European Investment Bank

AUDIT COMMITTEE

Annual Report to the Board of Governors

For the 2005 financial year

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

For the 2005 financial year

Table of contents:

1. INTRODUCTION 1

2. DEVELOPMENTS WITHIN THE BANK 1

2.1. Developments in the Bank's activities 1
2.2. Significant measures taken by the Bank 2
2.3. Specific measures taken by the Audit Committee 5

3. REVIEW OF AUDIT WORK 6

3.1. External auditors 6
3.2. Evaluation and Internal Audit 6
3.3. European Anti-Fraud Office (OLAF) 6
3.4. European Court of Auditors 6

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2005 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE 7

5. CONCLUSION 8

1. INTRODUCTION

The statutory role of the EIB's Audit Committee is to verify that the Bank's operations have been conducted and its books kept in a proper manner, as defined in the Statute and Rules of Procedure. The Audit Committee fulfils its role by:

- overseeing the work performed by the external auditors and co-ordinating such work with that of the internal auditors;
- safeguarding the independence and integrity of the audit function and the follow-up of audit recommendations; and
- understanding and monitoring how Management is assessing the adequacy and effectiveness of internal control systems, risk management and internal administration.

The *Audit Committee* has provided its opinions on the financial statements of the EIB Group, the Bank, the Investment Facility and the FEMIP Trust Fund for the financial year 2005.

The annual report from the Audit Committee to the Board of Governors provides a summary of the Committee's activities during the period since the last Board of Governors' meeting in June 2005. A separate summary report of the Audit Committee's activities in respect of the Investment Facility is also provided.

2. DEVELOPMENTS WITHIN THE BANK

2.1. Developments in the Bank's activities

The *Audit Committee* noted a number of developments that may impact on its work and has followed up matters identified in its 2004 annual report, as follows:

Investment Facility: Within the framework of the Cotonou Agreement, the Bank manages Member States' resources under the Investment Facility as well as associated own-resources lending in the Africa Caribbean and Pacific (ACP) and Overseas Countries and Territories (OCT). The *Audit Committee* has monitored the activities of the Facility, and notes the ring-fencing of the Investment Facility management, allowing clearer identification of expenditure and remuneration in 2005 and, in accordance with an instruction from the European Commission, the first-time adoption of International Financial Reporting Standards (IFRS) accounting standards in the preparation of the 2005 financial statements. The *Audit Committee* has signed a statement regarding the 2005 financial statements of the Facility.

Facility for Euro-Mediterranean Investment and Partnership (FEMIP): Further to the ECOFIN and European Councils decisions at the end of 2003, with the creation of the FEMIP Trust Fund and the implementation of the Special FEMIP Envelope in 2004, the "Reinforced FEMIP" has now become fully operational. Based on the Council resolution, it is further stipulated that **"**the incorporation of an EIB majority-owned subsidiary dedicated to Mediterranean Partner Countries will be fully assessed in December 2006, on the basis of an evaluation of the reinforced Facility's performance, and taking into account the outcome of consultations with the Barcelona process partners"**.**

In 2004, the *Audit Committee* reported that Internal Audit had identified a number of significant areas for improvement in the procedures and reporting requirements related to the administration of the EC-funded Risk Capital Facility for Mediterranean Partner Countries. As consequence of the audit, monitoring levels applied to risk capital operations in the Mediterranean were significantly strengthened over the course of 2005.

The *Audit Committee* acknowledges its responsibility for verifying proper monitoring of the FEMIP Trust Fund and has signed a statement regarding the first (2005) financial statements relating to the Fund (which were drawn up under the IFRS accounting standards).

Enhanced EIB Group co-operation: In 2005, the new Strategy for the EIB Group proposed to add Small to Medium-Sized Enterprises (SME's) to the Bank's own key priorities[1], putting the combined efforts and strengths of the EIB and EIF to work more efficiently through an increase in synergies.

[1] Economic and social cohesion; Implementation of the Innovation 2010 Initiative; Development of Trans-European and Access Networks and Environmental protection and improvement.

JASPERS/JEREMIE: The technical assistance facility known as JASPERS, 'Joint Assistance in Supporting Projects in European Regions', involves, for the first time, a partnership between the Commission (DG REGIO), the EIB and the EBRD. Through combining the efforts of the three institutions, it is intended to support the successful implementation of cohesion policy in the programming period 2007-2013 by greatly increasing the resources available for project preparation. JASPERS is expected to become operational in late 2006.

The *Audit Committee* also notes the creation of JEREMIE, "Joint European Resources for Micro to Medium Enterprises', as part of the EIB Group's efforts in support of EU policy initiatives, which is expected to become operational in 2007.

Borrowing Policy and Liquidity targets: The *Audit Committee* has reviewed the Bank's borrowing policy and liquidity drivers, noting in particular, the funding strategy pillars, including core currencies, other currencies and the types of products available to lower the cost of funding and to diversify the portfolio.

The *Audit Committee* notes that a share of EUR 5bn from the 2006 borrowing programme was approved for use in 2005[2] (2004: EUR 5bn) by the Board of Directors, once again being subject to favourable conditions being available on the capital markets for different types of operation.

The *Audit Committee* also reviewed the cash flow patterns and transaction volumes involved, noting that by 2008, there was expected to be a convergence between funding and disbursement requirements and additionally, that in-flows from loan repayments would start to smooth following the introduction of the new interest rate setting mechanism in 2005.

Loan Portfolio Quality: The Bank uses sophisticated concentration measures based on Credit Value-at-Risk to describe risk correlations in the loan portfolio. Over 2005, the portfolio concentration measures traditionally used by the Bank showed a slight increase when expressed in nominal terms. However, risk-weighted indicators continue to point to a broadly stable concentration in the Bank's loan portfolio. The distribution of loan grading of the year-end stocks of loans establishes the level of the year-end Fund for General Banking Risks (FGBR) due to general lending risks. The new level of the FGBR, which has increased by EUR 60m compared to the 2004 year-end figure, is essentially the net result of an increase in loans granted and the application of a new set of lower default probabilities to these same operations. The *Audit Committee* notes that the Bank's has decided to increase the provisions for specific loans based on objective evidence of risk of non-recovery.

2.2. Significant measures taken by the Bank

From the Audit Committee's perspective, significant measures have been taken by the Bank to respond to the changing environment and to manage the risks arising from trends in its activities:

Achievement of Objectives*:* The *Audit Committee* has been regularly updated on the Bank's progress towards 2005 targets set for each of the Bank's institutional objectives to contribute to EU policy goals[1] and for the objectives of meeting customer expectations, financial performance and for providing an appropriate internal structure to support the Bank's activities. The Bank's overall performance is measured in terms of Key Performance Indicators (KPI's). The *Committee* notes the Bank recorded at least 95% achievement of all KPI targets for 2005[3].

In June 2005, following a review of the Bank's Strategy at the mid-point of the planned capital increase term, the Board of Governors approved a new Strategy for the EIB Group. The new Strategy should be implemented with a view to maintaining financial self-sufficiency; the implementation measures being articulated via the Corporate Operational Plan 2006-2008, as summarised below.

