Business opportunities reflected in the growth of the Bank's pipeline and therefore also, indirectly, the operational environment; and
- Analysis of transition impact, risks and returns across the portfolio.

The conclusions of this analysis are used to strengthen the judgement which is used in developing the plan and cannot be applied mechanically.

Box 4: The Bank in 2020

The Bank's operational profile will include:

- 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

The Bank will, across all its operations:

- 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.

5.1.1 Regional directions

Table 5.1 presents a regional summary of the full SPM analysis.

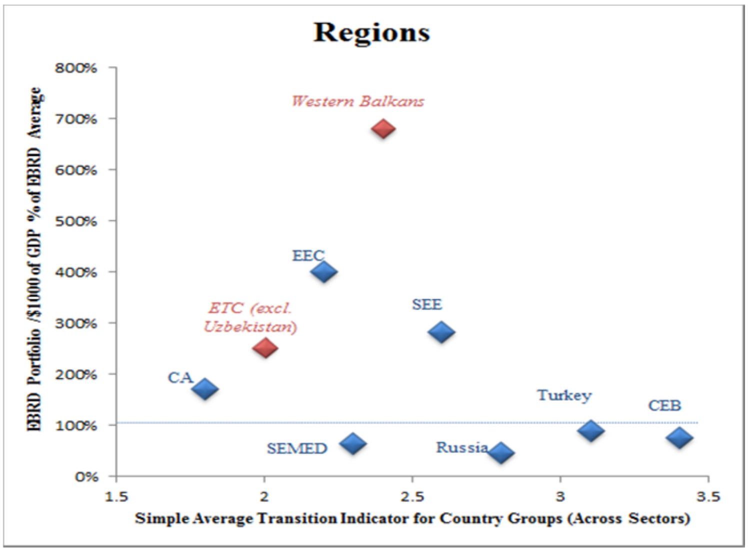
Table 5.1: Summary of Strategic Portfolio Management Dimensions by Region

	CA	CEB	Cyprus and Greece	EEC	Russia	SEE	SEMED	Turkey
Transition	Above average	Below average	N/A+	Below average	Well above average	Lowest	Below average	Highest
Risk	Moderately high	Lowest	N/A+	Highest	Medium	Moderately high	Moderately high	Medium
RAROC	Low*	Moderately low	N/A+	Medium	Highest	Moderately low	Lowest	High
Pipeline Strength	Strong	Relatively weak	Strong	Weaker	N/A	Relatively weak	Strong	Strong
Strategic Priority (SCF)	Priority	Not emphasised	Grow to potential	ETCs a priority	Not emphasised	Western Balkans a priority	Grow to potential	Not emphasised

* *Excluding one-off fees*

To provide more context for the regional distribution of the Bank's overall effort, chart 5.1 provides a snapshot of the Bank's portfolio.

Chart 5.1: Bank's Relative Regional Intensity and Transition need

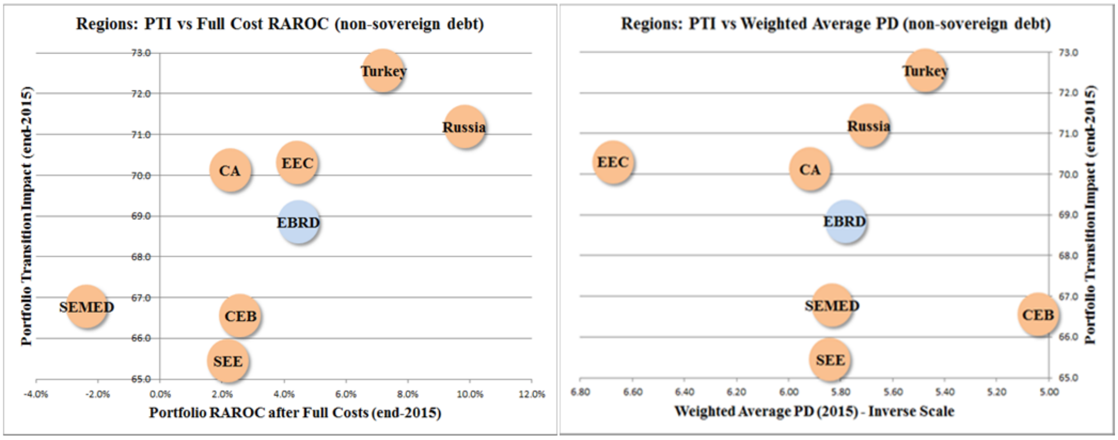


The chart shows the Bank is already well placed to deliver on the SCF directions in Central Asia, EEC and SEE, including the ETCs and Western Balkans. It would be consistent with the SCF to continue efforts to 'develop operations to full potential in the recipient countries of [SEMED]'. For Cyprus and Greece, acceleration is to be anticipated given the short time of expected engagement.

Operational strategy needs to be informed by reality on the ground. The demand profile across the region is important in determining operational directions for the period covered by the SIP for the Bank cannot invest where there is no demand that meets the Bank's principles. The business pipeline at concept review stage, which expresses our current understanding of eligible investment opportunities over the coming period, is highly consistent with achieving the strategic objectives of the SCF. In Cyprus & Greece, SEMED, Central Asia and Turkey the pipeline is strong; and in CEB, EEC and SEE, where the pipeline is less strong, the relative size of regional portfolios are already well aligned with SCF directions.

Complementing the strategic guidance and consideration of demand, regional analysis of transition impact, risks and returns across the non-sovereign debt portfolio is presented below.

Chart 5.2: Regional Portfolio Transition Impact by Return and Risk



SPM is built around the notion of trade-offs between different objectives and subject to constraints. The transition and RAROC metrics on their own provide no useful guidance—the regional bubble charts above, if applied mechanically, would promote corner solutions. There are other limitations of the numerical analysis. It covers only 61% of the Bank's portfolio (although some indication on the remainder is provided below. The data is inevitably backward looking and the results only as good as the underlying assumptions, for example on costs and provisions. However, taken in conjunction with the conclusions on strategy and demand, as well as with risk concentration considerations, these provide a meaningful foundation for decision making.

Drawing together the geographic, pipeline and non-sovereign debt analysis, the SIP 2017-2019 assumes the following directional changes relative to the SIP2016-18 geographic directions:

- A slight increase in the planned build-up of the portfolio in SEMED and Cyprus/Greece reflecting increased opportunity relative to the SIP2016-18 assessment, particularly in infrastructure PPPs, energy sector and energy efficiency in SEMED, while actively managing the available pipeline to improve RAROC and transition performance;
- Minor adjustments in the growth path of the other regions reflecting the analysis of business opportunity, additionality, country factors and RAROC results.

5.1.2 Sectoral and product directions

The SCF is less explicit on the direction of change at sectoral level. The table below summarises the transition, risk, RAROC and pipeline considerations taken into account on a non-sovereign debt basis.

Table 5.2: Summary of Strategic Portfolio Management Dimensions by Sector

	Energy	FI	ICA	Infrastructure
Transition	Highest	Below average	Lowest (still above floor)	Above average
Risk	Moderately high	Lowest	Highest	Medium
RAROC	High	Highest	Lowest	Moderately low
Pipeline Strength	Strong	Weaker	Relatively weak	Strong

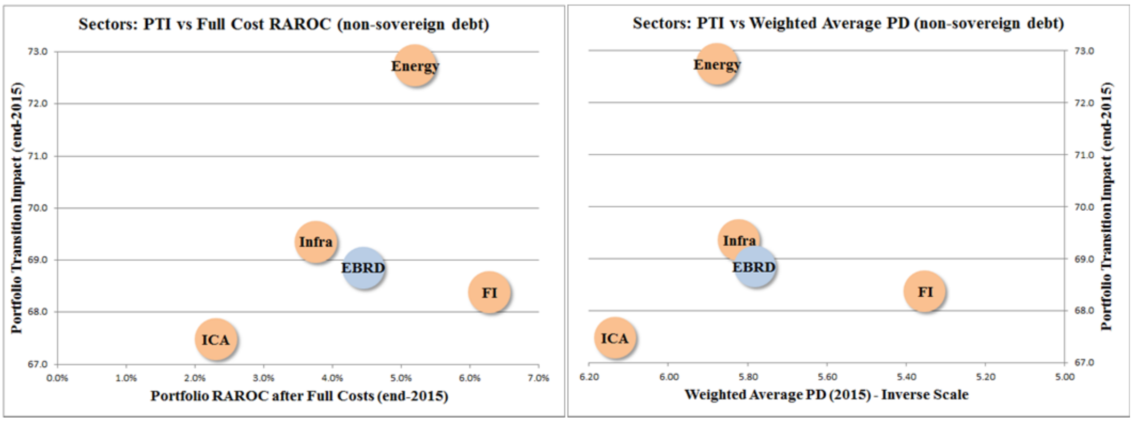
Investment in the corporate sector has been a particular Bank priority since the financial crisis. However, the results in the table suggest that the transition and financial performance of the ICA has been relatively less strong than other sectors. The underlying causes of this outcome will be further analysed with a view to taking steps to raise the impact of ICA projects in both dimensions.

Chart 5.3 sets out the sectoral analysis of transition impact, risks and returns across the non-sovereign debt portfolio below.

The suggested SIP2017-19 trajectory is based on pipeline developments taking account of transition, risk and return considerations. Thus, on the basis of the assessment, the following potential directional changes relative to the SIP2016-18 directions:

- Upward adjustment of activity in the **energy sector** reflecting both the transition and RAROC analysis and positive pipeline development;
- Activity level in the **infrastructure sector** in line with SIP2016-18 reflecting transition and RAROC considerations and positive pipeline development;
- Limited downward adjustment for the **financial sector** despite good financial performance, reflecting adverse market conditions and pipeline trends;
- Marginal downward adjustment for the **corporate sector** reflecting transition and RAROC results, market conditions and pipeline trends.

Chart 5.3: Sectoral Portfolio Transition Impact by Return and Risk



Equity Investments

Equity data has not so far been part of the analysis of return. The Bank's equity ABI has remained relatively stable (with the exception of 2014) over the last seven years and has been between 10-15% of total ABI. Recent portfolio development shows that, despite relative stability in aggregate ABI, no single region or sector is able to provide steady equity ABI levels. This demonstrates the significant impact of economic cycles and market opportunities for equity deals. Recently, the lack of recent equity operations in Russia and the slight reduction in CEB has been compensated by an increase in EEC and Turkey.

Analysis of the returns of the equity portfolio show that while the Bank generated significant income from its equity operations in the past (1992-2004), direct equity returns over the past 10 years (2005-2014) have been below expectations due to a number of external and internal conditions including the financial crisis of 2007-2008 and sizeable losses in energy and regulated industries. Considering the portfolio historically in the context of these caveats, the FI sector and ICA have yielded the greatest returns (FI: 20.9% IRR 1992-2004, 0.9% IRR 2005-2014 and ICA: 10.6% IRR 1992-2004, 0.8% 2005-2014). During the first vintage, 1992-2004, SEE and CEB yielded the greatest returns (22% IRR and 13% IRR respectively). However during the second vintage, 2005-2014, CEB and EEC yielded the greatest returns (6% IRR and 2% IRR respectively).

The SCF summary presented in Box 4 points to a rising share of equity investments in the Bank's portfolio by 2020. However, this aspiration is even more dependent on exogenous forces than other parts of the Bank's objectives. The Bank does not set an annual target for its equity operations since it is important to ensure that the focus of investment is on the quality of the operation – from both the transition and financial perspective – and not the volume of investment. Currently, it is unlikely that the Bank's equity portfolio will grow over the period covered by this SIP. This is in part due to a somewhat weaker existing pipeline of quality investments. In addition, the continuing absence of operations in Russia restricts the opportunities for Bank investment in equity. Finally, the recent first closing of the Equity Participation Fund will increase the level of co-investment of Bank and EPF resources lowering the Bank's equity holding relative to where it would otherwise have been, but releasing capital for further investment.

Sovereign Debt

The sovereign debt portfolio was excluded from the primary analysis given comparability and interpretation problems.

The sovereign debt portfolio constitutes 26% of the Bank's aggregate debt portfolio, and carries an average PTI of 77.3 and RAROC of -1.6% for year-end 2015 after full cost. The sovereign debt portfolio is unevenly distributed across sectors and regions, with SEE, EEC, Infrastructure and Energy dominating. While the sovereign portfolio performs very well with respect to transition, the financial metrics on the surface appear less positive. However, the results of the RAROC analysis for the Bank's sovereign debt portfolio reflect fixed margins and the relatively high risk nature of many countries of operation. In this respect, using RAROC for this segment of the portfolio can be misleading. It is also important to note that in the Bank's history, there has never been a default on a sovereign loan. It is noteworthy that the significant sovereign energy sector portfolio performs exceptionally well with respect to transition.

5.2 Investment activity

Investment through projects and their linked policy activity is the Bank's prime instrument for promoting transition. This section presents an analysis of the projected evolution of the Bank's investment portfolio over the period 2016 to 2019 reflecting the input of sector and country banking groups about the prospects for delivery of the Bank's objectives over the period.

5.2.1 Annual activity 2016-2019

On the basis of first half results and current pipeline trends, end year ABI for 2016 is estimated to be in the range of €8.6 to 9.2 billion, probably in the top half of the range. Beyond 2016, uncertainty in the business and operational environment in several large countries of operations is high and rising as highlighted earlier. This influences the short and medium term operational outlook, as the five largest countries of operations accounted for just over half of total ABI over the past three years. This high level of uncertainty implies that the range of possible investment outcomes is widening, with the likelihood of achieving investment levels at the upper end of the range across all major countries of operation declining.

As a result, the planning assumption is that the Bank may not be able to convert investment opportunities at full potential in the coming years in one or more of its major countries of operations, even in a reasonably optimistic scenario. With this background, it is prudently proposed to widen the ABI range in the scorecard for 2017 and to adjust the planned growth of the upper end of the ABI range downward by €200 million relative to SIP2016-18 to €8.9 billion for 2017 and by €650 million to €9 billion in 2018. Consistent with this caution, only a marginal increase of the upper end of the ABI range to €9.1 billion is proposed for 2019. Although this SIP envisages lower levels of activity than in the SIP2016-18, particularly in CEB, should the context in which the Bank operates be more favourable than anticipated Management will work fully across its region to seek business opportunities to reach higher levels of activity.

The previous section combined the strategic and business drivers of the Bank's work. Overall, the geographical distribution of annual activity levels is projected to be broadly consistent with the Bank's strategic direction. Projections underpinning this analysis are also based on the following assumptions:

- Under the current guidance of Directors, Management conducts selective defensive portfolio and restructuring operations in Russia. Based on portfolio dynamics over the past two years, it is assumed that ABI in the range of €0 to 100 million per annum may be required from 2017-2019 for such defensive portfolio and restructuring operations;

- Based on the latest trends and an assessment of current pipeline, the equity share of Annual Bank Investment is projected at around 10%; and
- A marginal increase of sovereign lending to around 18% of Annual Bank Investment is projected in relation to activity in the energy and infrastructure sectors.

