



**European Investment Bank**

**AUDIT COMMITTEE**

**Annual Report to the Board of Governors**

**For the 2007 financial year**

## AUDIT COMMITTEE

### ANNUAL REPORT TO THE BOARD OF GOVERNORS

For the 2007 financial year

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## 1. INTRODUCTION

According to the Statute and Rules of Procedure, the EIB's Audit Committee is responsible for auditing the Bank's accounts and reports each year to the Board of Governors on the results of its work. 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 and procedures, while the detailed audit work is carried out by an external audit firm.

The *Audit Committee* has issued the Statements on the EIB Group, the Bank, the Investment Facility, the FEMIP Trust Fund and the EU Africa Infrastructure Trust Fund for the financial year 2007, confirming that the financial statements prepared for these entities give a true and fair view of their financial position, on the results of their operations and of their cash flows for the year under review. This report describes the work done by the Committee since the last meeting of the Board of Governors, including supervision of the follow-up on prior year recommendations and new recommendations for improvement in the Bank activities.

The report presents the principal areas on which the Committee is called to report, namely the proper conduct of the Bank's activities, with specific attention to risk management and the audit of the financial statements.

## 2. BANK ACTIVITIES

In order to receive assurance that the operations of the Bank are properly conducted, the Audit Committee obtains a good understanding of the business issues<sup>1</sup>, communicates regularly with management and corroborates the information received through regular reports with information obtained through meetings and past knowledge.

### 2.1 New developments

Achievement of 2007 Corporate Operational Plan (COP) targets. The Audit Committee has been regularly updated on the Bank's progress towards the main 2007 performance targets. In 2007 we witnessed a strengthening of the existing strategy and objectives, with achievement (or overachievement) of all Key Performance Indicator (KPI) targets and particular consolidation in the area of taking more but controlled lending risk. Through continued borrowings, even in a turbulent financial environment, and also by maintaining attractive conditions for its loans, the Bank played the role of a stabilising factor in the financial markets in the time of a world-wide financial and credit crisis. As a result, a more even pattern of signatures and disbursements throughout 2007 was noted, with a less evident "year end rush" and consequently less operational risks. However, as explained in more detail in Chapter 3, the credit crisis had an indirect adverse impact on the consolidated financial statements, with a significant fair value adjustment caused by the appreciation of the EIB borrowings in the market.

The volume of SFF signatures tripled, with the aggregate of SFF/RSFF/LGTT<sup>2</sup> standing at EUR 1 737 m or 116% of the COP target and growing by almost four times compared to last year. New Signatures in Europe with loan grading C and below, an indicator that measures one of the key components of the EIB's strategy – i.e. "taking more but controlled lending risk for more value added", stood at EUR 6 605 m, attaining the COP target and increasing by 17% compared to last year. This notable performance (compared to the target and historical achievements) was possible as strong efforts made over the past years to expand SFF and more recently RSFF activities have started to bear fruits. The Audit Committee understands that the Bank achievements in these areas have been enhanced as a result of both the changes in the financial climate and the preparatory work performed in 2006 and before.

Despite these additions in the higher risk category, the overall portfolio quality remains stable, according to internal rating provided by Risk Management. This is due, in part, to the aging of the

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<sup>1</sup> The Audit Committee aims to meet all the Bank's Directorates at least once a year.

<sup>2</sup> SFF stands for Structured Finance Facility; RSFF for Risk Sharing Finance Facility and LGTT for Loan Guarantee Instrument for TENs Transport.

existing portfolio which improves the rating (expected losses decrease as the loans get closer to maturity) and also by transfer to a higher internal grading category of outstanding loans to the two new Member States which joined the EU in 2007.

The Audit Committee received a presentation on the new pricing system and on the rate setting and quoting, aimed to provide comfort to the Committee in relation to the monitoring and control mechanisms on the constitution and allocation of the Net Funding Result (NFR), which is a measure of the Bank's ability to pass its funding advantage on to the final beneficiaries. The Committee was satisfied with the Bank's efforts in this area and notes that the full NFR result is passed onto the beneficiaries of the Bank's loans.

The Board of Directors approved the COP 2008-2010 in November/December 2007. The COP was presented to the Audit Committee with explanations on the establishment of KPIs, the associated targets and the actual results for 2007, existing and new strategic objectives, together with other challenges facing the Bank and the planned response. The Audit Committee noted the significant increase in the 2008 targets for SFF/RSFF/LGTT signatures and obtained assurances that the Bank had the human resources and the competence to manage these products.