The Board of Directors approved the new Corporate Operational Plan (COP) 2006-2008 in December 2005. The COP builds on the general orientations in the strategy approved by the Board

[2] The 2006 borrowing programme within the Corporate Operational Plan (COP) 2006-2008 has a global borrowing authorisation of EUR 55bn. Actual borrowing in 2005 from the 2006 borrowing programme was EUR 2.9bn

[3] All KPI targets were achieved except for the number of new clients attracted from outside Europe. The *Audit Committee* notes the on-going work of the Ops B Directorate to define other indicators which would better reflect performance by reference to the nature and specificity of operations and countries in the regions covered (including ACP and OFT countries).

of Governors in June 2005 and on subsequent strategy papers notably on the interest rate setting mechanism and enhanced EIB Group co-operation. The COP has been established to address the Bank's key priorities for supporting growth and employment in the EU in line with the Lisbon Agenda whilst serving the development and policy objectives of the EU. It highlights areas of known uncertainties that will affect the Bank's achievements, such as developments in the capital markets, the future adoption of the Financial Perspectives for 2007-2013 and of external mandates.

The *Audit Committee* notes the Board of Governors endorsement of increasing value-added through increased risk tolerance (including SME financing) and the introduction of new financial instruments, and the Bank's commitment to success in this area by attention to promoter and borrower satisfaction and renewed, more flexible, partnerships with the European Commission, the commercial banking sector and other International Financial Institutions. The *Audit Committee* has been updated regarding the various new initiatives, organisational restructurings, revisions to relevant policies and procedures and budgetary implications necessary to implement the COP.

<u>Audit of the Governing Bodies</u> – In 2000, the President of the Bank initiated a process to audit the functioning of the Bank's Governing Bodies. The initial audit in 2002, and a follow-up in 2003, were performed by external auditors. At the time of the 2003 follow-up audit, all recommendations made in 2002 relating to the activities of the Audit Committee had been addressed. The *Audit Committee* notes that in early 2006, Bank management has undertaken a further follow-up of the findings from 2003 (which related to the Management Committee and to the Board of Directors). The 2006 follow-up concludes that all recommendations remaining relevant have been implemented and that where earlier issues have been superseded, appropriate alternative controls/procedures have been applied. Bank management is reviewing the options for continuing this initiative in the future.

<u>Accountability and Transparency:</u> Over a number of years, the Bank has responded to the increasing demand for democratic accountability of European institutions[4].

Specific actions taken in 2005/2006 include:

- a first public <u>*Statement on Corporate Social Responsibility*</u> in May 2005, which complements a number of other corporate governance measures including the Transparency Policy (published June 2004) and the annual Statement on Governance at the EIB;
- a review of the Bank's <u>*Public Disclosure Policy*</u> – including a public consultation on the associated proposals. The Policy is founded on a presumption of disclosure of information, in line with EU legislation, those of the EU Member States and internationally accepted practices;
- a new <u>*Records Management Policy*</u> and a set of common principles to ensure the reliability of the Bank's documents and records were approved by the Management Committee in March 2006, underlining the evidential value of authentic, reliable and usable[5] records as proof of business activities;
- greater clarity in the disclosures made in the <u>*Curriculum Vitae*</u> of the members of the Board of Directors and systematic publication of individual declarations of conflicts of interest in relation to projects;
- publication of the <u>*Curriculum Vitae of the Directors General*</u> of the Bank.

<u>Compliance function:</u> In order to enhance the EIB Group's function dealing with compliance aspects, in October 2005, the Bank appointed a Group Chief Compliance Officer to assess, advise on, monitor and report on the EIB Group's compliance risk. The *Committee* welcomes the creation of the Compliance function.

<u>Internal Control Frameworks (ICFs):</u> In 2005/2006, the *Committee* has received assurance from management that ICFs are in place to mitigate against key risks in all core activities and that the ICFs are regularly updated.

The *Audit Committee* also notes that during 2005, the Bank's management implemented a dedicated ICF for Financial Reporting.

In order to ensure that the ICFs are embedded effectively into the everyday management of the Bank, the *Audit Committee* considers that a real challenge for management is to ensure that all

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[4] Including calls made in the European Parliaments report on the Bank's activity reports for 2003, reference A6-0032/2005 (presented to the Economic and Monetary Affairs Committee (EMAC) in February 2005).

[5] ISO 15489 Information and documentation- Records Management

future ICF set-up and update exercises critically reflect on relevant business and control objectives and that the resultant ICF's are tightly focused to retain and optimise those controls which are necessary to support the associated risk tolerance assessments. In this regard, the *Committee* concurs with an equivalent observation of the Court of Auditors[6] that "at all levels of administration in the institutions….internal controls should provide reasonable (not absolute) assurance on the legality and regularity of the underlying transactions, costs of the controls should be in proportion to the benefits they bring in both monetary and political terms, systems should be based around a logical chain structure where controls are undertaken, recorded and reported to a common standard…".

Risk Management Policies and Procedures: The independent Risk Management (RM) Directorate is responsible for Credit, Asset and Liability Management (ALM), Market and Operational risks. In 2005/2006, the key activities of the RM Directorate were:

- *Revised Policies, Guidelines and Methodologies:* A number of changes to internal documents have been made, the key ones are summarised below:
    - o Credit Risk Policy updates in respect of project finance and the risk pricing and internal grading with respect to lending operations under the Investment Facility, FEMIP and ALA mandates;
    - o a Financial Risk Procedure and Methodologies (FRPM) manual was created in 2005 to complement the new Financial Risk and ALM Policy Guidelines (FRPG) which were issued in December 2004 (and which have been revised for example to reflect the new interest rate-setting methodology - implemented on 1 January 2006 which introduces a new method of monitoring the funding and lending activities of the Bank from a financial risk perspective); and
    - o guidelines to complement the Bank's Operational Risk Policy have been drafted and will be finalised in 2006.
- *Basel II compliance analysis* –In June 2004, "The revised framework for international convergence of Capital Measurement and Capital Standards" ("New Basel Accord" or "Basel II") was issued by the Basel Committee on Banking Supervision. The Bank is not subject to supervision by any national or European supervisory authority, nevertheless, it voluntarily applies relevant EU banking regulations and market 'best practices'. In this context, the Bank is developing a methodology and associated guidelines to implement the Basel II Internal Rating Based (IRB) Advanced Approach for calculating the EIB's Regulatory Capital Requirements[7] and makes a detailed disclosure of Risk Management activities in the Annual Report. Further preparations to enable the Bank to comply with the relevant key components of Basle II are underway.

Risk Management Reporting: In 2004, the *Audit Committee* reported that the quality of the Bank's reporting of risk events has improved in recent years. In 2005 the *Committee* has received suitable assurance from management of progress being made to contain the number and importance of risk events.