The projected number of projects for 2017 to 2019 reflects the balance between the number of small projects (less than €10 million) and the number of large to very large projects (above €50 million). The composition of 2015 Annual Bank Investment was significantly different from the previous year with an increase in the number of small projects as well as projects between €50 and €100 million and a decrease in the number of midsize projects. At end August 2016, the number of projects signed in the small and midsize categories was marginally above the end August 2015 levels. Combined with a year on year increase in number of projects above €50 million, this results in an increase in average project size. To reflect such changes, the number of operations for the period covered by this SIP is projected as a range based on an average project size between €21 and €24 million, compared to a range of €20 to €23 million in the SIP2016-2018.

Table 5.3 below shows the projected annual Bank investment and number of operations for the period 2017 to 2019.

Table 5.3: Number of operations and Annual Bank Investment 2015-2019

Actuals at reported rates Projections at planning rate of €/$ 1.15	**2015**	**2016**	**2017**	**2018**	**2019**
€ billion	**Act.**	**Est.**	**Proj.**	**Proj.**	**Proj.**
Annual Bank Investment	9.4	8.9*	8.9	9.0	9.1
Number of Operations	381	360-420	360-420	370-420	370-420

* 2016 ABI is estimated in a range of €8.6 to 9.2 billion based on signings to date and current pipeline trends with a mid-point of €8.9 billion used for the purpose of portfolio projections

5.2.2 Portfolio and operating assets development

The pattern of disbursements across years reflects the pattern of business activity within years. With business activity in 2015 significantly back loaded and strong activity in the first part of 2016, annual disbursements have been around 50% above previous year level at the end of August 2016 and around 18% above the end August 2014 level (for a similar increase in terms of Annual Bank Investment). Disbursements in the first half of 2016 included €1.3 billion of disbursements from projects signed in the second half of 2015, double the amount of disbursements for the same period in 2015, with close to €600 million disbursed for the Oyu Tolgoi and Naftogaz projects alone. Reflecting these trends and accounting for the delayed impact of the end 2015 activity on 2016 disbursements, annual disbursements are projected to rise sharply to €6.9 billion in 2016 and – after a return to trend levels of €6.5 billion in 2017 rise marginally to €6.6 billion in 2019.

Table 5.4: Annual disbursements 2015-2019

Actuals at reported rates Projections at planning rate of €/$ 1.15	**2015**	**2016**	**2017**	**2018**	**2019**
€ billion	**Act.**	**Est.**	**Proj.**	**Proj.**	**Proj.**
Disbursements	6.5	6.9	6.5	6.6	6.6

Reflow projections are based on an analysis of individual reflow parameters which are either estimated on the basis of actual information (this is the case for scheduled repayments on existing operating assets) or of ratios to operating assets (for prepayments, divestments, and write-offs) or portfolio (cancellations). Projections for the main reflow parameters for the period covered by the SIP are based on the following assumptions:

- Future repayment projections are established on the basis of scheduled repayments for existing operating assets and repayment profiles for new commitments based on historical trend analysis, taking into consideration the projected level of loan impairment. Annual repayments are projected at around 17.6% of the unimpaired loan operating asset stock compared to an historical average of around 18% for the period 2013 to 2015 and broadly similar to the projected SIP2016-2018 level.
- The level of annual prepayment is projected to increase to close to 6% of the unimpaired loan operating assets over the period 2016 to 2019, up from around 3% in 2015, with a peak projected in 2016 reflecting a number of large prepayments on projects with Ukraine banks including UkrsotsBank (due to a change of ownership) and UrkreximBank (subordinated debt conversion). In volume terms, prepayments for the period 2016 to 2018 are projected at around €3.3 billion, around 20% above the previous SIP projection.
- Annual divestments reached a record level of €1.2 billion in 2014 and remained high in 2015 at €1.0 billion. For the period covered by this SIP, divestments are projected at around 12% of equity assets, based on an examination of the stock of the Bank's current investments and possible exit opportunities, below the rate of 13% projected in the SIP2016-2018. In volume terms, divestments are projected at around €2.1 billion for the period 2017 to 2019. This compares to €2.9 billion for the period 2013 to 2015, of which more than one third were matured investments in the Russian Federation.
- Annual cancellations corresponded to around 7% of undrawn commitments in the period 2013 to 2015. The share of undrawn commitments cancelled is projected at a level above this historical trend at around 8% for the period 2017 to 2019.

As a result of the above assumptions, annual reflows are projected at around 18% of total portfolio in 2016 and to remain at around 16% for the period 2017 to 2019.

Table 5.4: Portfolio reflows 2015-2019

Actuals at reported rates Projections at planning rate of €/$ 1.15	**2015**	**2016**	**2017**	**2018**	**2019**
€ billion	**Act.**	**Est.**	**Proj.**	**Proj.**	**Proj.**
Portfolio Reflows	6.3	7.2	6.7	6.7	6.8

Table 5.5 provides medium term projections of portfolio and operating assets for operations across the Bank's region of operations resulting from the above annual activity, disbursement and reflow projections. These operational projections form the basis of the financial and capital utilisation projections later developed in this document.

Table 5.5: Portfolio and operating assets 2015-2019

Actuals at reported rates Projections at planning rate of €/$ 1.15	**2015**	**2016**	**2017**	**2018**	**2019**
€ billion	**Act.**	**Est.**	**Proj.**	**Proj.**	**Proj.**
Portfolio	41.6	41.6	43.0	44.3	45.2
Operating Assets	28.6	28.8	29.9	30.9	31.6
Active Portfolio Operations	1,864	1830-1930	1850-1950	1870-2070	1880-2080

Notable features of the portfolio are that:

- It is projected to increase by 9% from €41.6 billion at the end of 2015 to €45.2 billion at the end of 2019. Operating assets are projected to grow by 10% from €28.6 billion at the end of 2015 to €31.6 billion by the end of 2019;
- The portfolio in countries other than the Russian Federation is projected to grow by around 20% from 2015 to 2019 from €36 billion to €43 billion; and
- Taking into account the projected portfolio growth and historic trends of the average project size and continuing reflow pressure, the number of active projects in the Bank portfolio is projected to grow from 1,864 at the end of 2015 to between 1,880 and 2,080 operations by the end of 2019, an increase in a range of 1% to 12% depending on average project size.

Table 5.6 provides an illustrative projection of the Bank's portfolio regional composition to 2019.

Table 5.6: Illustrative regional portfolio composition 2015-2019

Actuals at reported rates Projections at planning rate of €/$ 1.15 € billion	2015 Act.	2016 Est.	2017 Proj.	2018 Proj.	2019 Proj.
Central Asia	3.9	4.0	4.3	4.4	4.6
Central Europe and Baltics	6.1	6.1	6.2	6.2	6.1
Cyprus and Greece	0.5	0.9	1.4	1.8	2.0
Eastern Europe and Caucasus	8.5	7.9	8.0	8.2	8.4
Russia	5.6	4.4	3.4	2.7	2.2
South-Eastern Europe	8.1	7.8	7.9	8.0	8.1
Southern and Eastern Mediterranean	3.0	3.9	4.8	5.5	6.0
Turkey	6.0	6.6	7.0	7.4	7.8
Total	**41.6**	**41.6**	**43.0**	**44.3**	**45.2**

% Share	2015 Act.	2016 Est.	2017 Proj.	2018 Proj.	2019 Proj.
Central Asia	9%	10%	10%	10%	10%
Central Europe and Baltics	15%	15%	14%	14%	13%
Cyprus and Greece	1%	2%	3%	4%	4%
Eastern Europe and Caucasus	20%	19%	19%	19%	19%
Russia	13%	11%	8%	6%	5%
South-Eastern Europe	19%	19%	18%	18%	18%
Southern and Eastern Mediterranean	7%	9%	11%	12%	13%
Turkey	14%	16%	16%	17%	17%

This distribution reflects the combination of strategic and market conditions set out earlier. The final distribution is also a result of the different activity levels, product composition and reflow rates in the different regions of the Bank as well as the maturity of the portfolio in each region – the areas of more rapid build-up of portfolio tend to be those where the Bank's work is less mature and reflow rates lower.

On the basis of the updated planning assumptions, the portfolio projections for the period covered by this SIP have the following features:

- By the end of the period in 2019, the two largest regional portfolios are projected to be in Eastern Europe and Caucasus (€8.4 billion) and South Eastern Europe (€8.1 billion), in spite of high average reflow rates projected at 14% and 16% respectively.

- The Turkey portfolio is projected to reach €7.8 billion based on the upper end of the Turkey ABI range. A determined effort will be made to contain this portfolio growth through active mobilisation of external financing to reduce EBRD exposure and, where possible, through selective portfolio sale.
- The Central Asia portfolio is projected to grow by 20% from €3.9 billion in 2015 to €4.6 billion in 2019.
- The Central Europe and Baltics portfolio is projected to slightly rise in absolute amounts in 2017 and 2018 and end the period at the same level as 2015 despite a high average reflow rate of 19% over the period covered by this SIP, but it is expected to slightly fall as a share of the Bank's overall portfolio over the same period.
- The Russia portfolio trend reflects at this stage the dynamics of the current portfolio including selective defensive portfolio and restructuring operations.
- The SEMED portfolio is projected to double from €3.0 billion at end 2015 to €6.0 billion at end 2019 reflecting new activity levels and a lower projected reflow rate of 9% in 2016 due to the lower relative maturity of the portfolio. The reflow rate is projected to increase to 15% by 2019.
- The portfolio in Cyprus and Greece is projected to grow from €0.5 billion to €2 billion at end 2019 with the reflow rate projected to increase from 8% in 2016 to 12% in 2019.

5.2.3 Scorecard parameters 2017

Based on the above projections, the following operational performance ranges are proposed for 2017 to deliver the transition objectives and taking into account the trends in operations:

- **Number of operations** range of **360 to 420** reflecting the ABI range and average project size dynamics at the start of this section**.**
- **Annual Bank investment (ABI)** range of **€8.1 to €8.9 billion** reflecting current pipeline trends, strategic approach and business development activity.
- It is proposed to further promote the mobilisation of external finance on the Bank's projects by increasing the **fungibility** between EBRD finance and Annual Mobilised Investment (AMI) to **€0.7 billion** in 2017 while keeping an **AMI floor of €0.8 billion**.
- A combined ABI and AMI floor of **€8.7 billion** to maintain the EBRD operating assets base and revenue generating capacity. Allowing for the increased €0.7 billion of fungibility between EBRD and mobilised external finance results in an ABI range of €7.2 billion to €8.9 billion, with the lower end of the range assuming the maximum fungibility of €0.7 billion.
- **Annual disbursement** range of **€5.2 billion to €6.5 billion** in line with the ABI range for 2017 with the lower end reflecting the potential impact of ABI/AMI fungibility.

An indicative geographic and sector composition of annual Bank investment is shown below.

Table 5.7: 2017 Indicative regional Annual Bank Investment

Projections at planning rate of €/$ 1.15	2016 BP	2017 BP*	
€ billion	Share	Indicative Share	Indicative mid -point ABI
Central Asia	12%	11%	900
Central Europe and Baltics	17%	15%	1,300
Cyprus and Greece	4%	7%	550
Eastern Europe and Caucasus	15%	15%	1,300
South-Eastern Europe	17%	16%	1,350
Southern and Eastern Mediterranean	15%	16%	1,350
Turkey	20%	19%	1,550

* 2017 BP also includes up to €100 million for selective defensive portfolio and restructuring operations in Russia.

Table 5.8: 2017 Indicative sectoral Annual Bank Investment

Projections at planning rate of €/$ 1.15	2016 BP	2017 BP	
€ billion	Share	Indicative Share	Indicative Volume
Corporate	26%	25%	2,100
Financial Institutions	27%	26%	2,150
Energy	23%	25%	2,100
Infrastructure	24%	24%	2,050

5.3 Policy activity

This section outlines the means through which policy engagement will be harnessed to deliver the Bank's objectives. And enhancing the combination of investment and policy activity is one of the key motivations behind the recent restructuring of the Bank's top management. This section also outlines how the SCF goal of having, by 2020, a strengthened policy engagement capability has been supported by the priority investment made in 2016.

The primary vehicle for implementation of this approach will be the objectives spelled out in individual country strategies and taken forward in support of the broad transition objectives set out in section 4.

The medium term policy reform engagement priorities contained in future country strategies will be grounded in country diagnostics. Concrete policy dialogue activities will be tracked alongside investment activities in the Country Strategy Results Framework with Country Strategy Delivery Reviews systematically reporting on both investment and policy engagement to provide a mechanism for accountability and measurement of policy engagements. This will be the fulcrum of the Bank's policy effort in future and the yardstick by which it is judged.

Further, in order to strengthen and align incentives across the Bank for policy reform dialogue, the Bank is progressing towards integrating delivery and performance assessment across investment and policy. Once policy engagement priorities are set in Country Strategies, specific policy objectives will be included in team scorecards. The delivery of all parts of the Bank against these objectives will be evaluated as part of the annual performance assessment. The approach of joint definition of objectives and joint accountability was piloted in 2016 in seven countries of operation. These objectives entered into the departmental scorecards for Banking, EPG, as well as other teams involved in delivery of the objectives. EPG maintained overall responsibility for tracking progress against the objectives. The results of this pilot will inform the setting of incentives within the newly formed Client Services Group in 2017-2018.

Investment in policy capability was a priority identified in the SIP2016-18. In the course of the year a number of key building blocks have been put in place which will be deployed to support policy activity across the period of this SIP.

The first pilot country diagnostic studies identifying the most binding constraints to private sector growth and well-functioning markets were undertaken in 2016. These studies inform, guide, and sharpen country strategy priorities and serve as a Bank-wide reference for policy engagement with country authorities. In 2016, the first diagnostics were produced to support the Country Strategy process for Egypt and Kazakhstan. Additionally, the bulk of the analytical work has been completed for Poland, Western Balkans and Moldova. The format has been refined to be consistent with the revised Transition concept in the course of the year.

Progress has been made in building a knowledge management system to effectively collect, manage, and utilise experience across the institution. In the first phase a set of notes were produced and distributed to encapsulate the Bank's experiences in areas such as privatization of energy companies, resolution of NPLs, among others. In the current second phase, the overall architecture of a Knowledge Management system is being designed and Communities of Practice will be created to share knowledge across departments.

