



European Investment Bank

AUDIT COMMITTEE

Annual Report to the Board of Governors

For the 2006 financial year

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ANNUAL REPORT TO THE BOARD OF GOVERNORS

For the 2006 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. Assurance obtained by the Audit Committee on the Bank's control environment	2
3. PRINCIPAL ACTIVITIES OF THE AUDIT COMMITTEE	4
3.1. Organization and meetings.....	4
3.2. Review of Audit Work	5
3.2.1. <i>External auditors</i>	5
3.2.2. <i>Evaluation and Internal Audit</i>	5
3.2.3. <i>European Court of Auditors</i>	6
3.3. The Financial Statements as at 31 December 2006 and the Annual Statements of the Audit Committee	6
4. CONCLUSION AND RECOMMENDATIONS	7

1. INTRODUCTION

According to the Statute and Rules of Procedure, the EIB's Audit Committee is responsible for the auditing of the Bank's accounts. In forming an opinion on the financial statements, the Audit Committee reviews the adequacy and effectiveness of the Bank's risk management systems and internal controls as they affect financial reporting, but also the process for monitoring compliance with relevant standards, procedures, and internal and external regulations that are applicable to the Bank.

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 2006. The present report summarises the activities of the Audit Committee since the last meeting of the Board of Governors, and in particular the activities that helped the Audit Committee to:

- Evaluate the control culture set by management;
- Understand the systems implemented by management to control transactions throughout their lifecycle;
- Verify progress made by management in the implementation of recommendations made by external and internal auditors; and
- Satisfy itself that there is a proper system and allocation of responsibilities for the day-to-day monitoring of the financial controls.

This report shows significant developments in the Bank and how the Audit Committee has covered them, as well as the work arising from the interaction with external and internal auditors and the review of the financial statements.

2. DEVELOPMENTS WITHIN THE BANK

2.1. Developments in the Bank's activities

The Audit Committee noted a number of developments with potential impact on its work and has followed up developments identified in its 2005 Annual Report, as follows:

New strategy: In 2006 the implementation of the new strategy announced as a priority in the 2005 Governor's Annual Meeting has started. This included an increased focus on value –added, a progressive increase in risk taking, EIB Group improved cooperation, enhanced cooperation with the Commission and the IFIs and the introduction of new financial instruments.

- *Value added.* The existing approach, which identifies the external value added of the projects, will be complemented by an internal value added dimension. A new "internal risk/return indicator" (IRRI) will facilitate surplus measurement by providing better estimates of project-generated income taking account of risks, financial and administrative costs. The Audit Committee will follow the development of this approach in 2007.
- *Increased Risk Taking.* The new orientation towards more risk is not visible yet in the evolution of the Bank's risk indicators; however the Audit Committee will monitor in 2007 the review of procedures and processes announced in the COP 2007-2009, in view of the higher work input per operation required, for example by SFF, and in general by operations with a lower internal loan grading. The Audit Committee noted the 2006 achievement of the target for operations within Europe with EIB internal loan grading of B- and below and the revision of the indicator to include operations with internal loan grading of C and below.
- *Structured Finance Facility (SFF).* We noted the extension and increase of the SFF over the next COP period. In relation to the challenging targets set, the Committee will follow the measures taken to manage the inherent risks associated with the focus to achieve increasingly higher volumes of signatures in the area of SFF operations, including the resource requirements for proper due diligence and enhanced monitoring.
- *New financial instruments.* The instruments developed together with the Commission and the EBRD, JASPERS and JESSICA, will require the development and implementation of appropriate procedures and controls and will place an additional burden on the entire audit

function of the Bank. The Audit Committee has started a dialogue with the Bank to ascertain that control and audit requirements of such new instruments are considered at an early stage in their preparation.

- *New strategic objective (Energy)*. In translating the EU policy agenda into its own objectives, the Bank has approved the integration of energy as a specific objective in the COP for 2007-2009, with appropriate guidelines and monitoring and an overall target for supporting the objective.

Technical developments:

New pricing model. The Audit Committee welcomes the new pricing model (the Blue Curve) as an improvement in terms of transparency and transfer of the Bank's lending advantage. In relation to a recommendation from the external auditors to improve documentation regarding the pricing of loans, the Audit Committee noted that this will be addressed in full by the new procedures manual which is about to be finalized.

New activities. The Audit Committee has learned that the EIB and the Commission are finalizing the institutional framework for the Risk Sharing Finance Facility (RSFF). The Bank is also developing venture capital operations in the field of infrastructure. The Audit Committee will evaluate its own time resources in order to ensure appropriate attention will be devoted to the new activities.

2.2. Assurance obtained by the Audit Committee on the Bank's control environment

The Audit Committee continually analyses the significant measures taken by the Bank to respond to the changing environment and to manage the risks arising from trends in its activities. In obtaining assurance vis-à-vis the quality of the internal control systems, the Audit Committee uses a combination of reactive and proactive techniques.

