

# **BOARD OF AUDITORS' ANNUAL REPORT TO THE BOARD OF GOVERNORS**

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for the period ended 31 December 2015

**Board of Auditors**

European Stability Mechanism

# 1. INTRODUCTION

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The Board of Auditors of the European Stability Mechanism (further referred to as the "ESM") is established pursuant to Article 30 of the Treaty establishing the ESM and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.

The Board of Auditors carries out independent audits, inspects the ESM accounts, audits regularity, compliance, performance, risk management and monitors as well as reviews the ESM's internal and external audit processes and their results.

This report is addressed to the Board of Governors in accordance with Article 24 (6) of the ESM By-Laws and provides details on the audit work of the Board of Auditors, its audit findings in relation to the financial statements of the ESM and its conclusions and recommendations for the period from 1 January to 31 December 2015. This report will be made available also to the national parliaments and supreme audit institutions of the ESM Members, to the European Court of Auditors and the European Parliament.

The members of the Board of Auditors were appointed by the Board of Governors as follows:

- Mr Ulrich Graf, nominated by the Supreme Audit Institution of the Federal Republic of Germany
- Mr Igors Ludboržs, nominated by the European Court of Auditors
- Mr Jean Guill, upon proposal of the Chairperson of the Board of Governors
- Mr Andrew Harkness, nominated by the Supreme Audit Institution of Ireland
- Mr Günter Borgel, upon proposal of the Chairperson of the Board of Governors.

The initial members of the Board of Auditors were appointed for a non-renewable term of three years on 8 October 2012, except for Ms Kaszasová and Mr Graf whose names were drawn by lot and were appointed for a non-renewable term of four years until October 2016 to ensure continuity of the work of the Board of Auditors. New members of the Board of Auditors are appointed for non-renewable terms of three years.

In October 2015, the three year mandates of Mr Gengler and Mr Muis expired. Ms Kaszasová resigned from the Board of Auditors as of 31 December 2015, due to changes in her professional engagements.

The Board of Auditors elected Mr Graf as Chairperson and Mr Ludboržs as Vice-chairperson, both for the term from October 2014 until October 2015.

On 21 October 2015 the Board of Auditors elected Mr Ludboržs as Chairperson and Mr Harkness as Vice-chairperson for a one-year term lasting until October 2016.

At the time of their appointment and during the performance of their duties, the members of the Board of Auditors took care to avoid all conflicts of interest and have refrained from any action incompatible with their duties. The members of the Board of Auditors acted independently and have not sought or taken instructions from the ESM governing bodies, the ESM Members or any other public or private body.

## 2. ACTIVITIES OF THE BOARD OF AUDITORS

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### 2.1. Meetings of the Board of Auditors

The Board of Auditors held 9 meetings in 2015. The purpose of these meetings was to be briefed by and to discuss with the ESM's management developments and oversight questions. These were in particular relating to the Board of Auditors' core missions:

- assuring the integrity and adequacy of the financial statements and the related controls frameworks as well as,
- performing selective efficiency and effectiveness reviews.

Additionally the Board of Auditors met once with the ESM Board of Directors in June 2015. In the same month, subsequently the Chairperson of the Board of Auditors attended the annual meeting of the Board of Governors. On 28 October 2015 the Chairperson of the Board of Auditors and Mr Graf, in his capacity as the former Chairperson of the Board of Auditors met with the Chairperson of the Board of Governors.

During their meetings the Board of Auditors received regular updates on the activities of the ESM and the ESM governing bodies, attended presentations by management on specific topics requested by the Board of Auditors and met with the internal auditor and the external auditor.

From 31 December 2015 to the date of this report, the Board of Auditors held a further 4 meetings.