Finally, in order to strengthen the resources available for policy reform engagement four sector economists have been deployed to regional hubs, building on previous successful decentralisation. This enhances the capacity of Resident Offices to undertake policy reform dialogue with official counterparts. In addition, three economists/analysts have been embedded with sector teams in Banking, allowing for smoother joint cooperation on sector reform priorities and more efficient incorporation of transition elements into Banking operations. The feedback is that the co-location of economists is assisting in identifying opportunities for enhancing transition impact.

5.4 Grant and concessional finance needs

Delivery of the Bank's objectives through both investment and policy dialogue is supported by the use of grants and concessional funds[5] mobilised from the Bank's donors and its net income. This section presents high level calculations of the needs and usage of these resources over the period covered by the SIP. These reflect the geographical and sectoral evolution of the Bank's activity over the period as presented in the previous sections. It also presents fundraising targets for the period covered by the SIP. Further, this section should be read in conjunction with the 2017 Donor Funding Outlook and the Shareholder Special Fund Work Plan. These each contain more detail on the precise direction of the Bank's efforts.

The Bank's business model is anchored in the use of commercially structured financing. Consequently, non-commercial resources (grants and concessional finance) target

[5] Typically, concessional finance will have extended tenors, grace periods and lower interest rates.

activities and objectives that are not achievable with market instruments alone. Their usage – and the assessment of the 'needs' to support the Bank's transition work presented in this section – reflects a combination of market failures and the Bank's strategic objectives. Their use is carefully monitored to ensure that the Bank's market objectives are preserved and supported. Such resources are important in enabling the Bank to undertake the business necessary for delivery its objectives. An important trend which has become evident over the past year is the increased use of concessional finance instruments (as opposed to pure grants) to support the Bank's priority areas. It is expected that this will grow in future years.

Chart 5.4 shows how EBRD's use of grants and concessional funds has evolved in parallel with the Bank's business. The increase in the use of such resources has followed the Bank's evolving sectoral and geographic strategic directions, as new responses have been found to the challenges faced by its countries of operation.

The Strategic and Capital Framework implied a continued and growing need to access grant and concessional finance, whether to enable investments or for stand-alone transition-high interventions. Areas where market conditions and the delivery of the Bank's objectives point to a growth in the use of grants or concessional finance include: stepping up Green Economy Transition work, strengthening the Bank's policy offer; further mainstreaming gender and inclusion throughout the Bank's operations, pursuing funding for critical infrastructure preparations, local capital market development and local currency lending and focussing more on the least advanced transition countries and regions. Applying the Bank's skills to address new objectives, such as the response to the refugee crisis in the Bank's countries of operation, can reinforce this trend.

Chart 5.4: Evolution of grants and concessional finance over time[6]

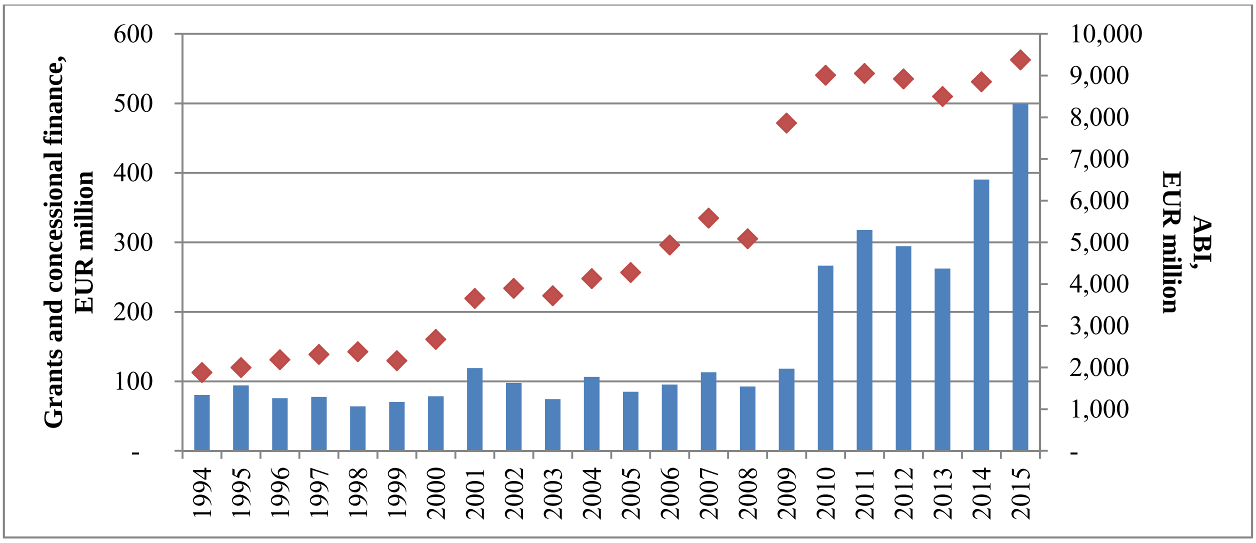


Chart 5.5 shows preliminary projections for needs and usage of grant funding over 2017 to 2019. To interpret the figures, 'needs' are the amount of grant funding estimated by operational teams to be necessary to deliver pipeline projects, some of which are at exploratory stages. As a result, the estimation of future needs is necessarily uncertain as some investment projects which they are intended to support may not materialise. Expected timings may also change, meaning that the outcome in individual years may

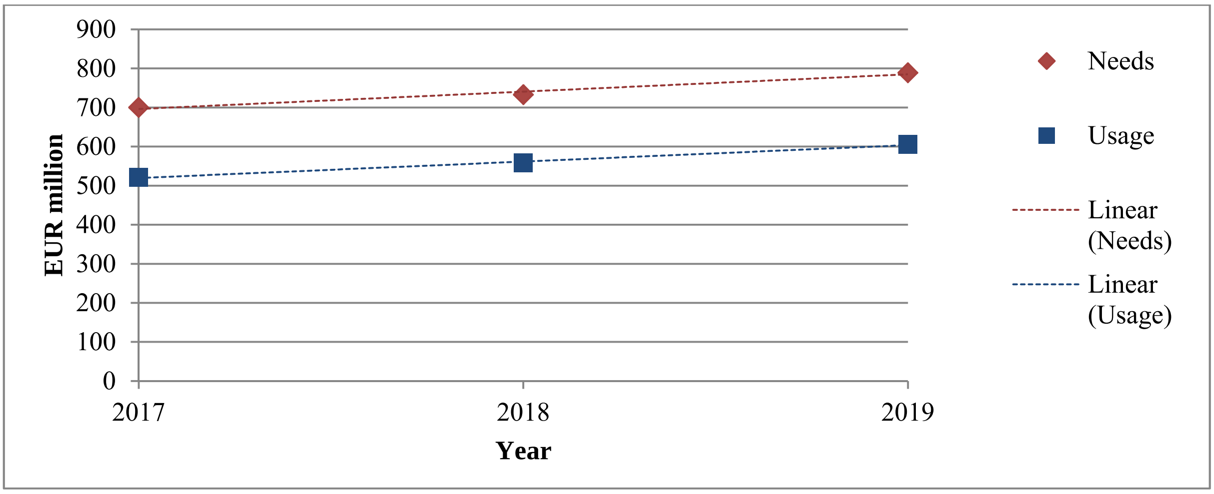
[6] This chart also includes co-lending and equity resources mobilised from donors. The amounts are not significant.

vary from the current estimate. On the other hand, 'usage' is the amount of grant resources it is estimated that the Bank earmarks during a year to launch activities. Grant usage normally runs at a lower level than needs in a particular year. Future projections are based on trends observed in the growth of grant needs - linked to ABI projections across regions and sectors.

The **grant** needs continue to be greatest in the ETC, SEMED and Western Balkans regions where affordability constraints are higher and grant support for sustainable infrastructure and energy efficiency projects are in high demand. It is expected that grant needs will remain consistently high for SME support, Sustainable Infrastructure and Green Economy Transition over the next three years. In addition, in line with the strategic direction of the Bank, there are growing needs for non-transactional grants related to policy dialogue and capacity development.

Concessional financing is likely to increase as an integral element of realising the Bank's Green Economy Transition aims. The Green Climate Fund (GCF) will become the Bank's main partner in this regard. At this juncture, it is challenging to estimate the precise need and usage of concessional finance, given its strong link to investment operations and the novelty of dealing with GCF as a funding partner. Given GCF's operating model, EBRD is likely to seek out – and is currently piloting - a more programmatic fundraising approach involving larger funding requests covering many operations, countries and years of implementation. As this new funding partner and fundraising approach beds down, the Bank will remain cautious in its fund-raising analysis for concessional finance. Therefore, concessional finance is not included in chart 5.4.

Chart 5.5: Grant needs and usage[7] 2017 to 2019



2016 saw an intensification of the refugee crisis with a call on the Bank to play its part in mitigating any negative impact on affected host communities in Turkey and Jordan. In response, the Bank developed a refugee support programme based on supporting improvements in municipal infrastructure and employment opportunities for refugees. It is estimated that the programme can lead to investment of €500 million over three years from 2016 to 2018, supported by grants of €400 million. Given the exceptional and time-bound nature of the Bank's refugee programme this demand for grants is not reflected above or in Chart 5.4.

[7] Not including concessional finance or funding related to the refugee response

The grant funding needs as identified by the Bank's operational teams for 2017 amount to €700 million, which is in line with the needs identified for 2016. When offsetting this against the stock of funds currently available for new projects, the resulting funding gap is €576 million.

Table 5.9 breaks down the total grant funding requirement between TC activities and co-investment grants notably for investment grants, risk-sharing, guarantees and first-loss cover. In addition, it shows the level of concessional lending that will also be needed to support EBRD operations and the additional grant funding needed for the Bank's response to the refugee crisis in Jordan and Turkey.

Funding requirements for 2017 are projected to be highest in ETC, SEMED and the Western Balkans, in line with previous years. Sustainable Infrastructure and Energy Security, and Green Economy Transition are the business areas with greatest demand.

The full analysis is presented in the 2017 Donor Funding Outlook which sets out funding needs, gaps and fund raising strategies in detail.

Table 5.9: Summary of 2017 donor funding gaps, €m

	Funding Gap
Technical Cooperation	225
Co-investment grants	351
Total Grants:	***576***
Concessional lending	*158*
Refugee Response	*85*

Fund raising plan

The Bank's fundraising target for grants and concessional finance is based on an analysis of forthcoming requirements identified within the Bank's pipeline and taking into account the available resources held at the Bank. This analysis and methodology is outlined in detail in the 2017 Donor Funding Outlook for Grant and Concessional Finance. Table 5.10 below summarises the indicative fund-raising targets for the period covered by this SIP.

Table 5.10: Indicative fund-raising targets and resource availability (€ million)

Sources	**2017 (target)**	**2018 (target)**	**2019 (target)**
Donor inflows	375	400	425
SSF[8]	110	100	100
Total	**485**	**500**	**525**
Concessional finance	*158*	*158*	*158*
Refugee response (including SSF allocation)[9]	*85*	*30*	-

Overall, funding targets will be lower than the identified needs and gaps as, by experience, some needs will either not materialise, change or be delayed. In this way, the identified funding gap for grants for 2017, of some €576 million, will not be met in its entirety. Fundraising targets from donors of grant resources is expected to be €375 million for 2017 and €400 million for 2018, compared to €450 million for 2017 and

[8] Amount for 2017 reflects existing Net Income Allocations. Future amounts are indicative and do not prejudge annual Net Income Allocation decisions by the Board of Governors.

[9] The Bank's current refugee programme runs until 2018.

€500 million for 2018 as anticipated in SIP2016-18. This reflects different factors, including a slightly lower projected path for ABI and the Bank's portfolio as well as increased role for concessional finance which was previously included in the donor inflows total and now is separated in the targets above. The estimated level of donor inflows for 2017, plus the indicative allocation of net income from the SSF, would go a long way towards meeting the needs.

Concerted efforts will be needed to both raise sufficient funds and manage existing and future resources effectively and efficiently. The fund-raising priorities for the EBRD for the next three years will include to:

- Increase funding commitments from existing bilateral and multilateral donors with a focus on the Bank's new strategic initiatives and efforts;
- Secure climate financing with a strong focus on mobilizing concessional finance from the Green Climate Fund enhancing strategic partnership with the Global Environment Facility (GEF), while continuing to explore opportunities with donors and other global climate funds;
- Further step up engagement with the EU including through efforts to mobilise more funds from EU delegations, from centrally managed thematic funds and to work closer with EU member states drawing on their structural and cohesion funds;
- Grow the Bank's donor base with new donors, including more countries of operations becoming donors and further access to private sector resources;
- Meet the urgent funding need for the EBRD refugee response.

6. FINANCE AND CAPITAL

Financial sustainability is a precondition for the Bank's continuing ability to deliver its transition mission. The key conclusion of this section is that **the Bank has sufficient capital capacity to both support and implement its strategy in the period of this SIP and to withstand potential losses from stress events**. The Bank is projected to remain comfortably in conformity with the capital control parameters set out in the Strategic and Capital Framework.

This section also shows that the Bank's capital is growing more slowly than had been projected in the analysis of future capital capacity presented in this SCF. This reflects lower than expected revenues for 2016 and for the period covered by the SIP, particularly as a result of the continuing financial weakness of the Bank's equity portfolio. However, the Bank remains profitable overall. It is useful to note that the relatively stable projections for the Bank's overall profitability and capital growth contrast with the sharp change in the assessment of the Bank's realised income over the period covered by the SIP.

The structure of the section is:

- Section 6.1 notes improvements in the Bank's framework to appropriately balance financial and transition objectives, while ensuring a **strengthened focus on financial sustainability**.
- Section 6.2 presents **medium term projections**: the overall projected growth in capital, indicative net income allocations and projected capital utilisation. Within this, there is specific attention on the performance of the Bank's equity portfolio;
- Section 6.3 assesses **the financial resilience of the plan**, including the potential impact of stress events;
- Section 6.4 sets out the proposed **2017 financial objectives**; and

- Section 6.5 proposes the level of **the 2017 Borrowing Programme** in order to achieve a prudent level of liquidity by the end of 2016.

6.1 Strengthening the focus on financial sustainability

The SIP2016-18 highlighted the objective of strengthening the Bank's financial sustainability over the medium term whilst fulfilling its transition mandate. In this context, **financial sustainability** is captured through the objectives to:

- Sustainably grow capital to support transition and operational objectives, provide a buffer against shock events and to allow for net income allocations to support the Bank's operational priorities; and
- Maintain prudent levels of capitalisation and liquidity and demonstrate sound financial management to support the Bank's 'triple-A' credit rating.

To support the delivery of these objectives, the Bank has developed tools to **better assess, monitor and manage returns against risk and required capital notably:**

- The return on required capital (RoRC) [10] captures the overall returns on debt, equity and treasury activities and has been followed in the Corporate Scorecard from 2016.
- Metrics to assess debt performance through risk-adjusted return on capital including a new Investment Profitability Model based on measures of the risk-adjusted return on capital which have been in use since September 2015. These allow the assessment of annual portfolio returns as well as projected returns on new projects.