The Audit Committee followed the discussions between management and staff regarding the proposed and ongoing compensation package reforms. The Audit Committee identified potential risks induced by the possible decrease in the staff morale and suffering relationships between staff and management in the longer term, which need to be managed in order to ensure that the quality and quantity of the Bank's operations are not affected.

New financial instruments. The Audit Committee is supporting the new initiatives taken by the Bank, by issuing Statements which give enhanced assurance to the EIB partners and by actively monitoring the external and internal audit processes. The Committee notes the new initiatives taken by the Bank, as described in the COP Annex 2, and in particular:

- The Audit Committee has accepted audit discharge responsibility for the *EU-Africa Infrastructure Trust Fund*. A full presentation on this initiative was provided to the Committee in 2007 prior to the signature of the trust agreement and the Audit Committee issues a Statement for the first set of financial statements dated 31 December 2007.

This fund is an innovative financial instrument that forms part of the EU-Africa Partnership for Infrastructure. The Trust Fund is not a separate legal entity. It currently holds EUR 87million pledged by Donors and managed by the Bank. Its aim is to increase appropriate and sustainable EU funding for African regional and trans-border infrastructure by combining public grant money with long term loans.

- *RSFF*. The Risk Sharing Finance Facility, signed in June 2007, is designed to foster private sector and public institutional investment across Europe in the field of Research, Technological Development, and Innovation investments. It is a key element of the Bank's contribution to the Lisbon agenda grouped around the term of i2i.
- *LGTT*. The Loan Guarantee Instrument for TENs<sup>3</sup> Transport is a Facility to be managed by the Bank and supported by a EUR 500 million allocation under the new TEN-T Financial Regulation over the period 2007-2013. It is designed to provide effective support to the financing of TEN-T through the provision of guarantees for stand-by facilities to cover revenue risks up to five years after the start of operation.
- *JASPERS and JESSICA*. The two instruments developed together with the Commission and the EBRD/CEB were presented in detail to the Committee by their respective Heads. The Audit Committee notes that the JASPERS 2006 audit has been completed after initial delays.

The Audit Committee would like the Bank to assess if its organisation and structures continue to be appropriate for the delivery of existing activities and for the emerging products and instruments and encourages the Bank's management again to develop a joint approach to the question of discharge procedures required for new instruments in general.

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<sup>3</sup> Trans-European Networks for transport and energy.

Organizational changes. In 2007, the Bank has established an independent Transaction Management & Restructuring function (TMR) within the Risk Management Directorate. This organisational change addresses previous Audit Committee calls for enhanced monitoring, as TMR will focus on EU post-signature transactions and monitoring of EU distressed counterparts, preparing financial and contract reviews and handling post-signature events and refinancing not under the responsibility of the directorate for lending in the EU. Monitoring of contracts outside the EU remains within the Operational Directorate for lending outside EU.

A more complex reorganization was taken with the creation of the Strategy and Corporate Centre (SCC), the Bank being in line with developments in other International Financial Institutions. The Audit Committee welcomes the integration of IT in this new Directorate as this brought IT closer to the business needs of the Bank enabling better planning of the system developments. At the same time, the Committee discussed the relative merits of having one Department combining the financial control with the strategy and management control functions and has recommended a review of the reporting lines for financial control. The Audit Committee noted the departure in retirement of the Financial Controller, with whom it cooperated very well over the past few years. The Audit Committee has asked the Bank to ensure that the level of technical expertise and the required professional qualification is maintained when the succession is finalised.

Information Technology. The Audit Committee follows the IT developments in the Bank to the extent the systems involved contribute to the accuracy of financial reporting but also as a source of risk in itself. The Audit Committee was pleased to note the stabilisation of Finance Kit applications which support key activities of the Bank and which have caused some concern during the previous years and also understands that further IT integration is being pursued, with a view to reducing duplication of data input and data reconciliation problems. Part of this is the implementation of FK Loans which is scheduled to start in 2008.

The Committee met with the new IT Director at the beginning of 2008 and was briefed on the new IT strategy which aims at linking the IT expenditure to the COP objectives and to shift the focus from the technical infrastructure to adding value to the Bank's services. Benchmarking with peers would also be part of this strategy. The Committee concurs with the intention to better align IT and business objectives.

With respect to the disaster recovery plan, the Audit Committee was informed that the move of the IT critical applications to *outside* data centres (although geographically close to the bank location) will be completed by the end of 2008 and this will ensure protection against loss of data.