The proactive techniques aim to challenge decisions pertaining to risk control, through interviews, probing questions and correlation with past knowledge. At the same time, the Audit Committee reacts to information received under the form of reports, presentations and notes, by internal discussions, further inquiry and qualitative assessments.

Achievement of 2006 COP targets: The Audit Committee sees the Corporate Operational Plan (COP), which covers strategic direction, planning and budgeting aspects, as the cornerstone of the management control system. The Audit Committee has been regularly updated on the Bank's progress towards 2006 targets set for each of the Bank's institutional objectives to contribute to EU policy goals 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 achievement of most KPI targets for 2006, reacting adequately when deviations arose.

The Board of Directors approved the new Corporate Operational Plan (COP) 2007-2009 in December 2006. The COP was presented to the Audit Committee which obtained details on the establishment of key performance indicators, new objectives and directions and had the opportunity to discuss the results of the Bank for the past year as well as the new targets set.

With regard to specific measures taken to contain the risks associated with the lending process, in 2006/2007 the Audit Committee noted:

- Improvement of the loan approval process: The Audit Committee noted, in September – October 2006, the review of the Fact Sheets which gives more guidance to loan officers but also introduces new fields (such as for OCCO¹ clearance) and is supposed to increase consistency in loan processing and approval.
- Loan monitoring: In 2006, the Audit Committee noted that the institutional importance of monitoring has been enhanced at management level, with a quarterly reporting to Management Committee and also that the relevant process objectives indicators, as set in the COP, were

¹ Office of the Group Chief Compliance Officer.

observed. The resources devoted to monitoring will be increased. The Audit Committee welcomes these developments and will continue to obtain information in 2007 about the efforts in the area of monitoring, in the light of the measures proposed in the COP 2007-2009, and in view of the new business lines opened by the Bank and the Group and the increase in risk taking.

- Involvement of OCCO in the due diligence process: The Audit Committee notes the recent decision of the Management Committee to involve OCCO in the due diligence process, which has a twofold objective: to ensure compliance of the lending operations with applicable policies, rules and regulations and to ensure the Bank is not exposed to reputation risk.

Accountability and Transparency: Over a number of years, the Bank has responded to the increasing demand for transparency and accountability of European institutions.

Specific actions taken in 2006/2007 include:

- Public consultation on Review of EIB's Anti-Fraud Policy. This action was opened in February 2007. The Audit Committee was given the opportunity to discuss it after it was published on the Bank's website.
- Statement of Governance was updated and enhanced to cover aspects related to the new strategy of the EIB Group, Business continuity and IT Governance, fighting fraud and corruption; and Corporate Social Responsibility.
- Complaints procedure: a Complaints Office under direct authority of the Secretary General was created in 2006 in order to deal with the treatment of external complaints and a new Complaints' Policy /Recourse Facility was also defined and implemented.
- New disclosure policy was adopted by the Bank after public consultation.
- Policy towards offshore financial centres (OFC): In its effort to ensure that no project, structure or investment supported by the Bank is intended to be used to facilitate tax evasion, fraud, money laundering or terrorist financing and also anticipating the requirements of a revised Money Laundering Directive, the Bank revised its own policy towards offshore financial centres. The paper aims to align the Bank's policy to international best practice and articulates specific control proposals. It also documents the Bank loans and investments connected with OFC.

The Audit Committee discussed with OCCO and the Secretariat General the content and quality of the information published in the EIB web page on the members of the governing bodies (Board of Directors, Management Committee and Audit Committee). As a proactive measure, the Audit Committee asked the Bank to consider the timeliness and appropriateness of extending the coverage of the declarations of interests (now limited to the members of the Management Committee) and also disclosing information about top level officers.

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 2006/2007 a number of adjustments have been made to the "EU – Credit Risk Policy Guidelines" and "Financial Risk and ALM Policy Guidelines".

Progress on Basel II compliance: The Audit Committee was informed of the progress towards the implementation of the Bank's decision to voluntarily comply with Basel II, including a solvency ratio computed according to the most advanced methods. The European Parliament also asked to be communicated the methodologies applied and the constituent components of the ratio. RM recognised the practical difficulty of computing the two basic parameters of the IRB advanced approach to credit risk (i.e. probability of default and loss given default), due to the lack of EIB experience on credit losses. As a result, it proposes to apply mapping techniques for the two parameters. To this effect a new customers' rating methodology has been introduced although the old loan grading system will continue to be used for other management purposes. In the important field of specialised lending, the method of the supervisory categories has been selected and the Bank is developing the set of slotting criteria needed in this method. As regards securitisation, RM estimated that it would be difficult to apply a Basel II compliant methodology. Work is also in progress in other areas, such as the treatment of guarantees, or the elaboration of an advanced methodology (AMA) for operational risk that will be presented to the Audit Committee at a later date.