These tools allow the Bank to better measure and understand the impact of activities on the Bank's financial sustainability.

In the course of 2016, the Bank's existing **financial policy framework** has been supplemented by an enhanced stress testing process. Further, the Bank's high level financial and risk management objectives have been articulated in a **Risk Appetite Statement** introduced during 2016, including a quantification of the risks associated with the Bank's business plan through Financial Loss Tolerance Thresholds.

In addition, the Board of Directors has approved a **Framework for Net Income Allocation Proposals** to guide Management in formulating net income allocation proposals during the SCF period. This includes the expectation that on a rolling three year basis at least 75% of the Bank's growth in members' equity should be retained in reserves.

6.2 Medium Term projections

6.2.1 Financial assumptions

The current expectation is that the key drivers of the Bank's profitability will be weaker during the SIP2017-19 period than anticipated in the SIP2016-18.

Debt

- The average margin on performing non-sovereign debt is assumed to weaken slightly to 3.2%, below the 3.3% average for 2013-2015 and the 3.3% average margins assumed in SIP2016-18. This is driven by market rates and by the planned changes in the regional composition of the portfolio.
- Specific provision charges are assumed at around €0.2 billion per annum for the period 2017-2019, based on expected loss parameters consistent with the Bank's

[10] See section 6.4.1.

Provisioning Policy. This results in a projected 7.0% increase in gross impaired debt assets over the period.

Equity (further discussed in section 6.2.2 below)

- Equity return: overall return (realised and unrealised) is assumed at 5% in 2017 rising to 7% in 2019. These assumptions are marginally below the return assumptions in SIP2016-18 of 6% in 2016 rising to 7% in 2018.
- Within this overall return, net realised equity gains on exits over the three years to 2019 are assumed at €0.1 billion, compared to the €0.9 billion of realised gains assumed over the period of SIP2016-18. (2016 estimate: €7 million net realised equity gains against a business plan objective of €255 million).

Treasury

- Treasury operating income assumed at €85 million for 2017 reducing to €75 million by 2019. The projected reduction in profitability in 2018 and 2019 mainly reflects lower sub-Libor benefit from funding activities (declining from 8 basis points in 2016 to 6 basis points in 2017 and 3 basis points by 2019).
- Average weighted investment return on Treasury assets is assumed at 20 basis points (average 2013-2015: 50 basis points).

Other

- Return on capital (and equity cost of funds) is assumed at 0% throughout the SIP2017-19 period based on EURIBOR forward rates.
- Administrative expenditure projections are based on the medium term budget assumptions set out in section 8.1.

6.2.2 Evolution of the equity portfolio

The evolution of the Bank's equity returns over the period covered by the SIP is the most significant sensitivity in the financial projection. This section places the current projections for both income and capital in context enlarging on the observations offered in section 2. From the outset, it is important to note that actual annual equity returns are inevitably volatile whereas projections assume a broadly linear pattern.

Overall **equity return** is analysed here**.** This compares annual net gains or losses (realised including dividends and unrealised) from share investments as a proportion of the fair value of the equity assets at the beginning of the relevant period. Table 6.1 shows actual equity returns from 2008 to 2015 with projected returns up to 2019.

Table 6.1: Actual and projected equity return

€million other than percentages	Aggregate CRR3: 2006-10	Aggregate CRR4: 2011-15	Forecast 2016	Aggregate SIP17-19
Realised return				
- Realised gains/(losses)	2,747	1,349	7	100
- Dividends	348	498	93	286
Total realised return	**3,095**	**1,847**	**100**	**386**
Unrealised gains/(losses)[(1)]	(774)	(1,601)	(107)	634
Overall equity return	**2,321**	**246**	**(7)**	**1,020**
Average equity return (**before** equity cost of funds)	**12.8%**	**0.9%**	**-0.1%**	**6.0%**
Equity cost of funds	2.9%	0.6%	0.0%	0.0%
Average equity return (**after** equity cost of funds)	**9.9%**	**0.3%**	**-0.1%**	**6.0%**

(1) Includes reversals on exit from share investments.

The average 6% assumed returns in SIP2017-19 are substantially lower than the IRRs that the Bank typically targets for its new equity investments and reflects how existing investments perform in the near term. However, these positive assumed returns are in contrast to -0.1% return estimated for 2016 (Q3 2016: 0.0%) and 0.3% average return after equity cost of funds over the five years from 2011 to 2015 (the 'CRR4 period'). Equally, the five years from 2006 to 2010 saw higher returns of 9.9%.

The performance of the Bank's equity portfolio in the recent period has reflected ongoing weakness in emerging market equity prices generally; weakening local currencies in the Bank's region of operation and the concentration of investment in Russia.

Over the CRR4 period, the Bank realised €1.35 billion in equity gains from investments and a further €0.5 billion in dividends. However, as the overall return was low, the fair value above cost in the remaining portfolio substantially reduced. As at 30 September 2016, the fair value of the equity portfolio was 12% below cost. This has reduced the potential for realised gains with limited exit opportunities above historic cost. The effect is amplified by the strategic decision to realise losses where exit prices are favourable relative to current fair value with a view to improving the quality of the legacy portfolio and free capital for more profitable deployment elsewhere. As a result, the aggregate expectations of net realised equity gains for 2017-2019 are €0.1 billion.

To understand the overall impact of equity on the Bank's capital position, the **evolution of the equity portfolio** is shown in table 6.2 in terms of assets at fair value[11] (the basis on which capital is required under the Bank's Capital Adequacy Policy). The value of the Bank's equity operating assets at fair value is projected to reach €6.1 billion by end 2019 representing a 15% growth from €5.3 billion estimated at the end of 2016. Based on these assumptions, equity would represent around 37% of the overall required capital for the Bank by end 2019 (broadly unchanged over the SIP2017-19 period).

Table 6.2: Actual and projected evolution of equity portfolio at fair value

€million	**Aggregate CRR3: 2006-10**	**Aggregate CRR4: 2011-15**	**Forecast 2016**	**Aggregate SIP17-19**
Opening equity at fair value (FV)	**4,264**	**6,342**	**5,433**	**5,318**
Additions	4,789	4,888	901	2,265
Divestments at FV	(4,681)	(5,546)	(916)	(2,194)
Dividends	(348)	(498)	(93)	(286)
Proceeds	**(5,029)**	**(6,044)**	**(1,009)**	**(2,480)**
Net gains/losses	2,321	246	(7)	1,020
Closing FV	**6,342**	**5,433**	**5,318**	**6,123**
Growth in fair value	*49%*	*-14%*	*-2%*	*15%*
Proceeds % of opening FV	118%	95%	19%	47%
Average p.a.	*21%*	*19%*	*19%*	*15%*

Note: Proceeds include divestments at FV and dividends

Within this growth:

- Additions are assumed at 10% of overall annual Bank investment (SIP2016-18: 13%).

[11] Including derivatives.

- Over the SIP2017-19 period, €2.2 billion of divestment proceeds are assumed representing around 41% of opening fair value over three years, or 47% including dividends. This represents around 15% of opening fair value being realised each year compared to 19% in the CRR4 period.

When assessing the **sensitivity** of the projections in sections 6.2.3 and 6.2.4 to equity assumptions:

- The Bank's **capital growth is relatively sensitive to equity assumptions**. If equity return was zero in the three years to 2019, then available capital would be €1.0 billion lower and return on required capital over the period would be 1.4%.
- The Bank's **capital utilisation is relatively insensitive to overall equity performance** as the Bank sets aside 75% required capital against equity and so increases in capital are largely offset by higher required capital. If equity return was zero over the three years to 2019, this would increase capital utilisation by around 0.5% (other assumptions, including divestment proceeds, being unchanged).
- However, **capital utilisation is, however, very sensitive to the level of equity** in the balance sheet (new investments and divestments). If the size of equity in the balance sheet was €0.5 billion higher at end 2019 (again, other assumptions unchanged), then capital utilisation would be 2.4% higher.

The planned size of the equity portfolio is also an important factor in the potential financial and capital utilisation implications of stress scenarios, as shown in section 6.3.

6.2.3 Projected capital growth

The Bank's capital is projected to grow over the SIP2017-19 period by €1.3 billion from €14.8 billion at end 2016 to €16.1 billion by end 2019; see Table 6.3.

Within this, nominal return on capital (prior to net income allocations), is projected at between 3.1% and 3.8% per year, lower than the 4% return assumed in the base case in the capital capacity analysis in the SCF. This is due to a number of factors: the SCF assumed a 0.5% return on capital from EURIBOR rates (SIP2017-19: 0%) and also higher equity returns (7% before equity cost of funds) and marginally higher leverage.

In terms of return on required capital, returns are projected to increase from the annual return of 4.0% in 2017 to result in a 4.3% return over the three years of the SIP2017-19 period.

The capital projections include indicative **allocations of net income** to 'other purposes' pursuant to Article 36.1 that would reduce the Bank's capital. Any net income allocation proposals need to be developed under the 'Framework for Net Income Allocation Proposals' ('the Framework'; discussed in section 6.1), which has an expectation that at least 75% of the Bank's growth in members' equity should be retained in reserves on a rolling three year basis. This has been taken into account for potential net income allocations assumed in 2017.

At the 2016 Annual Meeting, €198 million of net income allocation was approved from the Bank's capital to fund mainly the SSF 2017 Work Plan [12] and the Bank's

[12] Net income of €95 million was allocated to the core SSF in May 2016 in order to substantially fund the 2017 Work Plan consisting of €100 million in line with the indicative orientation for the size of the annual Work Plan set out in the SIP16-18, offset by an estimated €5 million savings; €10 million for Infrastructure Project Preparation Facility and €35 million for support to refugee hosting countries.

contribution to Chernobyl projects. This represented 25% of the capital growth for 2015.

Table 6.3: Projected growth in capital

€ billion	Actual 2014	Actual 2015	Estimate 2016	BP 2017	Proj. 2018	Proj. 2019
Debt return	**0.74**	**0.80**	**0.763**	**0.75**	**0.73**	**0.74**
Impairment charge	(0.44)	0.12	(0.11)	(0.21)	(0.22)	(0.21)
Net gains /(losses) from loans at fair value	0.00	(0.04)	0.005	0.01	0.00	0.00
Debt return after impairment	**0.30**	**0.88**	**0.65**	**0.54**	**0.52**	**0.53**
Realised equity (incl. dividends)	0.39	0.33	0.10	0.09	0.09	0.20
Unrealised equity movements	(1.03)	(0.05)	(0.11)	0.17	0.24	0.22
Total equity return	**(0.64)**	**0.28**	**(0.01)**	**0.27**	**0.34**	**0.41**
Treasury operating income	0.10	0.19	0.17	0.08	0.08	0.08
Return on capital	0.03	0.00	0.00	0.00	0.00	0.00
Administrative expenses (incl. depreciation)	(0.36)	(0.44)	(0.46)	(0.43)	(0.42)	(0.42)
Financial reporting adjustments	0.01	(0.11)	0.10	0.00	0.00	0.00
Total net profit before net income allocations	**(0.56)**	**0.80**	**0.45**	**0.46**	**0.52**	**0.60**
Members' equity (before net income allocations)	**14.30**	**14.95**	**15.04**	**15.30**	**15.70**	**16.20**
Net income allocations	(0.16)	(0.36)	(0.20)	(0.12)	(0.10)	(0.10)
Members' equity (after net income allocations)	**14.149**	**14.59**	**14.84**	**15.18**	**15.60**	**16.10**
Required capital	**11.97**	**11.51**	**11.61**	**12.19**	**12.69**	**13.07**
Return on members' equity (IFRS basis)	-3.8%	5.7%	3.1%	3.1%	3.4%	3.8%
Return on required capital						
Annual basis	-5.30%	6.7%	3.9%	4.0%	4.2%	4.7%
3 year rolling		*3.7%*	*1.8%*	*4.9%*	*4.0%*	*4.3%*

For planning purposes, indicative amounts for net income allocations[13] have been assumed over the period covered by this SIP as presented in Table 6.4 below.

Table 6.4: Indicative net income allocations 2016-19

€ million The year that the profits are recognised:	Actual 2015	Estimate 2016	BP 2017	Proj. 2018
Growth in capital	797	450	465	515
The year of NIA decision/ when the actual allocation is accounted for:	**2016**	**2017**	**2018**	**2019**
Indicative NIA for planning purposes	**198**	**115**	**100**	**100**
Allocation in 2016 consists of:				
Core SSF	*105* *			
SSF: Support for refugee-hosting countries	*35*			
Community Special Fund	*1*			
Chernobyl projects	*57*			
Annual allocation from reserves	25%	26%	22%	19%
Rolling 3 year average allocation from reserves (limit 25%)		n/a	24%	22%

* Includes €10 million for Infrastructure Project Preparation Facility (IPPF)

[13] Such decisions are taken by the Board of Governors and are not prejudged by these assumptions.

- €115 million is shown in the table as the highest level of Net Income Allocation in 2017 which is – on the basis of current projections – consistent with the Framework.
- €100 million in 2018 and 2019 as an illustration representing 22% and 19% of projected annual capital growth in 2017 and 2018 respectively.

Actual decisions on Net Income Allocations are taken by Governors on the basis of proposals from the Board of Directors.

6.2.4 Projected capital utilisation 2016-2018

The development of the Bank's actual and projected operations and capital utilisation is presented in Table 6.5. Operating assets are projected to increase from €28.8 billion from the end of 2016 to €31.6 billon at the end of 2019, or an increase of 10%:

- Statutory capital utilisation is projected to increase to 76%, by end 2019 well within the 92% prudential threshold.
- Capital Adequacy Policy ('CAP') utilisation is projected to marginally increase over the period from 78% in 2016 to 81% by end 2019, within the 90% prudential threshold. This compares to 82% CAP utilisation at end 2018 projected in the SIP 2016-18.

The capital and financial projections incorporate an implied risk profile for the projected portfolio. On the basis of the indicative changes in the regional shares within the portfolio by end 2019 and assuming that the average risk rating for each region remains unchanged, the average capital requirements for debt would be around 23% of debt exposure by end 2019 (September 2016: 22%). Within this, average risk capital requirement for non-sovereign debt would increase from around 25% to approximately 27%. The projected regional mix has no material impact on average margins and expected loss over the SIP2017-19 period.