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 2007/2008 include:

- Public consultation on the review of *EIB's Anti-fraud Policy*. The Audit Committee was involved in the consultations on the update of the EIB Anti-fraud Policy. Having provided specific comments in oral and written form, the Audit Committee will take note of the Policy in its final form and will seek assurance that it is properly implemented by the Bank. The Audit Committee encouraged a more pro-active approach to anti-fraud activities by the Bank and sought clarifications about its own role and about the staff awareness strategies. However, the Audit Committee considers that the final proposed version of the Policy remains largely passive. The Audit Committee encourages the Bank to reinforce its investigation function in order to be able to keep its commitments to the other IFI and the public at large and to increase the preventive and detection role of the function.
- The Board of Directors approved that a *Provisional summaries of decisions* taken at its meetings be made public.
- A review of the first year of implementation of the *Public Disclosure Policy* containing detailed statistics on the public requests for access to information, highlighting the key new elements compared with the 2002 Public Information Policy and making recommendations for further improvement.

## 2.2 Risk management activities

In order to be able to discharge its duties with regard to risk management activities, the Audit Committee has regular meetings with the Risk Management (RM) Directorate, Inspector General (IG), Office of the Group Chief Compliance Officer (OCCO) and other relevant services and reviews the monthly operational risk reports and quarterly risk reports, as well as all internal audit reports. The objectives of the Audit Committee are to:

- Obtain an understanding of the extent to which management has established an effective risk management system;
- Monitor responsibilities for risk identification, assessment, and management throughout the Bank;
- Discuss with management how risks, including fraud risk, are identified and how those risks are assessed in regard to likelihood of occurrence and impact;
- Understand Internal Audit's role and planned coverage;
- Review financial reporting risks and discuss with management how effective the controls in place are to mitigate those risks.

The risk categories identified by Basel II, including the specific banking risks, are covered by RM. In addition Internal Control Frameworks (ICF) are put in place which address operational controls by process. These are currently maintained and updated by Internal Audit, after being drawn up by Internal Audit together with the relevant Directorate. The ICFs were instituted pursuant to a different risk management framework and the Audit Committee would like the Bank to identify whether there is any duplication between the ICFs and RM activities, but also if there are any gaps in risk identification and risk assessment at the level of the Bank.

The Audit Committee recommends that the Bank undertake a gap risk analysis to make sure that all possible risks, in particular the risks that do not fall under the Basel II categories, are systematically identified and assessed in terms of their probability and impact. Such an evaluation should conclude on the degree of completeness of the risk identification and risk assessment activities in the Bank. An approach towards each risk or category of risk should then be formulated (i.e. acceptance, mitigation, avoidance through externalization).

Risk Management Policies and Procedures. The internal Policy Guidelines are continuously updated in order to support the evolution of the Bank's activity. Thus, the Credit Risk Policy Guidelines (CRPG) have been updated in order to expand lending possibilities, particularly with Single Signature Single Risk (SSSR) customers. The Financial Risk and ALM Policy Guidelines (FRPG) also went through a review process in 2007, to incorporate the introduction of Fair Value Option in the context of IFRS accounting standards, the authorization to conclude Overnight-Indexed Swaps to manage short-term interest rate exposure and the phasing out of the Investment Bond Portfolio, in addition to other minor technical changes. The Audit Committee, as a matter of course, follows these developments.

Basel II compliance: The Audit Committee welcomed the decision of the Bank to comply with Basel II requirements on a voluntary basis, the main objectives of this being the establishment of an adequate corporate governance system and procedures to identify, monitor, control, quantify when possible, and cover all the risks of the banking activity. During the reporting period, the Committee obtained assurance that the Bank was applying the selected methods appropriately and efficiently.

The Luxembourg banking supervisor provided the EIB with a letter, in their capacity of technical advisors, whereby the Group is designated as globally compliant. However, the Audit Committee also took note of the recommendations contained in the letter, which refer to, *inter alia*, the need for an Internal Audit review; the calculation of internal ratings for the entire loan portfolio (at present only 25% of the portfolio being covered); and the development of procedures for stress testing in relation to the internal ratings based approach.

Subprime crisis. The Audit Committee was promptly informed of the measures taken by the Bank to limit its potential exposure to the crisis. In spite of the deterioration in the financial market conditions since the Summer of 2007, the Bank has so far not suffered any meaningful adverse consequence from the still on-going market turbulences. The Bank's solid performance under all risk metrics has been presented to the Audit Committee.