Risk Management Reporting: The Audit Committee receives all Operational Risk Reports and is satisfied with the manner in which management addresses the various risk events, based on their relative impact and potential for reoccurrence. In 2007, the Audit Committee has asked for the following documents to be distributed on a regular basis, in order to acquire an enhanced perspective on more aspects of risk management:

- o Monthly ALM and Financial Risk Report; and
- o Rapport RM/FRD/DER sur les positions de la trésorerie.

Compliance with international standards and best practice: It is the Bank's declared policy to comply with best practice and international standards. The Audit Committee has proposed to the Bank services to prepare documentation on the potentially relevant industry standards, EU legislation and international best practice, to show in detail the criteria or rules that are applicable to the EIB, given its special nature. Although the Committee understands that the relevant legal standards and some others are incorporated by reference in the procedure manuals of the Bank, the advantages of having a detailed list would be the identification of possible gaps, enhanced monitoring capabilities and eventually assigning the responsibility for compliance monitoring in the best placed section of the Bank. In this line, for example, the IG is planning to undertake an external quality assessment review which, *inter alia*, would aim to verify if the Internal Control Frameworks (ICF) go along the lines of best practice, i.e. Basel II and COSO.

Information Technology: In 2006, the Bank has commissioned an evaluation of the achievements of the ISIS Programme by an external consultant. The report provides a good diagnosis of the various systems evaluated and shows various limitations, but also achievements, in the areas of integration, reporting/monitoring capabilities, data management solutions and user interfaces. While the report, due to methodological constraints, does not address the requirements for a continuous benefits measurement process and for a continuous process optimization, as originally envisaged in the terms of reference, the Audit Committee is following the subject, including new IT developments in the borrowings Finance Kit, with great interest and is expecting the Bank to use the findings as a starting point for implementing a formal IT Contribution Measurement Model. The problems detected in the report have prompted the Audit Committee to ask assurances, through an enhanced letter of representation from Management, about the accuracy of data in the financial statements.

Business Continuity Planning: The Audit Committee was informed that a draft Business Continuity Policy was submitted to the Management Committee for approval at the beginning of 2007, together with the planning and a policy paper on Pandemic preparedness. The review of the Business Impact Analysis and an evaluation of alternative strategies leading to the establishment and approval of a Business Continuity Strategy were in the final stages of preparation. The BCP will operate at Group level as it will also cover the EIF. The Audit Committee was concerned that the existing Business Continuity Plans as well as the IT Disaster Recovery Plan did not address cases of ordinary software interruption, as the one that actually affected the Bank in September 2006. We were informed that the plan would be updated leading to the full implementation of the Business Continuity Strategy. A full test of the Business Continuity Strategy and Plans is expected during the second half of 2007.

3. PRINCIPAL ACTIVITIES OF THE AUDIT COMMITTEE

3.1. Organization and meetings

The Audit Committee aims to meet all the Bank's Directorates at least once a year. The table below shows the Bank's services invited to give formal presentations of recent activities to the Committee in 2006.

Directorate/Unit/Service	Number of meetings
Management Control, Finance Directorate, Ops B, Evaluation Unit, Office of the Chief Compliance Officer, JASPERS, Presentation of EIF activities.	One meeting
Risk Management, Projects Directorate, OPS A.	Two meetings

Since the date of our last report, the Audit Committee undertook a series of internal initiatives, aimed at clarifying its roles and increasing its work efficiency but also at an increased transparency regarding its work. Worth mentioning are the proposed changes to the Audit Committee manual, an internal document and the drafting of an Audit Committee Charter, which will be made public on the Bank's website.

A member of the Audit Committee resigned at the end of 2006. According to article 26 of the Rules of Procedure, the Board of Governors had to appoint a replacement for the unexpired remainder of the term of office. However, another member could not attend, due to sickness, the February 2007 meeting of the Audit Committee, which led to a lack of quorum. This situation points to a potential weakness in the structure of the Audit Committee. Although we consider that the total number of members (three) and observers (three) is sufficient for the Audit Committee to fulfil its responsibilities, the current provisions regarding replacement and quorum are not flexible enough to ensure an efficient and continuous operation.

3.2. Review of Audit Work

In its work, the Audit Committee relies on external and internal auditors, from which it obtains a significant level of assurance on the accuracy of financial reporting, internal control mechanisms and potential risks that are managed through investigative work. The Audit Committee worked very well with both audit functions during the period under review, and has received the expected level of support in a timely manner.

3.2.1. External auditors

The Audit Committee met five times with the external auditors since last June. The main tools available for the Audit Committee for monitoring the activities of the external auditors are the critical path of reporting deadlines and the review and discussion of various reports submitted by the external auditors to management (such as Early Warning Report, Management Letter, interim and provisional audit clearance). The Committee has received, at each meeting, updates of the status of the audit work and was promptly informed of all potential problems.