Table 6.5: Operational and capital utilisation trends

At planning rate €billion (other than percentages)	**2014 Actual**	**2015 Actual**	**2016 Estimate**	**2017 Proj.**	**2018 Proj.**	**2019 Proj.**
Annual Bank investment	8.9	9.4	8.9	8.9	9.0	9.1
Portfolio	38.7	41.6	41.6	43.0	44.3	45.2
Operating assets at cost (prior to accumulated specific provisions)	27.2	28.6	28.8	29.9	30.9	31.6
Statutory capital:						
Prior to specific provisions	39.2	40.0	40.3	40.7	41.0	41.4
Accumulated specific provisions	0.6	0.8	0.8	1.0	1.1	1.2
Total statutory capital	**38.6**	**39.2**	**39.5**	**39.7**	**39.9**	**40.2**
Statutory capital utilisation (2)	**69%**	**71%**	**71%**	**73%**	**75%**	**76%**
Capital adequacy:						
Required capital	12.0	11.7	11.6	12.2	12.7	13.1
Available capital	15.1	14.5	14.8	15.2	15.6	16.1
Capital adequacy utilisation	**80%**	**80%**	**78%**	**80%**	**81%**	**81%**

(1) Actuals at reported rates; projections at planning rate of €/$1.15
(2) Based on both operating assets and statutory capital net of accumulated specific provisions (See 'Review of the Gearing Ratio Interpretation' (BDS15-018)).

It can be concluded that the Bank has appropriate capital to support and implement its strategy in the period to 2019, whilst remaining within the prudential thresholds.

There is some capital headroom to support additional operational activity and to absorb variations in projected capital utilisation, for example driven by sensitivities to the EUR/USD exchange rate[14] and the equity portfolio growth and returns.

6.3 Financial resilience

6.3.1 Resilience to stress testing

The Bank conducts stress tests to better understand potential vulnerabilities in its overall portfolio and sub portfolios. The Bank also assesses the impact of stress scenarios on the Bank's projected capital capacity, to understand if the operational plan is within an acceptable risk tolerance and the potential implications of stress events from a capital planning perspective.

To evaluate the robustness of the plan, the stressed parameters from the 'cyclical' (1 in 7 years) and 'severe' stress scenario (1 in 25 years) within the 2016 Annual Bank Wide Stress Test have been applied to the 2017-2019 operational plan. The potential losses and capital implications are assessed against the Bank's risk appetite statement parameters, as discussed in section 6.3.2.

For planning purposes, the Bank's main focus is on the severe scenario. The Bank aims to be sufficiently capitalised to withstand such a severe macroeconomic shock with resulting capital ratios consistent with retaining a triple-A rating under rating agency methodologies, whilst relying on perceived shareholder support for such a rating[15]. This equates to a capital utilisation level of 100% after stress.

The key impacts of the severe stress can be summarised as follows:

- 3 year cumulative debt losses of €1.6 billion (base case: €0.6 billion debt losses).
- 3 year cumulative equity fair value decline of 48% (SIP base case: 19% growth).
- Roughly 1 notch credit downgrade on all non-defaulted obligors (base case: none).
- Adjustments to operational assumptions: reduced equity divestments, debt prepayments and disbursements; increased levels of cancellation or restructuring.

In addition, the EUR/USD rate is assumed to depreciate by 25 cents from the planning rate of 1.15 USD per EUR in the SIP to a rate of 0.9 USD per EUR. This assumed strengthening of the dollar raises capital utilisation materially as the value of dollar assets is converted to euro, and then compared against a euro-denominated capital base. This effect is exacerbated when the Bank's capital base is reduced under stress.

In the first assessment of the impact of the stress on the operational plan in the SIP, the share of new equity in annual Bank investment (ABI) is assumed to remain at 10%, despite the severe economic circumstances modelled. The assumed equity portfolio increases as equity divestments under stress are presumed to fall, raising the level of equity assets and increasing capital utilisation.

Based on the severe stress and the prudent approach of implementing the original SIP operational plan through the crisis, capital utilisation at end 2019 is projected to be at 102%, compared to 78% at end 2016.

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[14] For example, CAP utilisation at end 2019 would increase by 2% if the euro depreciated against the US dollar from the $/€ 1.15 planning rate to a rate of $/€ 1.0 ('parity').

[15] Whilst the aim is to ensure minimum capitalisation, it should be recognised that in such circumstances, retaining a triple-A rating would be particularly subject to qualitative assessment by rating agencies.

The stress test results are primarily considered after the implementation of assumed Institutional Actions (IA)[16] that could be taken by the Board and management in response to such circumstances. These are relatively limited and include a reduction in the level of net income allocations, reducing the assumed equity share of ABI to 6% (which may in practice prove to be more driven by prevailing market conditions) and reducing the level of ABI in the second and third year of the planning period. In addition, using the 2016 Bank-wide stress test parameters, a reduction of ABI to €7.5 billion in the second and third year of the stress was assumed. This activity level for new business is consistent with investing through the cycle and avoiding negative signals to rating agencies regarding the Bank's investment capacity. It is this level of ABI which is used for assessing compliance with the Bank's risk appetite statement parameters (see section 6.3.2).

In order to illustrate the impact of each IA, 3 different severe scenarios were run with results presented in the table below. The first (Pre-IA) represents the severe stress without the consideration of IA. The second scenario considers a reduction of equity share only to isolate the impact of this action. Finally, the third scenario is presented after the implementation of both equity share and ABI reductions. It is the third scenario that is primarily considered for the purposes of capital planning, which is highlighted below. Peak capital utilisation figures are presented together with the absolute increase from 2016.

Table 6.1shows that:
- If no remedial action is taken in response to the modelled economic shock, the Bank's capital utilisation would marginally exceed 100%
- Possible Institutional Actions in response to the shock can mitigate the effect and ensure the capital utilisation remains below 100%. Indeed, reducing the equity share alone (whilst retaining ABI at SIP2017-19 levels) would achieve this outcome alone.

Table 6.6: Capital utilisation results – severe stress test

	Peak Capital Adequacy Utilisation	Increase in Capital Utilisation from 2016
Pre-IA		
Severe with SIP 2017-2019 ABI & equity share 10%	**102%**	**24%**
Post-IA		
Severe with SIP 2017-2019 ABI & equity share 6%	**98%**	**20%**
Severe with €7.5bn ABI for 2018/19 & equity share 6%	**94%**	**16%**

In conclusion, the results from the stress tests suggest that the bank's capitalisation levels would remain resilient and the Bank remain relevant in the event of a severe shock during the implementation of the 2017-2019 operational plan after Institutional Actions are considered.

It should be noted, however, that the results from the severe test are relatively close to the 100% capital utilisation limit. With this in mind, the Bank will continue to monitor this closely as part of future stress tests. It should not be taken that the Bank's portfolio has only marginal capacity to grow beyond levels projected in the operational plan;

[16] The assumed Institutional Actions in no way pre-empt or prescribe the actions that would be taken by the Bank if a stressed scenario were to play out. They are presented merely to illustrate the likely remedial impact of actions that may be available under such circumstances.

rather it highlights the requirement to generate proportionate retained earnings to support such growth. The equity portfolio suffers in this regard during a stress as overall returns quickly become negative, as compared to debt where interest income can continue to partially offset debt impairments.

In parallel, Management is exploring several initiatives which could increase flexibility with which the Bank responds to severe shocks in the future. These include greater standardisation of products to facilitate secondary sales, as well as strengthening of primary and secondary asset distribution channels by involving new private and public partners (including, for example, donors and insurance companies). Such actions will augment the Bank's transitional footprint, whilst not placing additional pressures on capital utilisation.

The Bank will continue to develop its stress testing framework and methodology and will use the output to inform the Bank's planning.

6.3.2 Risk appetite

In order to ensure that the dynamic between risk taking and capital reserves is prudent, a framework has been established to transparently quantify the level of financial loss that could be experienced (and absorbed) against each operational plan. Such losses and associated capital erosion are assessed under stressed conditions of differing severity. The results are then compared against boundaries, or *Financial Loss Tolerance Thresholds* (FLTT), to ensure the risk associated with each plan is understood and within the expected appetite.

Under the FLTT framework, the Bank looks at the severe stress (1 in 25 years)[17] and cyclical stress (1 in 7 years) to assess financial performance at different points on the severity distribution. Considering more than one scenario widens the understanding of the Bank's exposure to more predictable downturn conditions, but also against more severely correlated tail-risk shocks.

The results from these stress scenarios applied to the SIP2017-19 plan are presented below and compared against the FLTT for each respective metric. The minor increase in one year capital utilisation under the cyclical downturn scenario as compared to the 2016 Annual Bank Wide Stress Test is driven by a combination of more conservative baseline assumptions about equity divestments and minor adjustments to three year operational plan. The SIP2017-19 plan remains within all other Risk Appetite parameters above the Bank.

Table 6.7: Stress Tests Results vs. Financial Loss Tolerance Thresholds

FLTT Metric	Cyclical	Cyclical FLTT	Severe (Post-IA)	Severe FLTT
Net Earnings 1 year (€m)	-1,957	-2,100	-3,640	-3,800
Net Earnings 3 year (€m)	-1,012	-1,100	-3,325	-3,400
CAP Utilisation 1 year	7%	6%	15%	16%
CAP Utilisation 3 year	8%	10%	16%	20%

The Financial Loss Tolerance Thresholds form an integral part of the proposed business plan and the plan results in a resetting of the one year capital utilisation FLTT parameter

[17] After the consideration of Institutional Actions.

from 6% to 7%. This change will be reflected in the Risk Appetite Statement issued in the first quarter of 2017 and incorporating all relevant policy changes made in 2016.

6.4 2017 Financial objectives

6.4.1 Financial performance objectives in the scorecard

It is proposed that the Bank's financial performance is monitored within the 2017 corporate scorecard through:

- Realised profit before impairment as a financial performance objective;
- Return on required capital (RoRC)[18], which is a tracked measure; and
- Non-sovereign loan impairment ratio (NPL ratio), also tracked.

For 2017, the base case realised profit before impairment is projected at €500 million, within a range of €400 million to €600 million. This is lower than €575 million estimated in 2016 reflecting prudent financial assumptions, in particular with regards to Treasury operating income.

Table 6.8: Realised profit before impairment

€million	2015 Actual	2016 Estimate	2017 BP
Realised profit before impairment	949	575	500
Range		*475-675*	*400-600*

The RoRC was introduced as a tracked indicator[19] in the 2016 Corporate Scorecard and is a measure of the Bank's financial sustainability. The numerator captures overall financial performance under IFRS and the denominator represents the required capital used to deliver the financial performance.

The Bank's financial performance in any given year is subject to volatility (in particular volatility of equity performance). In order to mitigate this, the RoRC is tracked on a 3 year rolling average basis. Reflection will continue on the appropriate measures and target levels for risk adjusted returns for inclusion in future Corporate Scorecards, bearing in mind the need to manage volatility and the necessity of making the measure operational at a business level.

6.4.2 2017 projected income

The base case financial reporting profit before net income allocations for 2017 is €465 million (see Table 6.9). Within this:

- Banking is projected to contribute operating income of €1.0 billion before provisions, expenses and return on capital and €808 million after impairment.
- Treasury is projected in 2016 to contribute operating income of €85 million (of which €67 million income from investment activities and €18 million from funding activities) before provisions, expenses and return on capital.

[18] Debt RAROC is similar in nature to the RoRC measure for overall Bank performance RAROC includes expected loss (EL) as the average credit loss expected to be incurred ('averaging' impairment performance over time). RoRC covers debt, equity and treasury performance and the contribution of debt includes average actual debt impairment over three years. As such, RAROC has a forward looking element (EL) and therefore is a more appropriate tool for planning and new project assessment while RoRC (using actual debt impairment) is a better measure of past performance.

[19] A full explanation of the RoRC measure is contained in the Annex to SIP2016 -18.

Table 6.9: Projected income for 2017

€million	Banking					Treasury	Unallocated items	Total
	NS debt	Sovereign	Debt	Equity	**Total**			
Fee income	123	21	144	0	**144**			**144**
Net interest income	577	35	612	0	**612**			**612**
Dividends			0	92	**92**			**92**
Realised equity gains/ (losses)			0	0	**0**			**0**
Unrealised equity gains/ (losses)			0	174	**174**			**174**
Treasury investment income						67		**67**
Income from funding activities							18	**18**
Total income	700	56	756	266	**1,022**	67	18	**1,107**
Impairment	(209)	(5)	(214)	0	**(214)**			**(214)**
Risk adjusted return before costs	**491**	**51**	**542**	**266**	**808**	**67**	**18**	**893**
Total administrative costs								(429)
Total net profit (before net income allocations)								**465**
Opening required capital (1)	**5,378**	**816**	**6,195**	**4,141**	**10,336**	**1,175**	**97**	**11,608**
RAROC (before costs)	9.1%	6.3%	8.8%	(2) 6.4%	**7.8%**	5.7%		**7.7%**
RAROC (after full costs)								**4.0%**

(1) Required capital is based on 2016 forecast. Portion for unallocated items is related to operational risk.
(2) Return on capital for 2017 is illustrative based on assumed equity return for the year.

Overall, the 2017 financial plan represents a 4.0% annual return on capital (after taking into account expected loss on debt investments as projected impairment):

- Debt is planned to contribute around 60% of the total risk adjusted return before costs (€542m/€893m) with a RAROC return before costs of 8.8% compared to 9.9% achieved in 2015, mainly reflecting lower average margin assumption on the non-sovereign debt (see section 6.1.1) and higher required capital. Within the overall debt return, RAROC return before costs for non-sovereign debt is projected at 9.1% - which is lower than 10.5% achieved in 2015.
- The assumed 5% overall nominal equity return, is equivalent to 6.4% of opening required capital, which is lower than the projected debt return before costs.
- Treasury investment returns reflect a conservative investment policy; sub-libor funding benefit is unallocated (no associated required capital).

Of the total projected opening capital employed 53% relates to debt, 36% to equity, 10% to treasury and 1% to operational risk.

6.5 Liquidity and 2017 borrowing proposal

The assessment of the Bank's liquidity requirements and resulting proposals regarding the size of the Borrowing Programme is made annually in the context of each SIP and allows the Bank to plan its liquidity in a medium term context.

The Bank's Liquidity Policy is a key element in safeguarding the Bank's financial stability in the medium term and supports the Bank's AAA bond rating. The Bank ensures that at any time it is able to meet each of the minimum liquidity requirements set out in the Bank's Liquidity Policy.

Assuming that the Bank is unable to access the financial markets for funding, liquidity must be sufficient such that:

- Net Treasury liquid assets are at least 75% of the next two years' net cash requirements;

- At least 12 months of projected net cashflow requirements can be met under an extreme stress scenario; and
- The Bank's liquidity is considered a strong positive factor under the rating agencies' methodologies.

In determining the Bank's liquidity requirements for the following year and deriving the resulting Borrowing Programme proposal, the Bank sets an operating target for liquidity above the minimum policy requirements to retain flexibility in the execution of the Borrowing Programme.