### 2.2. Scope

The Board of Auditors has:

- performed limited review procedures in accordance with Article 30 (3) of the ESM Treaty and Article 24 (4) of the ESM By-Laws focusing, among other subjects, on the audit of the ESM's funding operations and follow-up of the audit of the ESM's lending operations;
- reviewed whether, and in how far, recommendations arising from the previous Annual Reports to the Board of Governors were considered and implemented;
- reviewed the ESM financial statements for the period ended 31 December 2015 as drawn up and adopted by the Board of Directors on 18 March 2016. The ESM's Financial Statements were prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006; the Directive 2006/46/EC has been amended by Directive 2013/34/EU. The ESM applies the same transitional period applicable to the Member States for transposition by 2016;
- noted that in accordance with the aforementioned financial statements, the balance sheet totals as at 31 December 2015 amount to EUR 779 billion and consist on the assets side mainly of loans and advances to euro area Member states (EUR 63 billion), debt securities (EUR 35 billion), subscribed capital called but not paid (EUR 394 million) and subscribed ("authorized" according to Article 8 of the Treaty establishing the ESM) capital not yet called and unpaid (EUR 624 billion). The total own funds

amount to EUR 706 billion. The total liabilities are composed mainly of debts evidenced by certificates (EUR 72 billion). The net profit for the financial year amounts to EUR 729 million, mainly the result of interest receivable and similar income (EUR 624 million), interest payable and similar charges (EUR 308 million), net profit on financial operations (EUR 439 million) and general administrative costs (EUR 49 million);

- monitored and reviewed external audit processes performed by PricewaterhouseCoopers, Société coopérative, Luxembourg (further referred to as "PwC");
- met members of the Management Board including the ESM Managing Director, Deputy Managing Director and the Secretary General, Heads of Corporate Governance & Internal Policies, Finance and Control, Funding, Investment and Treasury, Chief Risk Officer, Internal Auditor and other members of the ESM's management and discussed as well as reviewed relevant issues and developments;
- monitored and reviewed the internal audit processes and its results according to Article 24 (4) of the ESM By-Laws;
- received at its request various written representations from the ESM Management Board members and members of the ESM's management concerning issues of oversight interest.

## 3. FINDINGS AND RECOMMENDATIONS

The findings and recommendations related to the internal and external audits as well as to the Board of Auditors' own audits are presented and commented in the following sections of this report.

### 3.1. Financial statements 2015

In accordance with the ESM By-Laws, Article 23(2)(d) the Board of Auditors reported, in its separate Report on Financial Statements, the following:

"In 2015 the ESM has completed the development of the integrated control framework (ICF). This allowed the ESM Management to assert that, at 31 December 2015, the ESM maintained effective internal controls. It will require a period of time to fully embed all elements of the ICF within the institution. The Board of Auditors notes that, to the best of its judgment, no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the year ended 31 December 2015."

Based on knowledge obtained from exchanges of views with the ESM's management and the external auditors as well as based on publicly available information, the Board of Auditors is not aware of any significant subsequent events to be recognized in the ESM financial statements for the period ended 31 December 2015.

### 3.2. External audit

In accordance with the ESM Treaty, Article 29 "Accounts of the ESM shall be audited by independent external auditors approved by the Board of Governors and responsible for certifying the annual financial statements".

The ESM financial statements for the year ended 31 December 2015 were again audited by PwC. The external auditor was appointed as "réviseur

d'entreprises agréé" (statutory auditor) by the ESM Board of Governors on 8 December 2014. The engagement letter was signed by the ESM representatives on 19 December 2014. Based on this engagement letter, PwC was requested to carry out a statutory audit of the financial statements of the ESM for the year ending 31 December 2015 in accordance with International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier" (further referred to as "CSSF"), the Luxembourg legislation, the professional standards adopted by CSSF and the professional standards issued by the "Institut des Réviseurs d'Entreprises".

PwC issued an unqualified Auditor's opinion on 18 March 2016 stating that "In our opinion, the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2015, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directives."

In accordance with the ESM By-Laws, Article 24, (4) "It (Board of Auditors) shall monitor and review the ESM's internal and external audit processes and their results".

The Board of Auditors has met the PwC representatives several times; reviewed documentation prepared by PwC and discussed the auditor's strategy and planning, interim results and the closing of the audit.

The Board of Auditors brings to Board of Governors' attention the following:

- The ESM followed the Board of Auditors' recommendation in 2012 and 2013 to conduct a competitive procurement process for the selection of the external auditor of the ESM financial statements.
- Following the Board of Auditors' former recommendation PwC granted the Board of Auditors for the second time full access to the external audit working papers during a four-day re-

view at the PwC premises in Luxembourg. This review allowed the Board of Auditors to conclude that the audit documentation prepared by PwC, in respect of the ESM financial statements for the year ended 31 December 2015, was sufficient to understand the audit work performed.