Project and Operations Monitoring covers the follow-up of projects during implementation and of counterparties (promoters, borrowers and guarantors) after loan signature and up to full loan repayment. The Evaluation function also undertakes tasks to support the monitoring activities as described in section 3.2. To address previously reported weaknesses, on 1 January 2005, revised procedures were introduced for *Project Monitoring***:** (physical and financial monitoring at individual project level) and for *Counterparty Monitoring***:** (financial follow-up/reviews of borrowers and guarantors {the counterparties} involved in projects). In 2005, the *Audit Committee* has received encouraging updates from the Bank regarding the progress being made to reduce the monitoring backlog, including the recruitment of additional staff dedicated to this task. The *Audit Committee* also recognises the intrinsic risk in monitoring effectiveness where reliance is placed on information supplied by third parties and/or is subject to complex or imprecise rules (including local legislation). Therefore, the *Committee* remains concerned that the monitoring effectiveness and audit trails may not be optimised for some time as further monitoring procedures are only due to be phased into operation over a number of years.

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[6] Court of Auditors report on the Annual reports concerning the financial year 2004 (OJEU C 301 dated 30 November 2005) paragraph 1.84

[7] The Bank received technical advice from the Luxembourg Commission de Surveillance du Secteur Financier (CSSF).

IT Strategy: In 2004, the *Committee* identified that it would request a review of the efficiency and effectiveness of the investment in the ISIS information systems programme which started in 2000.

The *Audit Committee* also notes that the Bank experienced a number of problems during the implementation of a new ISIS application (for Borrowings) in July 2005. The problems required significant input to rectify, however, the Audit Committee has received assurance from management and the external auditors that financial and reputational risks associated with the problems have been contained and have not led to errors in the year-end financial statements. The Bank has subsequently decided to put on hold the implementation of the final ISIS application (for Loans).

The *Audit Committee* has been informed that Bank management is planning a review, the final report of which should include an assessment of the efficiency and effectiveness (including any improvements in functionality and control) resulting from the ISIS programme and the current IS/IT infrastructure. The review would satisfy the requirements of the Audit Committee.

Business Continuity Planning – The *Audit Committee* was briefed on the business continuity planning (BCP) arrangements and test results in September 2004. In October 2005, a further BCP test was undertaken and the associated findings indicated significant improvements had been made during the year.

2.3. Specific measures taken by the Audit Committee

The Audit Committee has also taken some specific measures related to its own roles and responsibilities. The two key measures are summarised below:

Audit Committee independence: The *Audit Committee* wishes to note that all representatives have respected the criteria to be independent of management during 2005/2006. In consideration of the need for the Audit Committee to also be independent of the Bank's activities, an observer of the Audit Committee voluntarily resigned from the Committee in April 2005 when a potential conflict of interest was identified between the role and his core job.

Changes in Accounting Standards: In 2005, the *Audit Committee* has reviewed the numerous changes to relevant International Financial Reporting Standards (IFRS) [which include International Accounting Standards (IAS)]. The *Audit Committee* recognises that, at an international level, there is little relevant experience of applying certain new or revised IFRS standards, (particularly as the newer or revised standards are based on principles of 'fair value' {rather than 'historic cost'} with varying degrees of application guidance and examples, and also because judgement is required in order to apply the standards to specific facts and circumstances), creating the potential for different accounting treatments. The *Audit Committee* therefore adopted a formal approach to reviewing the effectiveness of IFRS implementation in the 2005 consolidated financial statements and those of the Investment Facility and FEMIP Trust Fund by:

- assessing the business areas affected;
- considering the availability and reliability of systems and data;
- reviewing the level of other resources (staff and reporting tools) employed;
- requesting and receiving guidance and assurance from the external auditors on the appropriateness of the Bank's IFRS preparations;
- seeking (and receiving) suitable assurance that the Bank has identified the residual risks (associated with the lack of precise guidelines for IFRS implementation); and
- noting that Management has a pragmatic strategy to counter any associated reputational or financial risks.

Applying the above approach, the *Audit Committee* considers that it has been kept informed of the Bank's IFRS implementation program and the issues which had to be addressed at each stage. Based on its own work, and that of the external auditors, the *Audit Committee* is satisfied that the IFRS accounting entries and disclosures in the 2005 financial statements of the Group, Investment Facility and FEMIP Trust Fund are appropriate and meaningful.

Nevertheless, the *Audit Committee* considers that a period of time will be needed for consistency of new or revised IFRS standards interpretation to emerge through industry practice and the experience of working with such standards. Therefore the *Audit Committee* commits to monitoring how the application of new or revised IFRS standards impacts on the financial results of the Group, the

Investment Facility and the FEMIP Trust Fund and, as applicable in the future, how the financial results of the Bank will reflect the adoption of such standards.

3. REVIEW OF AUDIT WORK

3.1. External auditors

At each Audit Committee meeting, the *Committee* met with the external auditors. The *Audit Committee* reviewed the scope and reports of the work of the external auditors and concurred with the specific emphasis placed by the auditors on:

- IT systems changes;
- Structured products, and the monitoring of on-going issues;
- Internal Control Frameworks;
- Development of specific investment facilities, taking account of the fact that associated operations were in less stable countries and had correspondingly higher risk counterparties;
- Risk Management organisation and guidelines;
- The implementation and performance of the Compliance function;
- IFRS, and the new platform applicable as of 1 January 2005 (including the impact of accounting for Venture Capital and Guarantee activities).

The *Audit Committee* also performed the checks it deemed necessary to ensure the independence of the External Auditors. In doing so, the *Audit Committee* was informed about the proposal for the European Investment Fund (EIF) to enter into a contract with E&Y for the provision of advisory services regarding IFRS implications. The *Audit Committee* approved the assignment based on assurances from E&Y that the concurrent performance of the advisory assignment for the EIF and the external audit of the Bank assignments was allowed under external regulations and E&Y's own internal regulations for such advisory work because E&Y did not have a decision-making role.

3.2. Evaluation and Internal Audit

The work of the Inspector General, Head of Internal Audit and Evaluations Department is defined in the published Charter for Internal Audit and the Terms of Reference for Evaluations.

The *Audit Committee* was consulted on the drafting of the Internal Audit/ Internal Control Framework (ICF) work programme for 2006 and beyond and reviews and discusses each of the Internal Audit/ICF reports produced. The *Audit Committee* remains satisfied with the Bank's responses to internal (and external) audit recommendations, although an increased attention to the timeliness of actions is to be encouraged in some areas.

The Evaluations division undertakes thematic, sector and regional / country evaluations of completed projects which were financed by the Bank. Through its work, this division gives external observers a transparent view of the performance of the Bank, and provides internal feedback on aspects related to projects implemented. The *Audit Committee* has received copies of all Evaluations reports published in 2005.

3.3. European Anti-Fraud Office (OLAF)

OLAF is the EU's specialised body in combating fraud and corruption. Within the Bank, Internal Audit remains responsible for co-ordinating on-going investigations relating to Bank projects by informing management, the *Audit Committee* and OLAF of the nature and substance of any allegations of fraud within the Bank or within projects financed by the Bank. Joint Bank (Internal Audit) -OLAF investigations are conducted as necessary.

3.4. European Court of Auditors

The *Audit Committee* continued its relations with the Court of Auditors as in previous years and under the tripartite agreement (between the Bank, Commission and Court of Auditors) signed in October 2003. The *Committee* considers that there are no serious adverse findings related to the EIB Group in the Court of Auditors - Annual reports concerning the financial year 2004, OJEU C301 dated 30 November 2005. The Court did not undertake any on-the-spot visits related to Bank projects and hence did not request the Audit Committee to participate in any joint reviews.