The additional liquidity requirements to ensure this flexibility for 2017 are estimated based on the Bank being able to temporarily stay out of the market so that it is not forced to borrow funds in unfavourable market conditions and also that the impact of variations in operational cashflows can be absorbed whilst respecting the minimum Liquidity Policy requirements. Should circumstances arise such that there would be no headroom under the minimum Liquidity Policy requirements, the Bank would be forced to return to the market to borrow, notwithstanding market conditions at that time.

The review of the Bank's projected liquidity requirements within this SIP document results in a proposal for **a Borrowing Programme for 2017 of €8.0 billion net new issuance**. The proposed new funding level of up to €8.0 billion in 2017 compares to an expected funding level in 2016 of €6.0 billion[20] out of the approved €7.0 billion 2016 borrowing programme (Actual Q3 2016: €4.1 billion).

With the proposed €8.0 billion Borrowing Programme it is projected that at the end of 2017 the Bank will have 111% coverage of the next two years' net cash requirements (to end 2019), as illustrated in Table 6.10.

The projected liquidity at the end of 2017 ensures the Bank achieves the highest rating on liquidity from the rating agencies, without targeting a specific rating agency methodology. As such, the Bank has introduced a 1 year stressed ratio which broadly ensures that the Bank's liquid funds are sufficient to meets its cash requirements against one year debt service plus 50% of undrawn commitments liquid assets. The Bank's Liquidity Guidelines require a minimum 100% coverage under this one year ratio at any given time. Coverage under this ratio at the end of 2017 is projected to be around 111%.

As described above, the size of the proposed 2017 Borrowing Programme is based on the Liquidity Policy and setting an operating target above the minimum requirements. However, the higher proposed Borrowing Programme relative to the 2016 Programme is primarily as a result of needing to marginally build liquidity given increasing debt repayments from 2017 onwards combined with lower than planned issuance in 2016. This continuation of broadly stable funding levels by the Bank will provide a good signal to the market, whilst ensuring projected liquidity will remain very conservative and prudent. Net Treasury liquid assets are projected to decrease from €17.4 billion estimated for end 2016 to €17.3 billion at end 2017, with debt redemptions due in 2017 of around €6.9 billion projected to increase to €7.3 billion in 2018, then decreasing to €6.5 billion in 2019.

Table 6.10: Projected 2017 year end liquidity ratio

[20] Any unutilised amounts relating to previous years' borrowing programme are not carried forward for utilisation in 2017.

	Year end 2017	Year end 2018	Year end 2019	Aggregate 2018-2019
€ billions				
Opening Gross Treasury liquid assets	**23.6**			
Less short term debt (incl. Nuclear Funds & Cash collateral)	(6.2)			
Net Treasury liquid assets	**17.4**			
Movements in the year:				
Net operational disbursments and profit net of net income allocations	(1.2)	(1.0)	(0.7)	(1.7)
Scheduled debt redemptions (incl. new issuance)*	(6.9)	(7.3)	(6.5)	(13.8)
Net annual cash requirement	**(8.1)**	**(8.3)**	**(7.2)**	**(15.5)**
Projected funding level	**8.0**			
Closing Net Treasury liquid assets	**17.3**			

*Combination of remaining 2016 issuance of €2.0 billion and 2017 new funding.
Assumption: 30% of new issuance redeemable within 2 years.

	End 2017
Next two years' net cash requirement	15.5
Net Treasury liquid assets (includes **€8.0 billion** projected funding)	17.3
Liquidity ratio (min. requirement 75%)	**111%**

7. OPERATIONAL EFFECTIVENESS AND EFFICIENCY

The Strategy Implementation Plan 2016 to 2018 signalled the Bank's intention to set up an Operational Effectiveness and Efficiency Programme. The programme has been pursued rigorously throughout the year. It has a dual purpose:

- To improve the way in which the Bank operates through simplifying and modernising processes and practices; and
- To support the creation of capacity to deliver the Bank's objectives more effectively over the SCF period, within a flat nominal budget initially for 2017 and 2018.

This section provides an overview of the programme which shows the depth and breadth of the change that is being promoted over the period covered by this SIP. It goes on to describe the concrete initiatives which will be implemented in 2017. The capacity created in 2017 and beyond will be used to support the delivery of the Bank's priorities.

7.1 The programme

The programme is wide ranging, touching on all the Bank's processes. It is organised in four pillars:

- **Investment process** covering debt portfolio monitoring; product structuring and delegated authority; and streamlined transition ratings
- **Strategy delivery and results** considering improvements to the Bank's country strategy process; its results management; and delivery of grant funded activity
- **Support and corporate** looking at a variety of corporate functions including a business services; budgeting and expense management; HR processes; IT operations; procurement; and office space
- **Bank-wide impact** seeking improvements in data management and governance and the method of decision making.

All these workstreams are underpinned by a cross cutting programme of investment in supporting technology. In parallel, the Board of Directors has examined ways of increasing its own effectiveness and efficiency, as well as contributing to the general Bank efforts.

7.2 Implementation

After an initial design period through 2016, the OE&E programme will move to implementation in 2017. Three areas of focus have been identified.

Client services

Naturally, many of the activities to be taken forward will support the creation of capacity in the Banking Department through simplifying ways of working, as well as reducing the demands on bankers. Specifically within Banking:

- **Portfolio Monitoring**: the creation of a cadre dedicated to portfolio management will have multiple benefits, including greater functional specialisation between origination and monitoring, improving the quality of each.

Three workstreams will have impacts in a number of parts of the Bank, including Banking:

- **Country Strategy formulation:** Moving to a new process for developing Country Strategies will reduce the length of time taken to create a country strategy by roughly a quarter and the number of people involved in their formulation, including within Banking.
- **Streamlined Transition ratings:** The implementation of Project Christopher will see the majority of projects receiving transition ratings through an automated process. This will avoid the need for bespoke work by economists and, importantly, remove the need for lengthy cross-departmental discussion.
- **Results Management measurement:** The programme is seeking to simplify and unify the Bank's approach to managing results associated with all activities, bringing together the different systems for measurement and management of results in the Bank. Again this will release capacity across the Bank.

A common theme in all these areas – and across the programme itself – is the modernising of the Bank's culture. As the Bank has grown, processes and approaches suitable for a smaller organisation have persisted. The OE&E programme has been the first opportunity for twenty years to reflect on how the Bank's business can best be delivered. The freed up capacity within the Banking Department will be used to strengthen delivery to clients and, through this, enhance the impact of the Bank overall.

Refining the IT operating model

A number of changes to the operation and organisation of the Bank's IT support function are to be implemented. The objective is to simplify and standardise the Bank's IT architecture and application usage to allow it to take advantage of developments in the IT market. This will mean moving away from developing tailored systems in house. In addition, cost reductions will be achieved through the renegotiation of supplier contracts and partial outsourcing.

Consolidating procurement

The Bank's procurement functions are split into three parts. This reflects a combination of the nature of the goods and services being procured and the source of their funding.

To rationalise this organisation, it is proposed to reduce the number of procurement teams to two – a Procurement Policy and oversight team to develop policy and have oversight of procurement by third parties and a Procurement operations and delivery team to manage all the Bank's procurement on its own behalf. Overall, this will allow savings through the simplification of policies; a more strategic approach to supplier management and greater knowledge sharing. Furthermore, this is an area in which the Bank's IT systems are particularly dated imposing substantial costs on both the Bank's suppliers as well as internally. The effect of these changes will be a better service to internal and external clients.

7.3 The required investment

Implementing these changes and achieving the benefits in terms of improved Bank delivery and cost savings will need ongoing investment over the three years covered by the Strategy Implementation Plan and the detail on how the capacity created through the OE&E programme will be redeployed within the Bank is set out in section 8.

The investment budget for OE&E is summarised in table 7.3. The budget is fully ring fenced and cannot be used for any other purpose. Due to uncertainties in precise timing from year to year any unused budget would be carried forward until the programme is deemed completed by Management and the Board at which time any remaining amounts would be cancelled and not accrue to the baseline of the Administrative Expense Budget.

Table 7.3: OE&E Investment Budget 2017 to 2019

Total Investment required for bud	2017	2018	2019	2020	2021	2022	2023	Total
Client Services	12,377	-	-	-	-	-	-	**12,377**
IT Operating Model	5,656	990	-	-	-	-	-	**6,646**
Procurement Operating Model	1,682	-	-	-	-	-	-	**1,682**
Other	3,825	3,325	1,000	-	-	-	-	**8,150**
Risk Unknowns	5,000	-	-	-	-	-	-	**5,000**
Total	**28,540**	**4,315**	**1,000**	-	-	-	-	**33,855**

8. RESOURCING

The previous sections set out the Bank's objectives, the work it would undertake in meeting those objectives and the financial and capital implications of that activity. This final section covers the resourcing of the proposed plan. It consists of three parts:

- A medium term projection for the Bank's budgets over the period covered by the SIP together with its underlying assumptions and how the investments and capacity creation of the Operational Effectiveness and Efficiency programme will relate to this profile;
- A detailed proposal for an Administrative Expense Budget for 2017 including explanation of the role which ongoing reallocation and previous efficiency measures play in its construction; and
- A final section provides an update on the Bank's approach to HR issues.

8.1 Medium term resources

Section 7 set out a multi-year investment programme to support the OE&E programme. For both Board and Management, the future funding of the programme and the use of the capacity it will create over time are an important part of the context for proposing and approving the 2017 Administrative Expense Budget. This section considers the interrelationship between the evolution of that budget over the period 2017 to 2019 and the OE&E investment programme.

The key conclusions of this section are:

- The OE&E programme is estimated to require investment of £29.3 million over three years.
- The capacity created by the programme will allow Management to fulfil the commitment made in the SIP2016-18 for a flat Administrative Expense Budget for 2018, excluding compensation increases. The overall capacity created would make it possible to achieve the same result in 2019 and 2020, all things remaining the same, including no material new investments being identified and approved by the Board of Directors
- Management proposes to use the savings and capacity created in 2017 to make identified priority investments in 2017. Additional investments to deliver the SIP2016-18 priorities are indicated for 2018 and 2019 without pre-empting decisions about the total size of the budget for these years.
- On this basis, there remains unallocated capacity in those years without an identified purpose. Assuming that the level of unallocated capacity is the same in 2020 as 2019, the cumulative total capacity across the period would amount to £27.3 million.
- These projections also imply the level of unallocated capacity in the period 2017 to 2020 would be £2 million less than the total estimated OE&E investment.
- As a matter of principle, over the period available unallocated capacity should offset OE&E investment. Management will make every effort to identify additional savings or achieve lower OE&E investment to close this shortfall over the period to 2020.
- No decisions about the use of the unallocated capacity are implied by this document. Any use of such capacity will always be subject to the approval by the Board in the context of the annual budget discussions.

The projections are based on assumptions about OE&E delivery and the external environment, the actual level of savings and investment will be closely monitored and will be clearly presented year by year in the SIP document (in addition to quarterly reports).

Budget growth over the SIP2017-19 period

This section presents a three year projection of the Bank's budget to complement the projections in other parts of the document. The SIP2016-18 included a commitment to maintain a flat budget for 2017 and 2018 on the assumptions that:

- Increases in staff costs from agreed compensation increases in 2017 and 2018 would be in addition to a flat nominal budget;
- No material changes are made to the assumptions underlying the proposed Operational Plan; and
- The one-off investments required by the OE&E Programme are treated as additional to the flat budget.

A material change would prompt a thorough assessment of any incremental resource needs for the Board's consideration and approval. Such changes could include commencement of activity in a new country of operation or new guidance from Directors on engagement in Russia.

Although this SIP proposes a lower trajectory of growth of Bank investment than in the SIP2016-18, it is appropriate to maintain the previously proposed budget path. The revision is relatively small and – as has been shown – subject to potential changes in future years. The fluctuation is also driven mainly by a cautious assessment of the prospects for transition delivery through business growth for the coming years and the need to retain the ability to respond should greater opportunities emerge. The OE&E Programme is ambitious and has risks. These include the speed at which the Programme can be delivered and the pace at which capacity can be freed up. As a result, retaining the flat budget framework committed for 2017 and 2018 is a prudent approach.

Table 8.1 illustrates the projected development of total administrative expenses to 2019, with a flat baseline prior to compensation for planning purposes. An **Administrative Expense Budget of £346.0 million is proposed for 2017**, compared to a restated 2016 budget of £342.9 million.

This budget is supported by a planned **OE&E Investment Budget** of £29.3 million, of which **£24.0 million is proposed for 2017**. As discussed in section 7, this is a ring-fenced budget, separate from the Administrative Expense Budget. The conditions under which this budget will be used are set out in section 7.

Together these budgets amount to £370.0 million (€429.2 million).

Table 8.1: Projected total administrative expense 2017 – 2019

£m	2016 Restated	2017 Budget	2018 Estimate	2019 Estimate
Admin Exp. Budget prior to compensation	**342.9**	**342.9**	**342.9**	**342.9**
Reduction in 2017 Budget		(1.8)		
Cumulative compensation increases		4.9	10.8	16.6
Administrative Expenses Budget		**346.0**	**353.7**	**359.5**

£m	2017 Budget	2018 Estimate	2019 Estimate
OE&E Investment Budget	**24.0**	**4.3**	**1.0**
Total OE&E Investment Budget 2017-19			29.3

Euro budget	2017 Budget	2018 Estimate	2019 Estimate
Aggregate budget GBP	370.0	358.0	360.5
GBP/ EUR rate	1.16	1.16	1.16
Admin expenses EUR	**429.2**	**415.3**	**418.2**

OE&E and medium term capacity creation

The SIP2016-18 showed that delivery of the medium term budget profile was dependent on the successful implementation of the OE&E programme presented in section 7. This section shows how this is reflected in the medium term projections.

The OE&E Programme is targeted to free up £9.6 million budget capacity in 2017, rising to £20.4 million in 2018 and 2019. In aggregate, savings of £50.4 million are delivered by the Programme over 2017-2019. These are enabled by the separate £29.3 million OE&E Investment Programme budget over three years for restructuring discussed in section 7, and by IT investments, the cost of which are to be absorbed within the Administrative Expenses Budget.

Management proposes to apply this first £9.6 million in savings during 2017 to specific needs and to allocate the remainder to reducing the Administrative Expense Budget.

Of the incremental £10.8 million of savings delivered in 2018, Management estimates that these could be utilised as follows:

- £1.2 million resources needed for strategic priorities identified in the SIP2016-18, increasing planned utilisation from the net £7.8 million in the 2017 Administrative Expense Budget to £9.0 million in 2018 and 2019.
- The impact of absorbing the capital expenditure associated with the OE&E Programme within the Administrative Expense Budget of £2.1 million in 2018 and £3.3 million in 2019.