- The Board of Auditors takes note of PwC's "special topic report" as part of the management letter covering the internal controls in place with respect to the design and operating effectiveness of the IT controls implemented in the areas of IT Security, Program and System Changes, and IT Operations. The Board of Auditors noted the conclusions and encourages the ESM's management to follow up on its findings and recommendations.
- The Board of Auditors takes note of PwC's management letter and encourages the ESM's management to follow up on its findings.

### 3.3. Internal audit

The ESM Treaty, Article 28 stipulates: "An internal audit function shall be established according to international standards". Additionally, Article 24 (4) of the ESM By-Laws requires: "It (the Board of Auditors) shall review the ESM's internal and external audit processes and results".

Following a recommendation given by the Board of Auditors the internal audit function consists of one Senior Auditor and one Auditor. The Board of Auditors monitored management responses and proposed resolutions of the matters raised.

The ESM's internal audit performed a number of audits and reviews. The ESM's internal audit evaluated the adequacy, effectiveness and timeliness of actions taken by the ESM's management on findings and recommendations including recommendations made by the Board of Auditors and the external auditor. The ESM's internal audit provided the Board of Auditors with an annual report to outline the activities of the ESM Internal Audit function for the year 2015 and the planned activities for 2016.

The ESM introduced an audit clause which has been included in the service level agreements with key suppliers. Based on this clause the internal auditor of the ESM is able to conduct audits of the suppliers. The audit clause for one key supplier is still under discussion.

### 3.4. Audit of the ESM's funding operations

In 2015 the Board of Auditors carried out a first audit of the ESM's funding operations. Based on Article 24(5) of the ESM By-Laws the Board of Auditors appointed subject matter experts to support the audit work.

The audit covered the ESM's funding strategy, the process for auctions and syndications as two relevant formats for issuing debt and the ESM's investor relations activities.

The ESM largely followed the recommendations given by the Board of Auditors. Nevertheless the Board of Auditors would like to address the following:

- In the past the ESM's funding strategy was driven by the need to raise money quickly and by investors' risk appetite in terms of volume and maturity of the issues. The Board of Auditors welcomes the ESM's efforts to develop a more analytical approach that helps to further optimize the funding portfolio regarding the balance of funding costs and liquidity risk.
- The ESM generates its long term funding mainly through syndications run by the lead banks. Given the fees for syndications and the reliance on the syndication funding format, the Board of Auditors recommends a stronger use of auctions whenever the relevant parameters are appropriate.

### 3.5. Follow-up of the audit of lending operations

According to the ESM Treaty (Article 13(6)) the ESM has to establish an "appropriate warning system" to ensure that it receives any repayments due by the beneficiaries in a timely manner.

Following its audit of the ESM's lending operations, the Board of Auditors recommended in February 2015, the introduction of several amendments to further strengthen the current implementation of the Early Warning System procedure.

The Board of Auditors notes that the ESM has amended the Early Warning System procedure

accordingly. The amended procedure was endorsed by the Board Risk Committee on 26 November 2015 and approved by the Board of Directors on 18 March 2016.

In line with the recommendation the ESM updated the procedure by incorporating:

- An expanded analysis of liquidity projections to a period of 12 months, on a rolling basis to allow for early detection of potential vulnerabilities that may trigger an event of liquidity stress;
- An expanded medium-term analysis of the economic and financial outlook including stress scenarios;
- A move from payment-dependent reporting to regular quarterly reporting format to ensure continuous monitoring and an early identification of liquidity or solvency risks.

### 3.6. Follow up of previous Board of Auditors Annual Reports to the Board of Governors

The Board of Auditors notes that the ESM has revised its procurement policy in May 2016.

As outlined in its previous Annual Reports, the Board of Auditors reiterates its recommendation that the ESM adopts the EU regulatory framework as its own.

## 4. IN CLOSING

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The ESM, for the period under review, was in its third year of full operation. The Board of Governors is invited to consider the findings and recommen-

dations mentioned in this Annual Report and to undertake appropriate initiatives.

Luxembourg, 18 May 2016  
Board of Auditors