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2005 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE

The *Audit Committee* has examined the Bank's consolidated and non-consolidated financial statements, including those of the Investment Facility and the FEMIP Trust Fund for 2005.

In 2005, the non-consolidated accounts continue to have been prepared in accordance with the general principles of the European Directive[8] applicable.

The consolidated, Investment Facility and the FEMIP Trust Fund financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS), and with the general principles of the European Directive applicable (the IFRS prevailing in the case of contrary provisions).

The *Audit Committee* considers that market appreciation of the different accounting regimes needs to be carefully managed by the Bank to avoid mis-understanding.

In respect of the financial statements of the Bank and the EIB Group, the *Audit Committee* noted the following matters:

- The Fund for General Banking Risks has increased by EUR 60m (in the financial statements of both the Bank and the Group) as explained in section 2.1.
- Specific provisions: Specific loan and guarantee provisions resulted in a EUR 37m charge to the Bank's 2005 Profit and Loss account (2004: EUR 60m) and a charge of EUR 53.5m in the consolidated Income Statement.
- The impact of application of the revised IAS 39 Fair Value Option (FVO) on the results and total reserves in the consolidated financial statements was as follows:
  - 2004 reserves (restated) – decrease of EUR 102m
  - 2004 income (restated) – increase of EUR 5m
  - 2005 income – decrease of EUR 208m
- Venture capital operations: Value adjustments resulted in a write-down (unrealised loss) of EUR 22.8m in the Bank's profit and loss account.

  However, the application of the revised version of IAS 39 in the consolidated financial statements obliges the recognition of unrealised gains related to the valuation of the Group venture capital portfolio. As a result, (unrealised) gains in the consolidated reserves amounted to EUR 97.2m.
- In the context of the consolidated financial statements, financial guarantees managed by the EIF have been accounted using the methodology applied in prior years following confirmation by the external auditors that the difference between the valuation thereby derived and the alternative, if IAS 39 fair valuation methods were to be strictly applied, was not material.
- In the consolidated financial statements, the cost of providing staff pension and health insurance schemes benefits is determined using projected unit credit actuarial methods. In 2005, the Bank has maintained a gradual (deferred) recognition of actuarial variations in the consolidated income statement[9] and the associated specific provision for the year amounts to EUR 8m.

  In respect of the Bank's financial statements, a provision of EUR 40.5m has been made related to actuarial losses in the staff pension and health insurance scheme benefits plans.[10]

The *Audit Committee* submits a separate report to the Board of Governor's regarding the financial statements of the Investment Facility, as annexed to this report[11].

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[8] This is fully consistent with the fact that not all EU Member States have adopted IFRS for non-consolidated financial statements. If the Bank decides to adopt IFRS for the first time in its annual financial statements for the year ended 31 December 2006, certain disclosure are required in its interim financial statements prior to the 31 December 2006 statements, but only those interim financial statements purporting to comply with IAS 34. Explanatory information and a reconciliation will be required in the interim report that immediately precedes the first set of IFRS annual financial statements. The information includes changes in accounting policies compared to those under the general principles of the European Directive currently applicable.

[9] The new version of IAS 19 (endorsed 2005) will be applicable in 2006 and will allow presentation of annually calculated actuarial losses and gains to be made in a Statement Of Recognized Income and Expense (SORIE-account) rather than in the income statement.

[10] Last year, such provisions were recorded as extraordinary charges (2004: EUR 68.5m).

Based on the work undertaken and the information it has received (including a favourable opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Bank), the *Audit Committee* concludes that the Bank's consolidated and non-consolidated financial statements and those of the Investment Facility and the FEMIP Trust Fund have each been drawn up correctly and that they each give a true and fair view of the 2005 results and financial status according to the principles applicable to the Bank.

The *Audit Committee* is of the opinion that it has been able to carry out its work to fulfil its statutory mission under normal, unrestrictive conditions. On this basis, the *Audit Committee* signed its annual statements on 7 March 2006.

5. CONCLUSION

In 2005, the *Audit Committee* is satisfied that the Bank has continually demonstrated that it has an appropriate strategy, policies and procedures to drive the business forward. The Committee has received assurances from Management and from the external auditors that Bank Management is implementing those strategic aspects that the Audit Committee looks at first and foremost by:

- integrating practices to ensure appropriate financial reporting;
- developing and enhancing the financial and risk reporting process; and
- capitalising on the 'best' practice pronouncements being made internationally on business management, corporate governance, auditing and accounting.

The *Audit Committee* is satisfied that it has provided an appropriate balance of proactive and effective supervision during 2005, through implementation of a 'listen, ask, assess and challenge' approach and without infringing on management's responsibility.

Looking ahead to 2006/2007, in addition to the assurances sought on an on-going basis, the *Audit Committee* can summarise its approach to the key findings of this report by resolving to seek particular assurance from Management that:

- quality ranks before quantity in borrowing and lending activities;
- internal controls (notably ICF's) continue to optimise responsiveness to associated risk tolerance assessments;
- the Compliance function is operating effectively and without restriction and, in particular, can provide the Committee with assurance on the regulatory framework as applicable to the Bank;
- overall project monitoring effectiveness is being further developed in due time;
- the effectiveness of Information Systems/Information Technology (IS/IT) matches known business needs and that such systems availability leads to efficiencies in working practices on a timely basis; and
- an active approach is being maintained with respect to the numerous changes being made to relevant International Financial Reporting Standards (IFRS) which apply within the EIB Group and that market appreciation of the effects of using different accounting regimes is being carefully managed to avoid mis-understanding.

Date , 3 May 2006

M. COLAS, Chairman **R. POVEDA ANADÓN, Member** **M. DALLOCCHIO, Member**

Having participated in the work of the Audit Committee as Observers, we concur with the above report.

S. ZVIDRINA **O. KLAPPER** **N. PHILIPPAS**

[11] For the 2005 financial statements, a separate statement of the Audit Committee has been made in respect of the FEMIP Trust Fund.

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

INVESTMENT FACILITY

For the 2005 financial year

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

ON THE INVESTMENT FACILITY

for the year 2005

Table of contents:

1. INTRODUCTION 1

2. DEVELOPMENTS WITHIN THE INVESTMENT FACILITY 1

2.1. Developments in the Investment Facility's activities 1
2.2. Significant measures taken by the Investment Facility 2
2.3. Specific measures taken by the Audit Committee 3

3. REVIEW OF AUDIT WORK 4

3.1. External auditors 4
3.2. Evaluation and Internal Audit 4
3.3. European Anti-Fraud Office (OLAF) 5
3.4. European Court of Auditors 5

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2005 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE 5

5. CONCLUSION 6

1. INTRODUCTION

Establishment of the Investment Facility

Within the framework of the Cotonou Agreement, the Bank has been entrusted with the mandate to manage the Investment Facility, a revolving fund financed from the European Development Fund, in addition to associated own-resources lending in the Africa Caribbean and Pacific (ACP) and Overseas Countries and Territories (OCT). The Investment Facility was established within the Bank as an autonomous business unit with operations officially starting on 1 April 2003; its activities are presented in a separate set of financial statements.