This would leave remaining annual capacity of £9.3 million in 2018 and £8.1 million in 2019, as illustrated in chart 8.2. If this capacity is also assumed to be available in 2020, then an aggregate £25.5 million of capacity would be estimated for the remainder of the SCF period to 2020. Including the reduction of £1.8 million through OE&E savings in the 2017 Administrative Expense Budget proposal, would result in £27.3 million of savings over the whole period, compared to a maximum OE&E Investment Budget proposal of £29.3 million.

Table 8.2: Indicative unallocated savings in the budget

£m	2017 Budget	2018 Estimate	2019 Estimate	2020 Indicative	Total 2017-20
Baseline Admin Expenditure Budget prior to compensation	***342.9***	***342.9***	***342.9***	***342.9***	
Reduction in core 2017 Budget	**(1.8)**				**(1.8)**
Unallocated capacity projected in core budget:					
Net investments in 2017 Budget	11.6	11.6	11.6	11.6	46.4
Incremental SIP16-18 priorities		1.2	1.2	1.2	3.6
OE&E savings	(9.6)	(20.4)	(20.4)	(20.4)	(70.8)
Other Savings	(3.8)	(3.8)	(3.8)	(3.8)	(15.2)
P&L impact of OE&E IT investments		2.1	3.3	3.3	8.7
Use of net savings to reduce 2017 Budget	1.8				1.8
Sub total: Unallocated capacity	**0.0**	**(9.3)**	**(8.1)**	**(8.1)**	**(25.5)**
Total reductions/ unallocated capacity	**(1.8)**	**(9.3)**	**(8.1)**	**(8.1)**	**(27.3)**
OE&E Investment Budget (maximum envelope)	**24.0**	**4.3**	**1.0**		**29.3**
Difference to baseline	**22.2**	**(5.0)**	**(7.1)**	**(8.1)**	
Cumulative difference to baseline	***22.2***	***17.2***	***10.1***	***2.0***	

On the basis of these projections, the level of unallocated capacity in the period 2017 to 2020 would be £2 million less than the total estimated OE&E investment. As a matter of principle, over the period available unallocated capacity should offset the OE&E investment and accordingly Management will make every effort to identify additional savings or achieve lower OE&E investment to close this shortfall over the period to 2020.

The budget indicated in the projections does not pre-empt decisions by the Board of Directors on the use and allocation of these annual savings. The use of such capacity will be determined by the Board in the context of the annual budget discussions.

The projections are based on assumptions about OEE delivery and the external environment, the actual level of savings and investment will be closely monitored and will be clearly presented year by year.

Medium term framework

For the purposes of developing the flat budget growth framework:

- The 2017 Administrative Expense Budget incorporates an increase of £4.9 million based on the proposed staff compensation adjustment of 3.5% applied for staff and the associated impact on benefits linked to salaries and the performance based compensation pool from 1 April 2017[21] (i.e. impact for nine months).
- For 2018 and 2019, the increase in the overall budget is based on an illustrative compensation adjustment of 3% from 1 April each year plus the full year impact (the 'carry over' effect) of the 2017 and 2018 adjustments.
- Because inflation, primarily in the UK, has been relatively modest, Management has proposed that inflationary and other pressures that increase costs for the same volume of resources be absorbed within the 'flat budget' framework. Should inflation trends materially change in the future, this approach may need to be reviewed in 2018 and beyond.

Strengthening the institutional capacity of the Bank

A central feature of the medium term budget presented in SIP2016-18 was the multiyear investments proposed for furthering sustainability (Green Economy Transition), supporting policy capability (VP, Policy) and enhancing the control environment (Risk, OCCO, ESD). This investment supports:

- Implementation of the Green Economy Transition (GET) approach.
- Implementation of the commitments of the Strategy for the Promotion of Gender Equality to mainstream gender across the Bank's activities.
- Strengthening policy engagement to better fulfil the Bank's transition mandate.
- Reinforcing the protection of the Bank's financial integrity and reputation, as well as respond to rising risks in the application of the Bank's Environmental and Social Policy.

The assumptions presented for incremental investment in SIP2016-18 have been revisited to ensure their continued validity. The key adjustment made to the originally path of investment in this SIP relates to GET, where cumulative required funding for 2017 is £1.3 million lower. This reflects: (i) a £0.5 million reduction in carry over related to new staff recruited in 2016 (expertise and level); and (ii) phasing the

[21] Includes salary adjustments for short term staff as the market price for new staff is expected to be higher. However, compensation adjustments for the Board of Directors, President and Vice Presidents and the Chief Evaluator are funded within the zero nominal framework.

incremental staffing over the three years from 2016-18 rather than 2016-17 as originally envisaged which results in shifting £0.8 million of the total resource increase from 2017 to 2018. This prudent approach recognises the time needed to assess the potential of innovative GET activities which will only be seen during 2017 given the timing of 2016 recruitment.

Table 8.3: Investment in institutional capacity over the SCF period

£000	2016 Budget	2017 Estimate	2018 Estimate
VP3	629	1,390	1,390
Control Environment			
Risk Management	525	1,630	1,938
OCCO	403	585	585
ESD (including Gender)	286	521	587
Green Economy Transition (original plan)	2,834	5,928	5,928
Adjustment to GET		*(1,300)*	*(500)*
Adjusted GET investment	2,834	4,628	5,428
Cumulative SIP16-18 priority areas	**4,676**	**8,753**	**9,928**
Incremental investment		4,077	1,174

In terms of the priorities identified in the SIP2016-18, the bulk will be delivered by the 2017 Administrative Expense Budget, with final incremental planned investment of resources for Risk Management of £0.3 million and up to £0.8 million for GET in 2018.

8.2 2017 Administrative Expense Budget

8.2.1 Overview

The 2017 total Administrative Expense Budget (including compensation) of £346.0 million represents a 0.9% nominal increase from the restated 2016 budget. Due to favourable exchange rate movements, the budget in euro of €401.4 million is a reduction of 12.5% from the restated 2016 budget (at the planning rate).

Table 8.4: Administrative Expense Budget for 2017

Administrative Expenses £m	2015 Actual	2016 Budget	2016 Restated	2017 Budget
Operating Expenses	260.6	286.1	283.3	285.3
Retirement Plan	39.3	42.3	42.3	42.4
Depreciation	25.6	17.3	17.3	18.4
Admin Expenses GBP	**325.4**	**345.7**	**342.9**	**346.0**
Exclude:				
Cumulative compensation increases				*(4.9)*
Admin Expenses excl. compensation increase				*341.1*
GBP/EUR rate	1.32	1.34	1.34	1.16
Admin Expenses EUR	428.1	462.5	458.8	401.4

Prior to the impact of the 2017 compensation proposals, increases of £11.6 million have been funded through £13.4 million of budget reductions, resulting in a net budget reduction of £1.8 million.

Table 8.5 sets out the increases that have been accommodated within the flat nominal budget for 2017 and the following observations can be made:

- £6.2 million of cost increases (factors (a) to (c)) that relate to decisions in the 2016 Budget or earlier and to the impact of external factors. As well as carry over impacts, increased budgets reflect higher staff and resident office costs as a result of the depreciation of pound sterling against the US dollar and other currencies. Additionally, the increased depreciation budget of £1.7 million for the headquarters building reflects the expense consequence of previous capital expenditure[22].
- £5.4 million of budget increases to support the business priorities of the Bank (factors (d) to (f)). These include the incremental budgetary impact of the resource priorities identified in the SIP2016-18 [23] (see previous section), funding for identified priorities in 2017 (discussed further below) and an increase in the mobility costs budget.

Regarding the £1.3 million of incremental funding provided in 2017 (factor (f)):

- £0.6 million refers to market data/information services where suppliers have indicated that the Bank will need to pay significantly higher costs. The Bank is reviewing its approach to these services;
- £0.3 million additional budget to enhance business development activities an element of which will fund new business development activities in China.
- £0.4 million of other funding to increase domiciliation/tax expertise, add an additional staff member in the Office of the Chief Economist, to support the new senior management structure and for other uses.

These budgetary increases have been accommodated by budget reductions as follows:

- £1.6 million from review and adjustment of the Banking Department budget to reflect the actual expenditure trends (includes reductions across all main cost categories);
- £2.2 million of net budgetary reductions mostly impacting staff costs, including review of benefits and retirement plan budgets, as well as a number of budgets across different functions being revised and adjusted downwards; and
- £9.6 million of savings planned in 2017 as a result of the implementation of the OE&E programme: £5.7 million under Client Services; £3.6 million in IT and £0.4 million related to procurement.

[22] This includes the fitting out of levels two and three of HQ, lift refurbishment and other large projects.

[23] The combined 2017 incremental impact of the SIP2016-18 priorities is £4.1 million comprised of £0.4 million carry over related to the full year impact of 2016 investment (within line a)) and £3.7 million of 2017 investment (within line (d)).

Table 8.5: Key movements in the 2017 Budget

£ million		2016	Increase	Reduction	2017
2016 Original Budget		**345.7**			
	Budget restatement	(2.8)			
2016 Restated Budget		**342.9**			
a.	**2016 carry overs:**				
	FY impact of 2016 Comp increase		0.8		
	Phasing of 2016 SIP priorities		0.4		
	Sub-total		**1.2**		
b.	**FX impact:**				
	Staff costs		3.1		
	RO rent		0.2		
	Sub-total		**3.3**		
c.	**HQ depreciation**		**1.7**		
d.	**2017 increment of SIP 2016-18 priorities**		**3.7**		
e.	**Incremental funding:**				
	Market data/ information services		0.6		
	Business Development		0.3		
	Other		0.3		
	Sub-total		**1.2**		
f.	**Mobility**		**0.5**		
g.	**Reduction of underlying Banking budget**			**(1.6)**	
h.	**Review of staff costs and other budgets (net)**			**(2.2)**	
i.	**OE&E savings**			**(9.6)**	
2017 prior to 2017 Compensation & Benefits			**11.6**	**(13.4)**	**341.1**
	2017 Compensation & Benefits (9 months phasing)				4.9
2017 Budget with Compensation & Benefits					**346.0**

Restatement of 2017 Budget: equity due diligence and post investment support

It is proposed to start using management fees[24] received from the EPF investors (€5.3 million or around £4.6 million per year[25]) to strengthen the equity business of the Bank. In addition, the Board is requested to approve the proposed change in treatment of third party costs related to all equity transactions (including both direct and indirect investments).

The 2016 Budget within the SIP2016-18 includes a total of £2.8 million budget ring-fenced for equity due diligence and post investment support (Nominee Director expenses). It is proposed to reclassify equity related third party actual expenditure and associated budgets out of the Administrative Expenses Budget in 2017 to a new fee and commission expense account to be set up within revenue. This is reflected as a net reduction and restatement of the 2016 Budget by £2.8 million.

These expenses will then be managed within an annual cost envelope of up to £7.4 million, as an aggregate of the expected EPF management fees and reclassified budgets. Expenditure on equity due diligence and post investment support will be reported to the

[24] In addition, the upfront costs associated with the establishment of the EPF have been recovered and ongoing administrative costs will also be separately recovered, in addition to fees received.

[25] Based on the 2017 Budget exchange rate of €/£ of 1.16.

Board on an annual basis as part of the Equity Portfolio Performance Analysis reporting.

This new treatment of equity related third party expenses is to ensure that decisions on equity transactions are not driven or constrained by availability of the budget. This is particularly important when the equity business is under heightened scrutiny to deliver quality investments and value creation activities. At the same time, an annual envelope limited by the EPF management fees and the reclassified budget along with proposed regular reporting to the Board on actual expenditure should provide sufficient comfort with adequate governance under the new treatment.

2017 Budget detail

Administrative Expense Budget by expense line

Table 8.6 presents the 2017 Administrative Expense Budget by cost line.

The £6.4 million (2.9%) increase in staff costs (including £0.1 million for the retirement plan):

+ £1.2 million carry overs, including full year impact of the 2016 Compensation and Benefits Proposal (£0.8m) and phasing of the 2016 SIP priorities (£0.4 million);
+ £4.9 million budget increase earmarked for the 2017 Compensation and Benefits proposals, including the impact on the Performance Based Compensation (PBC) pool;
+ £3.2 million increase for 2017 SIP priorities;
+ £3.1 million FX impact from the depreciation of GBP against other currencies;
+ £0.2 million increase in the PBC pool linked to volume, based on 13.5% of assumed eligible salaries;
+ £0.4 million linked to incremental funding proposed for 2017 ((e) in Table 8.5);
+ £0.5 million increase in the budget of mobility to fund prior commitments and support integration between resident offices and HQ;
- offset by a £7.1 million reduction including OE&E and other efficiency savings.

The £8.7 million (16%) reduction in non-staff costs:

- £9.5 million reduction in consultancy, mostly due to reclassification of the budget lines in IT (£6.8 million), OE&E savings (£1.8 million) and review of underlying consultancy budgets;
- £0.2 million reduction in legal costs;
+ £0.7 million increase in other direct costs, linked mostly to higher market data costs; and
+ £0.3 million increase in travel and hospitality costs mostly linked to SIP2016-18 priorities and new investments of the Bank.

The distribution of IT costs is different from that in the SIP2016-18. At the time of rebasing the IT budget in 2016, the entire impact of the shift from capital to operating expenditure was shown under consultancy costs for simplicity and due to the uncertainty of which cost lines would be affected by the changing delivery model (Software and Infrastructure as a Service). During 2016 the costs have actually been more pronounced on IT and Telecommunications as well as staff costs and less through the use of consultants.

The £5.4 million (8.3%) increase of indirect and depreciation costs:

- £3.8 million increase in IT and telecommunications costs due to the reclassification of budget lines linked to staff in IT previously funded from the capital expenditure budget, offset by efficiencies resulting from OE&E.
- £1.1 million increase in depreciation, of which £1.7m relates to HQ occupancy depreciation, offset by £0.6m reduction in IT depreciation.
- £0.5 million increase in RO occupancy across various regions, including the impact of exchange rate movements.

The 2017 Budget incorporates a Management Reserve of £1.0 million. Together with the existing £0.3 million General Contingency (where the use is subject to Board approval), the total contingency funds in the 2017 Budget are £1.3 million, or around 0.4% of the total budget.