The Audit Committee is monitoring market conditions and seeks assurance that there are appropriate controls in place at the EIB to mitigate the impact of future market turbulence. Independently, the Audit Committee receives information on significant defaults or frauds in the banking sector and continuously verifies that the controls in place at the Bank address similar risk scenarios.

The Audit Committee was informed that OCCO has actively cooperated with the operational directorates and did not have any major cases to report to the stakeholders since last June.

### **2.3 Organization and meetings**

The Audit Committee has approved its own *Charter*, which is now public on the EIB's website<sup>4</sup>. The main purpose of the Charter is to enhance transparency vis-à-vis the Committee's activities and its role.

In October 2007 the Audit Committee had, for the first time, a joint session with the *EIF Audit Board*. The meeting revealed commonalities between the two bodies and potential for future cooperation. It was agreed that such meetings should be held at least once a year.

## **3. AUDIT OF THE FINANCIAL STATEMENTS**

### **3.1 Review of Audit Work**

In its work, the Audit Committee cooperates with external and internal auditors, from which it obtains the required level of assurance on the accuracy of financial reporting and on the relevance of internal control mechanisms and the way the controls are implemented. The existence and functioning of appropriate controls is also confirmed through detailed relevant assurances the Audit Committee request and receives from Management.

The Audit Committee received continuous and proper support from both audit functions during the period under review, and has received the expected support in a timely manner.

The cooperation with the European Court of Auditors is regulated by the Tripartite Agreement, which was renewed by mutual accord in July 2007.

#### *3.1.1. External auditors*

The current contract for external audit services was concluded in December 2004. Ernst & Young (E&Y), one of the Big 4 audit firms, was appointed for a period which ends with the approval of the 2008 financial statements. In 2007, E&Y was also appointed as auditor of the EIF, which has created synergies in the general audit process.

The Audit Committee meets regularly with the external auditors. In order to be able to rely on the work of the external auditor, the Audit Committee monitors the audit work, reviews the various reports received from the external auditor, including the management letter and obtains assurance regarding the auditor's independence. The Committee has received, at each meeting, updates on the status of the audit work and was promptly informed of all potential problems. In between meetings, the liaison is ensured through the Secretariat General, which monitors the implementation of an agreed critical path for reporting deadlines and acts as a central point for all audit related issues.

In 2007, the points of specific emphasis for external audit, established in agreement with the Audit Committee, were:

- IT Systems Changes planned in 2007;
- Valuation in the context of Fair Value Option and IFRS 7 implementation;
- Loan Substitutes monitoring in the context of the "Subprime" crisis
- Internal Control Framework (ICF) – Follow-up;
- Development of specific investment facilities;
- Risk Management organisation and guidelines;
- Compliance with IFRS standards.

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<sup>4</sup> See <http://www.eib.org/about/publications/audit-committee-charter.htm>

The Audit Committee obtained a confirmation of independence from E&Y for the current and previous year. Also in 2007/2008, the Audit Committee reviewed potential additional engagements<sup>5</sup> involving the external auditor and decided on a case by case basis which are allowable and which pose a conflict of interest issue. The Chairman of the Committee addressed a letter to E&Y explaining the conditions and limitations in this respect and two internal notes were also issued for guidance to the Bank services.

### *3.1.2. Inspector General*

The Inspector General, who reports to the President, is responsible for three functions which are key contributors to the assurance obtained by the Committee, namely Internal Audit, Fraud Investigations and Operations Evaluation. The Inspector General has free access to the Audit Committee and may request private sessions with the Committee, even if this was not the case in 2007/2008.

The Audit Committee reviews and comments on the Internal Audit work plan and receives all internal audit and evaluation reports, as well as communications about alleged wrong doings and on status of investigations. Internal Audit reports are usually discussed with the auditees and the Audit Committee monitors the completion of the agreed action plans (AAP), which define the practical modalities in which internal and external audit recommendations are implemented.

Two previous Audit Committee recommendations referring to Internal Audit were addressed during the reporting period, namely the Internal Audit Charter was revised in consultation with the Audit Committee and a Quality Assurance Review of Internal Audit took place, in accordance with the requirements of the Institute of Internal Auditors. The report concluded positively on the Internal Audit activity, with some recommendations for improvement. A formal action plan for implementation is to be established by the Inspector General and communicated to the Committee.