Role of the Audit Committee

The statutory role of the EIB's Audit Committee is to verify that the Bank's operations have been conducted and its books kept in a proper manner, as defined in the Statute and Rules of Procedure. The financial regulation of the Cotonou Agreement provides for the audit and discharge procedures of the Investment Facility to be the same as those defined for the Bank.

The Audit Committee fulfils its role by:

- overseeing the work performed by the external auditors and co-ordinating such work with that of the internal auditors;
- safeguarding the independence and integrity of the audit function and the follow-up of audit recommendations; and
- understanding and monitoring how Management is assessing the adequacy and effectiveness of internal control systems, risk management and internal administration.

The Audit Committee has provided its opinion on the financial statements of the Investment Facility for the financial year 2005.

The annual report from the Audit Committee to the Board of Governors provides a summary of the Committee's activities with respect to the Investment Facility during the period since the last Board of Governors' meeting in June 2005.

2. DEVELOPMENTS WITHIN THE INVESTMENT FACILITY

2.1. Developments in the Investment Facility's activities

The Audit Committee noted a number of developments that could impact on its work in some respect. The key findings are reported below:

Cotonou Agreement: The Cotonou Agreement was signed in 2000 for a period of 20 years, with a possibility for revision every five years. A first revision took place in 2005, with the signature of the revised Cotonou Agreement (Cotonou II) in June 2005. The first financial protocol of the original Cotonou Agreement entered into force on 1 April 2003, after completion of the ratification process, and will expire on 31 December 2007. A new financial protocol covering a six-year period from 2008 to 2013 is currently being negotiated. However the terms of Cotonou II are already being applied in accordance with transitory measures approved in the second half of 2005.

The main differences between the first and second Cotonou Agreements are:

- concessional loan provisions for infrastructure projects to post-natural disaster countries and those countries subject to restrictive borrowing conditions under the Heavily Indebted Poor Countries (HIPC) initiative or another internationally agreed debt sustainability framework;
- the Facility shall support the ACP financial sector and shall bear part of the risk of the projects it funds, with financial sustainability being ensured through the portfolio as a whole, not from individual interventions;
- future changes to the Bank's remuneration for managing the IF; and
- revisions to the rules and procedures for procurement and grants.

Negotiations for the financial endowment of the IF under the second Financial Protocol are still ongoing. The agreement of the second Financial Protocol, expected to run from 2008 to 2013 will in due course entail a decision on the amount of resources to be managed by the Bank in the ACPs. These concern the replenishment of the Investment Facility, the volume of Own Resources the Bank is ready to make available and the subsidy endowment.

Strategic Development: The *Audit Committee* has received a presentation of the overall objectives, investment principles and strategy of the Investment Facility and of the results achieved so far, the changes that have occurred in the business and operating environment, together with the impact on forecast operations of these and other constraints faced by the Bank in the implementation of its mandate. The IF's objective of reducing poverty in the ACP states goes hand in hand with that of ensuring the financial sustainability of the IF, which is managed as a revolving fund (debt service payments flow back into the Facility to be re-invested). With this in mind, strategic business development targets for 2006-2008 have been focused on infrastructure (projects in co-financing with other development finance institutions) and the financial sector (co-operation with financial intermediaries) and further projects promoted by the private sector.

Operating Environment: Despite relatively robust economic activity levels in developing countries over the last two years, a significant number of countries in the ACPs remain dependent on the support and the commitment of the international community to make decisive strides towards poverty eradication. Nevertheless, overall investment levels remain relatively low in most ACP countries due, notably, to a perception of risk being too high in the region which also impacts on the number and quality of investment opportunities presented. Given this overall difficult environment, IF results achieved so far are encouraging both in terms of lending volume and in terms of geographical and sectoral diversification of the portfolio.

The *Audit Committee* notes that Cotonou II has introduced greater flexibility in the financing of infrastructure projects in HIPC or other ACP countries pursuing economic adjustment. This has directly translated into a significant increase in the relative share of infrastructure investments in the IF portfolio, whilst financial services continue to be a focus sector, in line with the provisions of the Cotonou Agreement.

The *Audit Committee* also notes that the impact of the IF is being enhanced by its ability to offer an extended range of flexible financial instruments – denominated in EUR, other widely traded currencies and even local currencies – that can be used in supporting the financing of development projects.

EIB Own Resource Lending in ACP countries: Under the successive Lomé Conventions which preceded the Cotonou Agreement, as well as under the current Cotonou Agreement, the Bank has contributed own resources to the financial package provided to the ACP States. This contribution is of political significance, as the ACPs consider it an important signal of the Bank's continued commitment to supporting the EU's development co-operation policies on their territories. In addition, the Bank has, according to the usual procedure, indicated the amount and conditions applicable to own resources it can make available to complement the Investment Facility. The *Audit Committee* notes the Board of Governors decision that the loans granted by the Bank shall be the subject of a satisfactory guarantee from the Member States for their aggregate amount, plus all related sums.

2.2. Significant measures taken by the Investment Facility

From the Audit Committee's perspective, a number of measures have been taken by the Investment Facility to respond to the changing environment and to manage the risks arising from trends in its activities:

Project-related Internal Controls: In its 2004 Annual Report, the *Audit Committee* noted Management's commitment to refine and adjust the policies and procedures regularly, in line with maturing experience, as the Investment Facility portfolio grows, so as to ensure a proper balance between financial goals and development objectives. In 2005, the *Audit Committee* notes the following progress in strengthening the project-related internal controls:

- intensification of co-operation with other financing institutions, including IFI's: sector programmes and country strategies are increasingly discussed and compared, information on projects shared and co-financing of projects taking place;
- Co-operation with the European Commission on two levels:
    a. the finalization of a new Management Agreement for the IF and the definition of procedures for IF treasury management – including the hedging of loans in hard currencies and for reporting on IF operations and accounts; and
    b. the receipt of more systematic information from the Commission on sectoral analyses and diagnoses at project and country level;
- the introduction of revised Credit Risk Policy Guidelines which reflect the IF's need for flexibility to enhance its development role by taking more risk whilst maintaining financial viability;
- finalisation of Guidelines for Equity Investments under the IF and the operational guidelines for the implementation of guarantees under the IF;
- the introduction of a development impact assessment framework for the IF to define its 'added-value' in an efficient, systematic and functional manner;
- recruitment of additional staff to carry out the project monitoring necessary to maintain the quality of the IF portfolio;
- the opening of regional offices in Kenya, the Republic of South Africa and Senegal during 2005 and the planned opening of regional offices in the Pacific (Sydney) and in the Caribbean (Martinique) in 2006;

Investment Facility Cost Management and Accounting: In the ACPs and OCTs, the Bank finances both operations on its Own Resources and under EDF funds (Investment Facility and old Lomé risk capital). The Investment Facility is by far the most significant mandate because of its revolving nature, size and visibility. Furthermore, its remuneration system, based on a cost-recovery principle, calls for clear and transparent management and cost accounting[1].