Table 8.6: Administrative Expense Budget for 2017

Administrative expenses £m	2015 Actual	2016 Budget	2016 Restated	2017 Budget	2017 vs 2016 £m	%
Salaries	111.8	121.9	121.9	127.3	5.4	4%
Benefits	48.1	44.3	44.3	44.6	0.3	1%
Performance based comp	15.3	13.4	13.4	14.2	0.7	6%
Other staff costs	2.1	1.7	1.7	1.6	(0.1)	(6%)
Total Staff costs	**177.4**	**181.3**	**181.3**	**187.6**	**6.3**	**3%**
Consultancy/Legal	14.7	32.1	28.9	19.2	(9.7)	(34%)
Travel/Hospitality	12.5	12.5	12.9	13.2	0.3	3%
Other direct costs	11.4	12.1	12.1	12.8	0.7	6%
Total Non-Staff costs	**38.6**	**56.7**	**54.0**	**45.2**	**(8.7)**	**(16%)**
Total Direct costs	**216.0**	**238.0**	**235.3**	**232.8**	**(2.4)**	**(1%)**
Occupancy	30.5	31.3	31.3	31.7	0.4	1%
IT and telecommunications	7.3	8.5	8.5	12.3	3.8	45%
Annual meeting	1.1	1.2	1.2	1.2	0.0	0%
Central staff expenses	4.1	4.7	4.7	4.7	(0.0)	(0%)
Institutional fees / expenditure	1.6	2.0	2.0	2.1	0.1	7%
Contingency		0.3	0.3	0.3	-	-
Total Indirect costs	**44.6**	**48.1**	**48.1**	**52.4**	**4.3**	**9%**
Operating expenses	**260.6**	**286.1**	**283.3**	**285.3**	**1.9**	**1%**
Retirement plan	39.3	42.3	42.3	42.4	0.1	0%
Depreciation	25.6	17.3	17.3	18.4	1.1	6%
Total Admin expenses GBP	**325.4**	**345.7**	**342.9**	**346.0**	**3.1**	**0.9%**
GBP/EUR rate	1.32	1.34	1.34	1.16		
Total Admin expenses EUR	428.1	462.5	458.8	401.4	(57.4)	(12.5%)

Departmental budgets

The total direct costs budget for 2017 of £232.8 million is broken down by department in Table 8.7[26]. It should be noted that this reflects the organisational structure as at 31 October 2016.

[26] Historic data is available on Board Online Information

Table 8.7 Direct costs by department

Direct costs £m	2017 Budget
Banking	99.1
Policy and Partnerships	14.1
Finance	13.4
HR and Corporate Services	37.8
Risk	17.5
OCCO	2.4
Office General Counsel	16.0
Office Chief Economist	1.7
Internal Audit	0.8
President's Office	1.3
Corporate Strategy	0.7
Office Secretary General	3.3
Communications	5.8
Evaluation Department	2.5
Board of Directors *	10.4
Unallocated	6.0
Total Direct costs	**232.8**

* This includes £0.97m budgets managed by Board Constituencies.

Resource management

The Bank continues to use its budgetary resources **flexibly and efficiently:**

- The Bank budgets accurately. Utilisation has consistently been at 99% over the past three years and 97% over the past five years.
- The Bank applies vacancy adjustments to its staff costs budgets reflecting that positions take time to hire and to be able to more effectively operate within a given budget.
- In 2016 the Bank has tightened its use of consultancy, travel and hospitality. Consultancy savings have been realised through a more rigorous internal review and rationalisation of consultancy advice. Travel savings have been realised through optimising travel budgets by considering travelling on restricted economy without compromising on health and safety. Savings have been achieved regarding team retreats through taking advantage of corporate synergies and commercial savings available by coordinating all HQ team retreats through one vendor and by reducing the frequency of retreats for all departments to every other year.
- Reallocation of resources by departments during budget implementation is encouraged. In addition, the move to money budgeting for staff costs is supporting a move towards more active management of staff costs with a better balance between junior and senior staff. The greatest scope for redeployment lies in the Banking Department, as discussed below.

Banking reallocations (resources and offices)

Banking continues to manage resources proactively, flexibly reallocating staff and budgets to address changing operational pressures. This may include physical reallocation of staff or budgets (geographic moves or transfer of vacancies), adjustment of staff dedications within the sector/country Banking matrix structure or reallocation of tasks and efforts without physical redeployment. The use of staff resources dedicated to the Russia portfolio, as well as redeployment possibilities, is constantly reviewed in the light of the guidance of Directors.

Over the first nine months of 2016 there have been 51 reallocations within the Banking Department, including:

- 35 geographic moves covering long term assignments of existing staff as well as transfer of permanent vacancies across the regions (transfers from/to HQ, as well as across the ROs). This includes 13 transfers across business groups reflecting adjustments within the sector/country matrix structure;
- Two further matrix moves made within the same location; and
- 14 other reallocations, the majority addressing resource optimisation within business groups at HQ.

Reallocations to resident offices are mostly to address resource pressures in Central Asia, Turkey and SEMED regions. Of these 51 moves, twelve relate to staff working on Russian business (transfers to HQ under ICA, Equity and Energy business groups, staff relocations to Belarus and Poland, a vacancy move to Central Asia, as well as transfers within the Russia region). This is in addition to five long term geographic reassignments out of Russia initiated in 2015 or earlier.

Over the course of 2017, reallocation will continue to be a theme within the newly established Client Services Group. Specifically, the optimal distribution and possible rationalisation of the Resident Office network will be examined in the context of the OE&E programme, taking into account the level and type of work activity being undertaken by the Bank in different regions. In particular, it will consider where activities can be managed more effectively and efficiently from larger regional hubs rather than local offices.

Headquarters and resident office resources

Last year, the Bank moved to a position of budgeting for IT expenditure through the operating expense budget. In this way capital investment in IT would be budgeted for through its impact on depreciation costs and could be easily compared with the cost of renting services. As a result, investment decisions would be driven only by value for money, not the source of funds.

In this SIP it is proposed to extend this approach for budgeting to the other parts of the capital budget. That is, **capital expenditure budgets will no longer be proposed to the Board for headquarters and resident offices** expenditure. The depreciation implications of capital expenditure decisions will be managed within the overall administrative expenditure budget.

The Bank will continue to develop its workplace `vision’ in 2017 under the aegis of the OE&E programme. The work on the Bank's real estate strategy – informed by the results of the workplace project - will resume in the second half of 2017 ahead of the expiry of the lease on the HQ building in 2022.

Key areas for non-IT capital expenditure planned for 2017 include:

- Within Headquarters, the reconfiguration of the second floor to allow transfer of staff from 155 Bishopsgate and to provide a pilot scheme for the Bank’s workplace ‘vision’; and

- In Resident Offices, the relocation of premises in Almaty, St Petersburg and Brussels; reconfiguration of the RO in Bucharest and new office openings in Alexandria and Odessa.

In recent years the Bank has built up its business development capacity in a number of shareholder countries in order to further promote foreign investment in its countries of operation. China is an increasingly important investor in the EBRD region, especially in Central Asia but remains significantly under-represented in the Bank's portfolio. The 'One Belt, One Road' initiative, for example, is an ambitious plan supporting China's trans-continental linkages with Central Asia and Europe through a network of infrastructure, energy and commercial investment which could be of interest. The establishment of China-based multilateral institutions such as the Asian Infrastructure Investment Bank (AIIB) has opened new areas of cooperation for the Bank. A Bank presence in Beijing is the most cost efficient and effective means for taking advantage of these new opportunities

In 2017, it is the intention to engage a China-based Senior Business Development representative on a consultancy basis, to provide a fully dedicated resource on the ground to establish and strengthen business development capability in the region. It is envisaged that office space would be provided free of charge by the AIIB. This arrangement will be similar to the initial support of business development activities in Japan and USA. Should this arrangement prove successful, a business case for establishing a permanent EBRD Representative Office will be presented to the Board for separate consideration.

More generally, reflecting the increased importance of business development activity in the Bank's work, Management will update the Board with an assessment of its global business development efforts to date.

IT resources

Going forward, the most significant single identified 'business as usual' IT project over the next three years will be to support the implementation of IFRS9 at a cost of around £5 million. In addition, capital expenditure is expected to be used to finish projects that have already been approved, for infrastructure and for smaller projects over the period. There may also be unidentified demand towards the period covered by the SIP.

The cost of IT investments to enable the OE&E Programme will be absorbed within the core flat budget for 2017. These investments represent a capital expenditure of £15.7 million over the period covered by the SIP, of which £10.4 million will take place in 2017. There will be an annual impact on expenditure (through depreciation and other items) of £0.6 million in 2017 (to be absorbed within the overall 2017 budget), rising to £2.1 million in 2018 and £3.3 million in 2019.

Delivery of the IT investments to support the OE&E Programme will, therefore, be a key focus for the IT Department.

8.2.2 Organisational efficiency

Organisational performance in the Bank's scorecard is measured on the basis of the annual number of operations and the number of operations monitored in the portfolio divided by the actual level of expenditure of the Bank expressed in sterling.

Based on the projected increase of the number of portfolio and new operations and on the projected operating expenditure, the target organisational performance ratio for 2017 is set within a range of 1.7 to 1.9 operations per million pounds (sterling) of operating expenditure.

8.3 The Bank's workforce

This section provides an overview of the Bank's staffing and the tools through which it will manage the necessary flexibility in skills, size and shape over the period covered by the SIP.

The table below describes the current composition of the workforce and compares it to the figures of the previous year.

Numbers and proportions		Prior Year (31 Aug 2015)	Prior Year proportion	This Year (31 Aug 2016)	This Year proportion
Location	HQ	1,668	70%	1,767	70%
	Resident Offices	727	30%	758	30%
Function	Banking	1,300	54%	1,356	54%
	Corporate functions	1,095	46%	1,169	46%
Contract Type	Regular	1,762	74%	1,872	74%
	Fixed term	498	21%	528	21%
	Other	135	5%	125	5%
Job level and gender	Non OTE (male)	968	40%	1,025	41%
	Non OTE (female)	807	34%	892	35%
	OTE (male)	95	4%	97	4%
	OTE (female)	525	22%	511	20%

The figures include bank funded and externally funded positions. In addition to the above figures, on 31 August 2016 the Bank was engaging 565 CCTs (contractors, consultants and temporary staff who are not paid via the Bank's payroll).

There are no clear changes in terms of the relative composition, with approximately half of the organisation employed in the Banking function, and three quarters employed on regular (open-ended) contracts. The move from headcount to budgetary control has two implications for the table and for workforce planning. First, drawing conclusions from headline employee numbers in isolation is not possible since different numbers of staff can be accommodated within the same budget envelope depending on the composition. Secondly, planning is based purely on the projection of expenditure, not headcount.

The context: 2017 to 2019

Staff are the Bank's largest expense and biggest asset. The overall need remains as set out in the SIP2016-18 – to manage a flexible workforce to meet the evolving needs of the Bank to ensure that it meets its overall objectives. This is more difficult in a context where the Bank's work is growing and changing, and the outside environment increasingly demanding.

In addition, the commitment to deliver stretching business objectives within a budget which is flat in nominal terms excluding compensation increases naturally presents tests for the workforce. The OE&E Programme is focusing on identifying and implementing changes to help support the Bank in meeting this challenge. An important objective across the Bank is to maintain the motivation and engagement of staff during this process. Most change programmes see a reduction in motivation and engagement during periods of uncertainty while individuals learn new ways of operating. The speed with which staff move through this change process is therefore important as is the support provided to acquire new skills where necessary.

Delivering a high performing and flexible workforce

Through its HR Transformation, focusing on Talent and Performance Management, the Bank is increasingly well equipped to meet the overarching challenge of managing its workforce. In summary, the key areas of focus over this period covered by the SIP period to drive a high performing and flexible workforce are:

Effective Talent Management

- Attraction – the aim is to continue to acquire high calibre and diverse talent, reduce reliance on external suppliers, and ensure integration into the organisation is quick enabling people to deliver at full capacity.
- Assessing potential and succession planning – talent review meetings will be conducted each year to assess individual potential and identify future successors for key roles. The aim is both to enable career enrichment and fulfil business needs.
- Development of leaders and staff - will focus on building behavioural and technical skills, knowledge and experience to deliver the Bank's mission. In addition, greater emphasis will be placed on increasing management and leadership capability in order to build a strong pipeline of future leaders, and enhance organisational performance. As the Bank implements the OE&E programme, strong and clear leadership will be increasingly important;
- Employee engagement - will focus on the identification and communication of our employee value proposition and promotion of a culture that supports our corporate behaviours. The aims are: (i) to convey exactly how working at the EBRD can add to a professional repertoire of experiences in return for performance and contribution; and (ii) to ensure that the Bank has an engaged workforce and retains the key talent required for the business to be successful.
- Ensuring diversity and inclusion to increase creativity, innovation and promote better decision-making. The Bank has established and is measuring diversity using metrics set out in the Talent Strategy. To progress towards realising the aspiration of having women in half of all Corporate Leadership Group roles, the Bank will aim for a 50/50 gender balance on succession plans for all CLG roles by the end of 2018.

Robust Performance Management

- Consistent objective setting – alignment of corporate, departmental, team and individual objectives to ensure a clear focus, and ensuring that objectives are equally stretching whilst being achievable.
- Consistent performance assessment – balancing the focus on 'what' has been achieved with 'how' individuals have worked, using behavioural competencies to assess this consistently across the Bank. Encouraging managers to have regular check-ins on progress throughout the year.
- Effective management of under-performers - HR guiding managers in how to address sub-standard performance, for example through candid developmental feedback, management training and following robust processes.

Through the period covered by this SIP, all departmental scorecards will include metrics to support robust performance management. These include measuring completion statistics for performance assessments and the quality of objective setting.

Appropriate Reward

- Reward is competitively positioned against the market and promotes high performance and the right behaviours.
- Reward facilitates mobility and staff development to enable a flexible and effective workforce responsive to changes to business requirements. Mobility also fosters the

development of talented employees and combined with better forward looking development planning will enable the Bank to 'grow' many of its future leaders.
- Reward is communicated in an open and transparent way and is managed following clear and consistent processes.

An example of becoming more open and transparent in 2016 has been the sharing with staff the market reference points and the current position of their salary against this. The reward strategy and guiding principles were also shared with staff, along with education on how market benchmarking is performed.

The corporate culture of the organisation is a reflection of how individuals work and interact with each other and with clients on a day to day basis. Central to this are the corporate behaviours which the Bank has identified to help guide the organisation to the next level in terms of engagement, reputation, and delivery, specifically:

- We develop mutually beneficial relationships
- We stretch for sustainable success.
- We demonstrate good citizenship.
- We innovate to remain relevant.
- We lead and manage our people with skill and care.
- We communicate with conviction and honesty

Ensuring the right composition of the workforce

Organisations need to regularly assess the appropriateness of their organisational structure as business requirements change over time. Throughout 2015 and 2016 the Enhanced Reserve for workforce flexibility was used to facilitate exceptional expenditure mainly to support departmental restructuring and supplement the budget provision for individual mutually agreed separations.

How progress is measured and reported

New HR systems have recently been introduced to support HR processes such as performance management, succession planning and recruitment, and this will enable more robust reporting through the period covered by this SIP. In addition employee engagement surveys and pulse surveys will be conducted regularly with all staff.