### *3.1.3. European Court of Auditors (ECA)*

The Audit Committee took part in a visit on the spot undertaken by ECA as part of their audit of the banking measures in the Mediterranean area in the context of the MEDA programme. The visit was preceded by a meeting between the Audit Committee and the Member of ECA responsible for the EIB, where procedural aspects of the said audit were discussed within the context of the Tripartite Agreement. The Committee was permanently kept up to date by the Bank on the progress of the audit and has obtained detailed responses from the Bank in relation to the audit findings. The Committee remains satisfied that the measures taken by the Bank are effectively addressing the risks highlighted in the findings concerning the legality, regularity and reliability of the accounts, which were included in the Court's 2006 Annual Report.

The Audit Committee received in the first months of 2008 the preliminary findings on the performance aspects of the same audit. The Audit Committee, while fully understanding the ECA technical approach, highlights that the activities the Bank carries out in the Mediterranean countries should be examined and understood in the context of the strategic and political objectives that are determined at a political level for the Mandate.

The Committee was also informed about the commencement of an audit by the ECA of the Commission shareholding in EIF.

## **3.2 The Financial Statements as at 31 December 2007 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<sup>6</sup>, the FEMIP Trust Fund and the EU-Africa Infrastructure Trust Fund for 2007.

For 2007 the non-consolidated financial statements have been prepared in accordance with the general principles of the European Directive applicable while the consolidated, the FEMIP Trust Fund and the EU-Africa Infrastructure Trust Fund financial statements have been prepared in accordance

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<sup>5</sup> The services provided by and the total fees paid to the external auditor for the previous year are disclosed on the EIB website at [http://www.eib.org/about/structure/control\\_and\\_evaluation/control\\_external-auditors.htm](http://www.eib.org/about/structure/control_and_evaluation/control_external-auditors.htm)

<sup>6</sup> The Audit Committee submits a separate report to the Board of Governors regarding its work in relation to the Investment Facility.



with the International Financial Reporting Standards (IFRS). The Audit Committee is aware that the Bank has established an IFRS Task Force with the view to prepare the Bank for the eventual adoption of IFRS for the statutory accounts, analyse the management of fair value volatilities, but also to ensure that the Bank stays up to date with new IFRS developments and analyses the implications of new and emerging standards in a timely manner. Also in this case, the Audit Committee has asked the Bank to ensure that the excellent level of IFRS technical expertise is maintained after the departure in retirement of a key member of staff.

Significant Accounting Changes: The 2007 consolidated financial statements were particularly affected by the new standard, IFRS 7 “Financial Instruments: Disclosures” and the amendments brought to IAS 1 “Presentation of Financial Statements”.

The amendment to *IAS 1* requires entities to disclose information that enables readers to evaluate the entity’s objectives, policies and processes for managing capital.

*IFRS7* requires disclosure of the significance of financial instruments for the financial position and performance of the entity. These disclosure requirements incorporate many of the requirements previously required under IAS 32. In addition, the new standard requires the reporting entities to include qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management’s objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel. Together, these disclosures provide an overview of the entity’s use of financial instruments and the exposures to risks they create. The Audit Committee obtained confirmation from the external auditor that the first time implementation of this standard for the consolidated financial statements was adequate.

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

Key elements of the statutory financial statements: The Audit Committee noted that the profit recorded for the financial year is EUR 1,633 million, increasing by 2.67% compared with 2006 ordinary profit (i.e. excluding the 2006 release from the fund for general banking risk). The balance sheet total has increased by almost EUR 13 billion, from EUR 289 billion at the end of 2006 to EUR 301.9 billion at the end of 2007, mainly due to an increase in loans and advances to customers, matched by a similar increase in debt securities in issue.

Impact of IFRS adjustments. The Audit Committee notes a negative impact of EUR 813 million on the EIB Group profit and loss account for 2007, compared to a positive impact of EUR 641 million in 2006; hence a cumulative impact of EUR 1,454 million over two years. The volatility is largely due to the application of Fair Value Option (FVO) in the context of the IAS 39 “Financial Instruments: Recognition and Measurement”. In the context of the subprime crisis the market price of EIB quoted bonds decreased less than the fair value of hedging swaps (consequence of the investors’ orientation towards quality instruments), in other words the Group had to take an unrealised loss to the profit and loss account due to a relative strengthening of its bonds in the market.

The Audit Committee has analysed in detail the paradoxical situation with the auditors and with the management of the Bank, in the context of the possibilities studied by the Bank to reduce such volatility in future but also in the context of the discussions currently taking place at international level vis-à-vis the need to reduce the complexity in the standard on financial instruments. The Audit Committee will follow the subject in 2008/2009.