The administrative arrangements for activities in the ACP countries and OCTs were revised in 2004 to improve transparency in the treatment of ACP activities, i.e. clear and separate budgeting, accounting, financial control, auditing and reporting, notably for the Investment Facility. As a result, in 2005, the management costs for the Bank's activities in the ACPs and OCT were ring-fenced. Costs have been contained within the maximum annual average amount authorised under the Council of the European Communities Decision of 8 April 2003 for EIB remuneration. The terms of this decision apply to the first financial protocol and have been extended to the first two years of the second financial protocol.

2.3. Specific measures taken by the Audit Committee

The Audit Committee has also taken some specific measures related to its own roles and responsibilities. The two key measures are summarised below:

<u>Audit Committee independence</u>: The *Audit Committee* wishes to note that all representatives have respected the criteria to be independent of management during 2005/2006. In consideration of the need for the Audit Committee to also be independent of the Bank's activities, an observer of the Audit Committee voluntarily resigned from the Committee in April 2005 when a potential conflict of interest was identified between the role and his core job.

<u>Changes in Accounting Standards</u>: In 2005, the *Audit Committee* has reviewed the numerous changes to relevant International Financial Reporting Standards (IFRS) [which include International Accounting Standards (IAS)]. The *Audit Committee* notes the first time adoption of these standards in the 2005 financial statements of the Investment Facility. The *Audit Committee* recognises that, at an international level, there is little relevant experience of applying certain new or revised IFRS standards, (particularly as the newer or revised standards are based on principles of 'fair value' {rather than 'historic cost'} with varying degrees of application guidance and examples, and also

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[1] The costs related to the implementation of the IF and Lomé mandates are fully covered by management fees received from the Member States, while the cost of Own Resource operations are met by the Bank's intermediation margin.

because judgement is required in order to apply the standards to specific facts and circumstances), creating the potential for different accounting treatments. The *Audit Committee* has therefore adopted a formal approach to reviewing the effectiveness of IFRS implementation in the 2005 financial statements of the Investment Facility by:

- assessing the business areas affected;
- considering the availability and reliability of systems and data;
- reviewing the level of other resources (staff and reporting tools) employed;
- requesting and receiving guidance and assurance from the external auditors on the appropriateness of the Investment Facility's IFRS preparations;
- seeking (and receiving) suitable assurance that the Investment Facility has identified the residual risks (associated with the absence of precise guidelines for IFRS implementation, and especially in view of the lack of mature investment markets in the areas of IF activity); and
- noting that Management has a pragmatic strategy to counter any associated reputational or financial risks.

Applying the above approach, the *Audit Committee* considers that it has been kept informed of the Investment Facility's IFRS implementation program and the issues which had to be addressed at each stage. Based on its own work, and that of the external auditors, the *Audit Committee* is satisfied that the IFRS accounting entries and disclosures in the 2005 financial statements of the Investment Facility are appropriate and meaningful.

The *Audit Committee* considers that the task of the Investment Facility to comply with IFRS in the coming years will be exacerbated due to reduced exemptions as the maturity of the portfolio of investments increases.

3. REVIEW OF AUDIT WORK

3.1. External auditors

At each Audit Committee meeting, the *Committee* met with the external auditors. The *Audit Committee* reviewed the scope and reports of the work of the external auditors and concurred with the specific emphasis placed by the auditors on:

- IT systems changes;
- Project monitoring;
- Internal Control Frameworks;
- Development of the Investment Facility, taking account of the fact that associated operations were in less stable countries and had correspondingly higher risk counterparties;
- Risk Management organisation and guidelines;
- The implementation and performance of the Compliance function;
- IFRS, and the new platform applicable as of 1 January 2005 (including the impact of accounting for activities under the IF mandate).

The *Audit Committee* also performed the checks it deemed necessary to ensure the independence of the External Auditors.

3.2. Evaluation and Internal Audit

The work of the Inspector General, Head of Internal Audit and Evaluations Department is defined in the published Charter for Internal Audit and the Terms of Reference for Evaluations.

A number of the Investment Facility's activities share common systems and controls with those of the Bank. Although no specific Internal Audit/Internal Control Framework (ICF) exercises were undertaken in 2005 in respect of the Investment Facility, the *Audit Committee* obtained assurance on the Facility's systems and controls by reviewing each of the Internal Audit reports produced for the Bank's systems and controls. The *Audit Committee* remains satisfied with the Bank's responses to internal (and external) audit recommendations although an increased attention to the timeliness of actions is to be encouraged in some areas. The *Audit Committee* was also consulted on the drafting of the Internal Audit/ Internal Control Framework (ICF) work programme for 2006 and beyond.

The Evaluations division carries out *ex post* evaluations of projects financed by the Bank, once they have been completed and coordinates the self-evaluation process in the Bank. Evaluation studies of projects financed by the Investment Facility are planned as part of the Bank's overall Evaluation portfolio.

3.3. European Anti-Fraud Office (OLAF)

OLAF is the EU's specialised body in combating fraud and corruption. Within the Bank, Internal Audit remains responsible for co-ordinating on-going investigations relating to Bank projects by informing management, the *Audit Committee* and OLAF of the nature and substance of any allegations of fraud within the Bank or within projects financed by the Bank. Joint Bank (Internal Audit) -OLAF investigations are conducted as necessary.

In 2005, no involvement from OLAF was required since no new cases of alleged wrongdoing on Investment Facility projects were reported.

3.4. European Court of Auditors

The *Audit Committee* continued its relations with the Court of Auditors as in previous years and under the tripartite agreement (the latest one having been signed between the Bank, Commission and Court of Auditors in October 2003), which is referred to in Article 112 of the financial regulation for the 9th European Development Fund. The *Audit Committee* noted that the Court did not carry out any Investment Facility related audits in 2005.

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2005 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE

The *Audit Committee* has examined the 2005 financial statements of the Investment Facility which, for the first time, have been prepared in accordance with the International Financial Reporting Standards (IFRS), and with the general principles of the European Directive applicable (the IFRS prevailing in the case of contrary provisions). The comparative figures and opening balances from the 2004 financial statements have been restated under the same accounting regime.

The *Audit Committee* considers that market appreciation of the change in accounting regimes needs to be carefully managed by the Investment Facility to avoid mis-understanding.

The *Audit Committee* noted the following matters:

- Expenses incurred by the Bank for the management of the Investment Facility: In 2005, the net general administrative expenses (and subsequent reimbursement by the Member States) are shown on the face of the Income Statement to give full transparency of the remuneration of the Bank for managing the IF.
- <u>Interest on bank deposits</u> arising from the funds provided by the Member States which have been received by the Bank on behalf of the Facility and which have not been disbursed yet is payable directly to the European Commission (in accordance with the Financial Regulation applicable to the 9th European Development Fund). Reflows, being repayment of principal or interest or commissions (other than appraisal fees) stemming from financial operations, and interest earned on reflows, are accounted for within the Facility.
- <u>Loan activity:</u> The significance of the increase in loan activities (2004 closing balance EUR 78.6m; 2005 closing balance EUR 194.0m) is also demonstrated by the increase in loan interest, up from EUR 1.7m in 2004 to EUR 12.1m in 2005.
- <u>Fair Valuation of operations</u>: The Investment Facility has applied the <u>revised</u> version of IAS 39. The associated fair valuation of equity investments has led to an unrealised profit of EUR 3.6m. The fair valuation movement on derivatives was an unrealised loss of EUR 5.4m. As at 31 December 2005, no loan was categorised as impaired.