In 2006, the points of specific emphasis for external audit, established in agreement with the Audit Committee, were:

- IT system changes planned in 2006;
- Valuation in the context of Fair Value Option;
- Internal Control Frameworks (ICF) – follow-up;
- Development of specific investment facilities;
- Risk management organization and guidelines;
- Compliance function; and
- Compliance with IFRS standards.

The Audit Committee assesses regularly the external auditor's independence, including the absence of any conflicts of interests. A potential conflict of interest was detected in advance by the Bank's staff with respect to the current external auditor who was excluded from participating in a call for tender.

3.2.2. 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 reviews and comments on the Internal Audit work plan. At the same time, the Audit Committee receives all internal audit and evaluation reports, as well as communications about alleged wrong doings and on status of investigations. The Audit Committee met the Inspector General at all Committee meetings.

Since 2006 Internal Audit accompanies its presentation of cases of alleged wrongdoing with an assessment of its reputation risk for the Bank. The Committee noted that the cases examined during the period were not expected to produce any financial loss to the Bank.

The Audit Committee reviews the work of Internal Audit and monitors the completion of the agreed action plans (AAP), which define the practical modalities in which internal and external audit recommendations are implemented and noted that the number of closed (i.e. resolved) AAPs exceeded the target established in the COP 2006-2008. However, the Committee is concerned with a number of open AAPs that are long outstanding, despite a follow-up mechanism that is working well.

3.2.3. European Court of Auditors

The Court of Auditors is currently conducting an audit on Bank activities in the Mediterranean area the preliminary findings of which were communicated to the Audit Committee. The Audit Committee will provide its support to the Court in finalizing this audit. In 2006, the Committee has not participated in on-the-spot missions with the Court of Auditors and has therefore not prepared any associated mission reports.

3.3. The Financial Statements as at 31 December 2006 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 2006.

In 2006, the non-consolidated accounts have been prepared in accordance with the general principles of the European Directive applicable. However, 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 EIF has also reported under IFRS for the first time in 2006. The Audit Committee, while recognising the methodological and practical problems posed by IFRS, reiterates its opinion that reporting under different standards at the same time should be reconsidered from the viewpoint of efficiency and best practice.

The Audit Committee also noted that in some cases different accounting criteria are applied to the same item in the IFRS statements of the Group and of the EIF. Although this situation was known and accepted by the two external auditors, the Audit Committee considers that a further effort of co-ordination should be made, as these differences could be misleading for the readers of the financial statements.

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

Impact of IFRS adjustments: The Audit Committee notes that the impact of the IFRS adjustments on the EIB Group accounts is:

- On the profit and loss account for 2006 – a positive impact of EUR641 million;
- On the reserves during 2006 – a positive impact of EUR202 million;

Taking account of the impact for the preceding years, the accumulated impact on the EIB Group accounts since 2001 due to IFRS amounts to EUR408 million.

Fund for General Banking Risk (FGBR): The Board of Directors approved the release of the FGBR to the Profit and Loss account for 2006 and approved that a request may be made to the Board of Governors to appropriate the same amount to the Additional reserves. The accounting and other implications were extensively discussed, and explained in the notes to the financial statements, and the Audit Committee was appropriately briefed on the subject. The impact on the non-consolidated profit and loss account amounts to EUR975 million, bringing the Bank's result to EUR2,566 million. On the other hand, there is no impact on the consolidated own funds.

Eurotunnel: The Audit Committee received constant updates on the developments regarding Eurotunnel, including on the acceptance by the Bank of the Plan de Sauvegarde and the partial sale of EIB debt, which has resulted in a release of part of the corresponding provision, with a net positive impact of EUR75 million on the Bank's result in 2006. The Audit Committee monitors closely the provisioning policy of the Bank in general, with special emphasis on the impaired assets.

Venture capital operations: In 2006 venture capital agreements were signed for EUR688 million, bringing total venture capital commitments to EUR3.8 billion at year end.

Post balance sheet event: The Audit Committee noted the increase, with effect from 1 January 2007, of the subscribed capital, due to the contributions of two new Member States: Romania and Bulgaria.

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 report².

Based on the work undertaken and the information it has received (including an unqualified 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 2006 results and financial status according to the accounting 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, unrestricted conditions. On this basis, the Audit Committee signed its annual statements on 13 March 2007.

4. CONCLUSION AND RECOMMENDATIONS

The Audit Committee is pleased to note that the Bank has appropriate mechanisms and policies in place to identify, manage and contain risks. With regard to the particular points noted for follow-up in our last year report, we have obtained sufficient assurances to conclude that:

- borrowing and lending activities are carried out with due care and consideration for qualitative aspects;
- the Compliance function is operating effectively and without restriction;
- overall project monitoring effectiveness was reasonably strengthened;
- 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.