- Write-offs: an equity investment comprising management fees of EUR 1.9m paid by the IF to a Regional Equity Fund has been written off as the Fund was closed prior to any investment.
- Foreign exchange: some investments in venture capital operations and loans were disbursed and were denominated in currencies other than the Euro; an exchange gain, mainly unrealised, of EUR 8.2m resulted from the appreciation of those currencies against the Euro between the time of disbursement and the year-end.

Based on the work undertaken and the information it has received (including a favourable opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Bank), the *Audit Committee* concludes that the 2005 financial statements of the Investment Facility have been drawn up correctly and that they give a true and fair view of the 2005 results and financial status according to the principles applicable to the Investment Facility.

The *Audit Committee* is of the opinion that it has been able to carry out its work to fulfil its statutory mission under normal, unrestrictive conditions. On this basis, the *Audit Committee* signed its annual statement on 7 March 2006.

5. CONCLUSION

In 2005, the Audit Committee is satisfied that the Investment Facility has demonstrated that it has an appropriate strategy, policies and procedures to drive the business forward within the framework of the Cotonou Agreement. The Committee has received assurances from Management and from the external auditors that Investment Facility Management is implementing those strategic aspects that the Audit Committee looks at first and foremost by:

- integrating practices to ensure appropriate financial reporting;
- seeking to develop and enhance the financial and risk reporting process; and
- capitalising on the 'best' practice pronouncements being made internationally on business management, corporate governance, auditing and accounting whilst being pragmatic about the relevance to the activities of the IF.

The Audit Committee is satisfied that it has provided an appropriate balance of proactive and effective supervision during 2005, through implementation of a 'listen, ask, assess and challenge' approach and without infringing on management's responsibility.

Looking ahead to 2006/2007, in addition to the assurances sought on an on-going basis, the Audit Committee can summarise its approach to the key findings of this report by resolving to seek particular assurance from Management that:

- quality ranks before quantity in lending activities (respecting the objective to be catalytic to economic and industrial development with the requirement in Cotonou II to ensure financial stability through the IF portfolio as a whole);
- overall project monitoring effectiveness is being further developed in due time; and
- an active approach is being maintained with respect to the numerous changes being made to relevant International Financial Reporting Standards (IFRS) which apply to the Investment Facility.

Date , 3 May 2006

M. COLAS, Chairman **R. POVEDA ANADÓN, Member** **M. DALLOCCHIO, Member**

Having participated in the work of the Audit Committee as Observers, we concur with the above report.

S. ZVIDRINA **O. KLAPPER** **N. PHILIPPAS**

European Investment Bank

Response of the Management Committee

To the Annual Reports of the Audit Committee

For the Year 2005

RESPONSE OF THE MANAGEMENT COMMITTEE TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE FOR THE YEAR 2005

1. Introduction

The Management Committee welcomes the Annual Reports of the Audit Committee.

This report:
- sets out the approach of the Management Committee to audit and control issues;
- elaborates some of the key developments within the Bank and within the Investment Facility during 2005 which have been commented upon by the Audit Committee; and
- gives the Management Committee's response to certain comments and suggestions in the Audit Committee Reports from prior years and 2005, including the Management Committee's proposed actions for 2006/2007.

In providing this response to the Annual Reports of the Audit Committee for the year 2005, the Management Committee is also mindful of the resolution of the European Parliament on the EIB activity report 2003 (2004/2187 (INI))[1] in which the European Parliament called on the Bank " *to continue to provide the European Parliament and the public, every year, with a summary of the action taken to improve the way in which it operates….".* This report therefore also aims to contribute to the existing constructive dialogue with the European Parliament by illustrating how Bank Management pays attention to the Bank's role as a policy-driven bank.

2. The approach of the Management Committee to audit and control issues

The Management Committee, Audit Committee, the external auditors and internal auditors have mutually constructive relationships. The Management Committee makes staff and resources available to ensure that the Audit Committee and external auditors can be provided with any explanation requested regarding the Bank's activities and its systems and controls.

The Bank also collaborates with the European Court of Auditors whenever this European Institution proceeds with an audit of operations or funds, which engage EU budgetary resources and which are implemented or managed by the Bank. The Management of the Bank supplies the Court with all necessary information when it audits EIB activities.

The Management Committee ensures that Internal Audit reviews all major business areas within a suitably frequent time period (based on independent risk assessments). Before deciding Internal Audit's forward programme the Management Committee consults the Audit Committee. Internal Audit establishes independent reports on its findings and also follows up on the implementation of agreed actions (to matters raised during both the internal and external audit processes). All its reports go to the Audit Committee at the same time as they go to EIB management.

The Inspector General and the Chief Compliance Officer have regular meetings with the Audit Committee.

Through the above, the Management Committee demonstrates its commitment to a strong and effective audit and control structure for the EIB.

3. Developments within the Bank in 2005

3.1 Enhanced EIB Group co-operation (and SME Financing as a key priority for the Bank)

Since 2005, the Bank has further strengthened SME financing as one of the Bank's key priorities and is combining the efforts of the Bank and the European Investment Fund (EIF) to work more efficiently through an increase in synergies. Such efforts are aimed at better identification of the most appropriate products required to improve access to finance for SME's, reflecting the variety of situations at national and regional level but also responding to the specificities of the financial counterparts in order to maximise value-added in this area.

[1] Resolution T6-0064/2005 – Committee on Economic and Monetary Affairs – PE 350.275.

The effectiveness of global loans, the Bank's traditional form of SME financing, is enhanced. New ways to increase visibility of the transfer of benefits to final beneficiaries and 'value-added' through more structured techniques or via development of risk-sharing schemes are now tested with various counterparts.

In parallel, closer cooperation between the EIB Group and the European Commission also aims at facilitating SME access to financing. The Joint European Resources for Micro to medium Enterprises ("JEREMIE"), an 'Access to Finance' initiative is being developed. It will include an SME and micro-finance facility within the EIF and specific support for financial engineering (notably for investment funds and guarantee schemes). Structural funds will be used to leverage EIB group support in the form of technical assistance, venture capital, loans or guarantees in favour of SME's and micro-enterprises.

3.2 Accountability, Transparency and Corporate Governance

Transparency/accountability constitutes one of the two pillars of the Bank's strategy, the other being value-added. As a publicly owned bank with the mission of furthering and supporting EU advancement, the Bank is committed to attaining a high level of transparency of its activities, thereby showing the value of its operational performance. Corporate governance at the Bank has been reinforced by a number of measures endorsed by the Board of Governors, agreed by the Board of Directors and developed and put into practice by the Management Committee on an on-going basis.