In 2007/2008 the Audit Committee, in addition to its ongoing duties, will focus efforts on:

- Coordination between the Bank and its subsidiary in the use of accounting criteria;
- Clarification of its own roles with respect to various operations mandated to the Bank;
- Follow-up of developments in the accounting world; the Group, in particular, having to comply with IFRS 7 "Financial Instruments: Disclosures" in its 2007 financial statements;
- Bank's efforts for further integration and stabilization of its IT systems.
- Bank's progress in the field of transparency; and
- Bank's compliance with international best practice, including the Basel Committee guidelines, to the extent that they are applicable to a special institution such as the EIB.

The Audit Committee welcomes the decision of the Bank to comply on a voluntary basis with Basel II. It considers that this proposal is aimed at a complete recognition of all the risks to which the banking activity is submitted, and at the establishment of an adequate corporate governance system and procedures to identify, monitor, control, quantify when possible, and cover these risks. The Audit Committee recognises the efforts and progress of the Bank in relation with this fundamental objective. On the other hand, Basel II is also a scheme of coverage of risks with capital. To that effect it offers a number of options, the best option in each case not being necessarily the most sophisticated, but the best adjusted to the circumstances and possibilities of the Bank. In this sense, it recommends the Bank to reconsider the decision of applying systematically the most advanced methods, as they could not suit the EIB.

² For the 2006 financial statements, a separate statement of the Audit Committee has been made in respect of the FEMIP Trust Fund.

The Audit Committee is satisfied that it has provided an appropriate balance of proactive and effective supervision during 2006, through the implementation of a 'listen, ask, assess and challenge' approach and without infringing on management's responsibility. The Committee believes that it has retained appropriate standing within the Bank, and that appropriate relations with management and Bank staff exist and operate well. In 2006 the Audit Committee has received the expected support from the Bank to allow it to properly discharge its responsibilities.

Date, 17 April 2007

R. POVEDA ANADÓN, Chairman M. DALLOCCHIO, Member C. KARMIOS, Member

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

O. KLAPPER

N. PHILIPPAS

E. MATHAY



European Investment Bank

AUDIT COMMITTEE

**ANNUAL REPORT TO THE BOARD OF
GOVERNORS**

INVESTMENT FACILITY

For the 2006 financial year

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS ON THE INVESTMENT FACILITY

for the year 2006

Table of contents:

1. INTRODUCTION	1
2. OVERVIEW OF AUDIT COMMITTEE WORK.....	1
2.1. Analysis of the Investment Facility's activities	1
2.2. Review of Audit Work	2
3. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2006 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE	2
4. CONCLUSION	3

1. INTRODUCTION

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 financial status is reported 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.

This 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 2006.

2. OVERVIEW OF AUDIT COMMITTEE WORK

2.1. Analysis of 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 second financial protocol, covering the period 2008-2013, was signed in June 2006 and includes an additional EUR 1.53 billion allocation to be managed by the EIB. This will be supplemented by an appropriation of up to EUR 2 billion and EUR 30 m for own resources lending in the ACPs and in the OCTs respectively which, as in the past, will be covered by a specific guarantee from the EU Member States. The new financial protocol will come into force upon completion of the ratification process of the revised Cotonou Agreement. In relation to the ratification process, the Committee noted the potential credibility risk to the organization if the availability of funds is delayed and the Bank is unable in 2008 to achieve a level of the operations at least comparable with previous years. A contingent plan may have to be adopted to address this situation.

Meeting with Management: The Audit Committee has received a presentation of the progress in the activities of the Investment Facility (IF) and the future business outlook. The Audit Committee learned that EUR1.6 billion was already committed, with approvals of EUR570 million in 2006. The funds are expected to be exhausted by the end of 2007.

Operational Context: An increasing number of operations relate to large project finance type of transactions and are characterised by innovative features compared to the Bank's traditional lending activities in the region. The ability to offer an extended range of flexible risk bearing financial instruments is a key source of value added to the benefit of the ACP operators. However, this implies increased complexity in the structuring of the financing packages and a resulting longer lead-time between approval and signature.

Monitoring Activity: The system to control risk is of particular interest to the Audit Committee and we understand that EIB systems of control are applied equally to IF and own resource operations. The Committee noted that the resources for monitoring have been adjusted accordingly. The Audit Committee obtained details about the arrangements made for control activities, including staffing. Overall it is considered that existing resources for financial monitoring are sufficient, given the particular aspects of the operations. However, monitoring arrangements will be reviewed in 2007, not only from the perspective of resource requirements but also from a mix of staff perspective with a view to strengthening the capabilities in the area of project performance and improving efficiency. The Audit Committee will follow the results of such review.

COP Targets: The Audit Committee noted that, while the targets for approvals were exceeded and for signatures were largely achieved (85% overall and only 62% from own resources), the disbursements target was underachieved, both in terms of own resources (52%) and overall (61%).

Significant measures taken by the Investment Facility: Guidelines for a more flexible use of own resources are being prepared. Thus, a proposal to increase the use of own resources in ACP countries and OCTS under the Cotonou Agreement was made to the Board of Directors in April 2007, which, if approved, will make it possible to step up the use of own resources for ACP and OCT operations, which would be particularly relevant i.e. in the light of the limited IF resources and the opportunities opened by the signature of the Infrastructure Trust Fund Agreement.

IFRS valuation: The Audit Committee noted that the entire portfolio of investments was valued on IFRS basis and that no major problems were encountered.

2.2. Review of Audit Work

External auditors: The Audit Committee met regularly with the external auditors. The Audit Committee retained the specific comments made by the external auditors in their Executive Summary Memorandum and the unqualified audit opinion. Audit Committee assesses regularly the external auditor's independence, including the absence of any conflicts of interests.

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 since our last report 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 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. Two evaluation reports allowed a significant coverage of EIB activities in ACP countries both for individual loans and global loans. The Audit Committee noted the recommendation, for individual loans in ACP countries, that detailed priorities are established and that cooperation with other IFIs should be improved; and also the fact that other recommendations dealing with the setting of appraisal fees, with the Bank's support to be directed to public sector operations and with other types of procedures have been implemented by the Bank's services. For global loans in ACP countries, the report highlights the need to reinforce development impact at the financial sector level, with use of the Technical Assistance Fund to be considered in coordination with the European Commission.

European Court of Auditors: The Audit Committee noted that the Court did not carry out any Investment Facility related audits in 2006.

3. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2006 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE

The Audit Committee has examined the 2006 financial statements of the Investment Facility prepared in accordance with the International Financial Reporting Standards (IFRS), and with the general principles of the European Directive applicable.

The Audit Committee analyzed the disclosure in the Investment Facility financial statements in comparison with the other sets of financial statements issued by the Group, with a view to ensure consistency. The AC had specific questions and comments related to the Investment Facility financial statements which were recorded in the minutes of its meeting and duly taken into consideration by the Investment Facility. The Committee also noted, in relation to the 2006 financial statements:

- Income statement: The net profit for the year doubled compared with 2005 (EUR23.7 million against EUR11 million in 2005) due to a similar increase in the net interest income, while the net fee and commission income and the net result on financial operations, the two smaller contributors, have fluctuated at a different scale (net fee and commission income recorded was EUR4 million in 2006 compared with only EUR0.7 million in 2005, however, the net result on financial operations was a EUR0.1 million loss this year compared with a net profit of EUR1 million in 2005).
- Credit and interest rate risk: The Investment Facility exposure totals EUR401 million (loans and equity investments net of accrued interest), increasing from EUR225 million at the end of 2005. Proper disclosure is given as required by IFRS, with analysis by nature of borrower, type of instrument, sector and interest rate.
- Loan activity: The aggregate signed undisbursed and disbursed exposures amounted to EUR939.6 million (2005: EUR612.7 million) and EUR386.4 million (2005: EUR215.1 million) respectively, including signed undisbursed and disbursed investments in equity funds and venture capital operations for EUR88.5 million (2005: EUR 81.6 million) and EUR51.2 million (2005: EUR20.8 million respectively).
- Write-offs: Two operations were impaired for a total of EUR 1.8m (compared with EUR1.9 million in 2005) of which one concerned a loan for an impairment amount of EUR1.7 million.

Based on the work undertaken and the information it has received (including the unqualified opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Bank), the *Audit Committee* concludes that the 2006 financial statements of the Investment Facility have been drawn up correctly and that they give a true and fair view of the 2006 results and financial status according to the accounting 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 13 March 2007.

4. CONCLUSION

The Audit Committee is pleased to note that the Investment Facility has appropriate mechanisms and policies in place to identify, manage and contain risks. With regard to the particular points noted for follow-up in our last year report, we have obtained sufficient assurances to conclude that:

- overall project monitoring effectiveness was reasonably strengthened; and
- an active approach is being maintained with respect to the numerous changes being made to relevant International Financial Reporting Standards (IFRS).

The Audit Committee is satisfied that it has provided an appropriate balance of proactive and effective supervision during 2006, through the implementation of a 'listen, ask, assess and challenge' approach and without infringing on management's responsibility. The Committee believes that it has retained appropriate standing within the Bank, and that appropriate relations with management and Bank staff exist and operate well. In 2006 the Audit Committee has received the expected support from the Bank to allow it to properly discharge its responsibilities.