The Bank's policies and the measures taken in the areas of defining and formulating strategies, ways and means of implementation and transparency towards civil society are summarised in the Corporate Operational Plan, Corporate Governance Statement and Public Disclosure Policy, to name but a few of the important series of documents to be found on the Bank's website.

The Public Disclosure Policy was drawn up following the Bank's first public consultation procedure on a Bank policy[2]. The Policy is founded on a presumption of disclosure but necessarily takes into account the fact that the Bank can only operate efficiently as a credit institution if banking relationships are managed appropriately. The Management Committee therefore considers that it has to strike a balance between attaining full disclosure to interested third parties and the clear duty of the Bank to protect the legitimate business interests and confidentiality requirements of its clients, particularly those from the private sector.

The Secretary General deals with complaints from members of the public concerning the Bank's Public Disclosure Policy, and the European Ombudsman handles instances of mal-administration. The Inspectorate General would operate an independent recourse mechanism for investigating complaints if the European Ombudsman considered a complaint from a non-EU citizen or organization to be outside his remit.

3.3 Compliance

In its response to the reports of the Audit Committee for 2004, the Management Committee mentioned that it had decided to establish a centralised compliance function at the Bank, thereby further reinforcing its corporate governance. A Group Chief Compliance Officer was appointed in October 2005 and this unit is now fully operational. In order to ensure staff awareness of the functions of the Compliance Office, appropriate training is being arranged for each business group throughout 2006.

3.4 Reinforcement of risk management policies and procedures

Even though the Bank is not subject to formal supervision, it complies with the main EU banking regulations and voluntarily complies with relevant Basel guidance. In this regard the Bank has initiated work towards implementation of relevant aspects of "The revised framework for international

[2] The public consultation adopted the public consultation principles of the European Commission and relevant principles applied by other IFI's.

convergence of Capital Measurement and Capital Standards" by the Basel Committee on Banking Supervision ("New Basel Accord" or "Basel II").

In February 2006, the Management Committee approved the implementation of the first stage of the Bank's Basel II project, being an Internal Rating Model and Methodology. The model has been extensively reviewed by the Luxembourg Commission de Surveillance du Secteur Financier (CSSF). Other stages of the Bank's Basel II project are in development in line with an established calendar.

3.5 FEMIP

In 2004, Bank management identified a number of significant areas for improvement related to procedures and reporting on the EC-funded Risk Capital Facility for the Mediterranean. The Management Committee can confirm that comprehensive guidelines now exist, covering in particular: monitoring; reimbursement of funds and the representation of the Bank in Investment Committees/Board of Directors. An independent Risk Management function has also been introduced and appraisal formats have been formally structured.

4. Developments within the Investment Facility in 2005

4.1 Policies and Procedures

In line with the intention stated by the Management Committee in its response to the Annual Reports of the Audit Committee for 2004, a number of policies and procedures relating to the evaluation of all types of risk related to investments made in the context of the Cotonou Investment Facility (credit and equity risk as well as market and operational risk) have been developed and are being implemented. The new or revised policies and procedures take into account the need to balance financial and development objectives and are based on experience gained with investments made so far as well as research into new investment possibilities.

5. Follow-up of Management Committee proposals from 2005 and proposed actions for 2006/ 2007

5.1 Coherent Corporate Operational Plan: "The COP for the EIB Group"

The reinforced focus on the notion of EIB Group formed part of the strategic considerations approved by the Board of Governors in June 2005**.** This strategic move took better account of the Bank's majority shareholding in the EIF and the resulting obligation to present consolidated accounts. Taking into account the Governors' orientations, the Management Committee presented a coherent COP for the period 2006-2008 for the EIB Group, which integrated the main pillars of operational strategy for the Investment Facility and the EIF.

5.2 Risk Management and Internal Controls

The reporting of risk events has evolved into a sophisticated system during recent years. It is supported by a range of policies and procedures which are subject to constant review in order to remain relevant and effective. The Management Committee is satisfied that the overall control structures of the Bank are effectively designed and operational in order to provide reasonable assurance on the legality and regularity of the underlying transactions.

The Management Committee takes note of the emphasis placed by the Audit Committee on relevant controls being embedded into the Bank's everyday activities and has reviewed existing Internal Control Frameworks (ICFs) to be satisfied that an appropriate level of detail is used to facilitate application and maintainability. The Management Committee will seek on-going assurance from responsible operational staff of the efficiency and effectiveness of ICFs as systems and associated control requirements evolve.

5.3 Project and Operations Monitoring

The Management Committee has continued to pay attention to the evolution of credit and financial monitoring so as to improve the overall monitoring quality of its operations and in order to gain demonstrable assurance regarding the soundness of the Bank's investments, including also all mandate operations. As noted by the Audit Committee, progress is being made in this area, and additional resources are being devoted to these monitoring activities.

5.4 IT systems

New IT systems have been implemented over a number of years within the "ISIS" project. As part of the ISIS project, a new borrowings system was implemented in July 2005. The Management Committee acknowledges difficulties experienced during the implementation and consequently decided to upgrade the new system and to defer the implementation of a further new IT system for loans (planned mid-2007). The existing loans system performs satisfactorily and considerable investments are planned beginning mid-2006 in order to ensure the existing system's stability and to improve further its integration with the other elements of the Bank's IT application architecture.

The Management Committee is planning an IT Benefits review (a requirement identified in the 2004 report of the Audit Committee) in order to have an assessment of the EIB Group's investment in the ISIS project.

5.5 Application of International Financial Reporting Standards (IFRS)

In 2005, the Management Committee closely observed advances in EU policies with respect to IFRS accounting standards and particularly those related to the revised version of IAS 39. The developments in IAS 39 have an impact on valuation of the venture capital investments in the context of the Risk Capital Mandate given to the EIF and thus on the accounts of the EIF, statutory accounts of the Bank, and on the consolidated accounts of the EIB Group.

The Bank has implemented the IFRS accounting standards applicable in 2005. In agreement with EIF and EIB external auditors, accounting for EIF financial guarantees will be carried out in accordance with IAS 39 from 2006. The Management Committee acknowledges that the complexities of IFRS compliance could increase further in future years particularly as activities develop in line with the new strategic objective for the EIB Group to add SME/venture capital financing activities to the Bank's own priorities.

The Management Committee commits to ensuring full IAS 39 compliance in future years. In this regard, the Financial Control department is developing formal IFRS procedures and respective responsibilities to address these matters across the EIB Group.

The lack of internationally-accepted and precise implementation guidelines for some aspects of IFRS, and IAS 39 in particular, adds difficulties to the process of consolidation of EIF accounts into the Group Financial Statements. The Management Committee considers the case for having the same external auditor for the Bank and for the EIF in order to harmonise the audit requirements. Such an arrangement would require agreement from the European Commission (EC). To date, the EC has preferred the EIF auditor to be independent of the Bank's auditor.

The issues related to IFRS implementation guidelines noted above are also relevant for the Investment Facility where the difficulty of measuring fair value is heightened because of the lack of mature market valuations in the countries of operation.

The year ahead will thus be marked by close observation of developments in relation to accounting policies and to IFRS in particular so as to ascertain again presentation of the annual accounts in full compliance with relevant accounting rules.