Date, 17 April 2007

R. POVEDA ANADÓN, Chairman M. DALLOCCHIO, Member C. KARMIOS, Member

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

O. KLAPPER

N. PHILIPPAS

E. MATHAY



European Investment Bank

**Response of the Management Committee
To the Annual Reports of the Audit Committee
For the Year 2006**

RESPONSE OF THE MANAGEMENT COMMITTEE TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE FOR THE YEAR 2006

1. The approach to audit and control issues in the EIB

The Management Committee remains committed to a strong and effective audit and control structure for the EIB. Mutually constructive yet appropriately independent relationships exist between the Management Committee, Audit Committee, the external auditors and internal auditors.

The Audit Committee and external auditors have full access to the Management Committee, Bank staff and resources in order to form their opinions on the Bank's activities and its systems and controls. The Management Committee supports the Audit Committee initiative to publish an Audit Committee Charter which will reinforce the credibility of its work.

The Management Committee continues to be committed to fully collaborate with the European Court of Auditors whose role is to audit operations or funds which engage EU budgetary resources and which are implemented or managed by the Bank.

An independent Internal Audit function is maintained and is charged with the review of all major business areas on a cyclical basis (timing based on independent risk assessments). Internal Audit reports to the President and the responsible Vice-President on its findings and also follows up on the implementation of agreed actions (to matters raised during both the internal and external audit processes).

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 remains 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.

2. Developments within the Bank and within the Investment Facility in 2006

2.1 Accountability, Transparency and Corporate Governance

The Bank remains committed to its strategic objective of transparency and accountability in order to demonstrate the value of its operational performance. Continual reinforcement of corporate governance at the Bank is sought via a variety of measures endorsed by the Board of Governors, decided by the Board of Directors and put into practice by the Management Committee.

The Bank's policies and the measures taken are summarised in a Corporate Governance Statement (published on the Bank's website 21 October 2006). The Bank's focus on corporate responsibility, not only in projects financed, but also in terms of the Bank's own carbon footprint, is set out in the Corporate Responsibility Report, published on the Bank's website 15 March 2007.

In April 2006, the Public Disclosure Policy was drawn up following the Bank's first public consultation procedure on a Bank policy¹. 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 provide an independent recourse mechanism in a (very unlikely) case that the European Ombudsman would consider to be outside his remit.

In 2007, a public consultation on the Review of the EIB's Anti-Fraud Policy commenced.

2.2 Compliance with international standards and best practice

The Management Committee wishes to re-iterate that even though the Bank is not subject to formal supervision, it voluntarily submits to main EU banking regulations, EU Policies and relevant accepted 'best practices'. In early 2005, the Legal department prepared an overview of the main elements of the legal framework within which the EIB operates, and which was of interest to the Audit Committee's activities, it being clear from the number of countries and variety of legal systems in

¹ The public consultation adopted the public consultation principles of the European Commission and relevant principles applied by other IFI's.

countries of the Bank's operations that any attempt to produce such a detailed list would be non-exhaustive.

Since the appointment of the Chief Compliance Officer in October 2005, the Bank has introduced such practices by adapting accordingly the Codes of Conduct for the staff of the Bank and for the members of the Management Committee and the manuals of the operational departments. In response to the current request of the Audit Committee, the Management Committee will initiate a procedure to ensure a systematic formal assessment of emerging industry standards and applicability in the Bank is undertaken and communicated to the Audit Committee on a regular basis.

Other practices which are identified as becoming generally accepted best practice within the banking sector will also continue to be examined for applicability to the Bank.

2.3 The Bank's Basel II project

Notwithstanding the observation in 2.2 regarding the supervision of the Bank, it is recalled that in 2005, the Bank initiated work towards the implementation of Basel II (or "The revised framework for international convergence of Capital Measurement and Capital Standards" by the Basel Committee on Banking Supervision, also called the "New Basel Accord") and the budget and the timetable were agreed on. Moreover, it has been ensured that the project is feasible in terms of complexity. The project has been supported by the Commission de Surveillance du Secteur Financier (CSSF) acting as a technical advisor, with the Bank maintaining its independence about the ultimate methodological framework.

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. Further progress in the project has continued in 2006/2007. The Management Committee welcomes the Audit Committee's support for a pragmatic approach to on-going and future Basel II work, which may lead to the adoption of solutions which are not necessarily the most sophisticated but which are appropriate to the purpose and substance of the Bank.

Overall, the Bank's Basel II project is in line with the envisaged budget and timetable. Its finalization is expected for the end of 2007.

2.4 Application of International Financial Reporting Standards (IFRS)

The Management Committee has continued to observe advances in EU policies with respect to IFRS accounting standards (as applied in the financial statements of the EIB Group, the Investment Facility and the EIF) and particularly those related to:

- IAS 39 (revised) as such developments 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, the Bank and on the consolidated accounts of the EIB Group. The effect of IAS 39 is also marked in the financial statements of Investment Facility which operates in countries where there is a lack of mature market valuations (although no problems were identified in the external audit process in 2006, the difficulty of measuring fair value remains); and
- the new version of IFRS Standard IAS19 (Employee Benefits) which was endorsed by the EU in November 2005 and applied for the first time by the EIB Group in the consolidated financial statements as at 31 December 2006. This version requires enhanced disclosure on post-employment benefits, thereby added transparency on the true total cost of EIB's workforce.

The EIF applied IFRS accounting standards for the first time to its financial statements as of 31 December 2006. The external audit process of the EIB Group revealed an isolated difference in a portfolio classification between the financial statements of the EIB Group and the EIF. The Bank's external auditors have confirmed that the difference was acceptable under IFRS and in any case was not material to the EIB Group financial statements for 2006.

In the financial statements for 31 December 2007, the new IFRS Standard on Disclosures for Financial Instruments, IFRS7, will be applied in the EIB Group, Investment Facility and EIF financial statements for the first time. It will consolidate the qualitative and quantitative reporting on the risks

associated with the financial assets and liabilities, within the respective financial statements. The amendments to IFRS Standard IAS1 on the Presentation of Financial Statements will also be applied from 2007. As a result, information on the Group's capital and the adequacy thereof will also be included in the financial statements. This Group's application of these standards will be subject to the due process and scrutiny of external audit.

The Bank still does not wish to be an early adopter of IFRS in the statutory accounts as long as there is no broad consensus among a significant majority of the Member States on such introduction, (especially as the introduction of IAS 39 Standard in its current version in the statutory accounts could lead to greater volatility in the Bank's unconsolidated financial results – an increasingly important issue in future years as activities develop in line with the strategic objective for the EIB Group to prioritise SME/venture capital financing activities).

An IFRS Project Team has been convened to oversee the response to important changes in this area. The Financial Control department will update its formal IFRS procedures and respective responsibilities to address such matters across the EIB Group.

As identified in last years report, the lack of internationally-accepted and precise implementation guidelines for some aspects of IFRS, and IAS 39 in particular, introduces a degree of subjectivity in the interpretation thereof. The Management Committee continues to consider the possible 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 competent EIF decision-making bodies – which has not been given to date.

2.5 Information Technology

New IT systems have been implemented over a number of years within the "ISIS" project. The Management Committee acknowledges a number of difficulties were experienced during the 2005 implementation of the new borrowings system and with subsequent upgrades. In order to bridge the gap until a decision is taken concerning the new IT back-office loans system, significant investment was made in 2006 to ensure that the existing system continues to meet the Bank's evolving business requirements.

The Management Committee has received the results of the external consultants assessment of the EIB Group's investment in the ISIS project. The Management Committee recognises the complexity and sensitivity of setting meaningful standards for judging the success of IT investments and will continue to work towards the introduction of an appropriate IT contribution measurement model.

As from May 2007, the IT department will be integrated into the new Strategy and Corporate Centre Directorate to ensure that all of the key instruments of change management are centrally co-ordinated and to provide closer integration of process and organisational appraisal/change initiation and associated IT application analysis. The role of IT will be more responsive through closer integration in the overall budget, project decision-taking, activity-planning and logistical processes; which in turn will enable a higher degree of IT contribution measurement.

2.6 Business Continuity Planning

The main purpose of Business Continuity Management (BCM) is to ensure that the EIB as an organisation has a response to major disruptions that threaten its survival or the continuity of its core business activities. BCM is defined as an holistic management process that identifies potential impacts that threaten an organisation and provides a framework – the Business Continuity Plan (BCP) - for building resilience with the capability for an effective response that safeguards the interests of its key stakeholders, reputation and value creating activities.

In the context of the current BCP review, the Business Impact Analysis performed so far will lead to an extension to the present scope of the Bank's BCP. A working programme has been established; reviewing and building on existing documents and arrangements, which will lead to a comprehensive test of the BCP in the 2nd half of 2007.

The IT software interruption which occurred in September 2006 due to a software bug led to unavailability of part of the Bank's front-office systems for several hours. The response by the Bank's services ensured that the incident did not lead to any financial loss or other negative impact. The bug has been resolved by the software provider.

2.7 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 all its operations and in order to gain demonstrable assurance regarding the soundness of the Bank's investments, including also all mandate operations. In 2006, the respective roles and responsibilities, and the scope of various monitoring activities have been further clarified to enhance: consistency of judgement throughout the project cycle; follow-up of main conditions and risks; analysis of cost evolution during implementation; and reporting quality. In 2007, the specific monitoring arrangements in the Investment Facility will be further reviewed.

2.8 Investment Facility Policies and Procedures

Since the launch of the Investment Facility operations in 2003, a number of policies and procedures have been developed and implemented. They relate 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) and take the need to balance financial and development objectives into account. The policies and procedures are regularly revised based on experience gained with investments made so far as well as the identification of new investment instruments and possibilities. Of particular note is the new Development Impact Assessment Framework (DIAF) which is applied for all ACP operations and takes a broader view of Value-Added.