The Audit Committee also noted reclassifications of prior year figures in the consolidated balance sheet amounting to EUR 5.5 billion, due to a netting-off, this year, of the positive and negative replacement values obtained in the valuation of foreign exchange forwards and foreign exchange swaps respectively. In 2006 these were presented separately, in other assets and other liabilities, grossing-up the balance sheet totals by the respective amount.

FEMIP Trust Fund: The net profit of the financial year was EUR 904 thousand (compared to a loss of EUR 934 thousand in 2006), while the balance sheet total increased by approximately EUR 3 million during the year.

\* \* \*

Based on work undertaken and the information 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 have been drawn up correctly and that they give a true and fair view of the 2007 results and financial status according to the accounting principles applicable to the Bank.

The Audit Committee is able to extend the same conclusion to the financial statements of the Investment Facility, the FEMIP Trust Fund and the EU- Africa Infrastructure Trust Fund, as these are covered to a large extent by the EIB's own risk control systems and internal and external audit arrangements.

The Audit Committee is of the opinion that it was able to carry out its work to fulfil its statutory mission under normal, unrestricted conditions. On this basis, the Audit Committee provided approval of its annual statements as of the date of signature of the audit report by the external auditors.

The Audit Committee has concluded that it met its responsibilities during 2007. The Committee believes that it has retained appropriate standing within the Bank, and that it has maintained appropriate relations with management and Bank staff. In 2007 the Audit Committee received the expected support from the Bank, which enabled it properly to discharge its responsibilities.

#### **4. CONCLUSIONS**

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

- The Bank made progress in the field of transparency;
- The progress towards Basel II compliance is satisfactory;
- The Bank's efforts for further integration and stabilization of its IT systems are becoming increasingly effective.

In 2008/2009 the Audit Committee, in addition to its ongoing duties, will oversee the tendering procedures for the selection of a new external auditor and will adapt its own role in the light of the revised Statute which will come into effect on the ratification of the Lisbon Treaty.

**Date, 15 April 2008**

**M. DALLOCCHIO, Chairman    C. KARMIOS, Member    O. KLAPPER, Member**

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

**N. PHILIPPAS**

**E. MATHAY**

**J. RODRIGUES DE JESUS**



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**INVESTMENT FACILITY**

**For the 2007 financial year**

**AUDIT COMMITTEE**

**ANNUAL REPORT TO THE BOARD OF GOVERNORS**

**ON THE INVESTMENT FACILITY**

**for the year 2007**

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## 1. INTRODUCTION

Under the Cotonou Agreement, in addition to lending from own resources, the Bank also finances operations in the ACP (African, Caribbean and Pacific) from a EUR 2.037 billion risk bearing Investment Facility whose funds are provided from the European Development Fund. The Investment Facility was established within the Bank as an autonomous business unit with operations officially starting on 1 April 2003; the operations carried out under the Investment Facility are accounted for in separate 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 took note of the fourth Annual Report prepared by the Investment Facility and the financial statements for 2007. This report from the Audit Committee to the Board of Governors provides a summary of the Committee's work specifically targeted on the Investment Facility during the period since the last Board of Governors' meeting in June 2007.

## 2. AUDIT COMMITTEE WORK

### 2.1. Review of Investment Facility's activities

The assurance expressed by the Audit Committee is based on the fact that the Investment Facility (IF) shares a number of systems with the Bank, notably those involved in risk management, human resources management, treasury management and financial reporting. In addition, the Investment Facility is subject to the internal and external audit procedures of the Bank. The key aspects noted by the Audit Committee for the Investment Facility in 2007/2008 are developed below.

**Cotonou Agreement:** The Cotonou II Agreement is currently under ratification. The scope is enlarged, notably for the High Indebted Poor Countries (HIPC) interest rate subsidy. The financial protocol of the new agreement incorporates a second capital endowment of EUR 1.1 billion for the IF.

**Operational Context:** Activity levels for 2007 under the Investment Facility were to some extent constrained by the limited availability of resources under Cotonou's first financial protocol pending the entry into force of the second financial protocol – and the related additional Investment Facility capital endowment - which is likely to be delayed by about six months compared to the initially foreseen date of 1 January 2008. The current pipeline of Investment Facility operations would absorb more than the balance available for new approvals, hence the need for careful management of resources and the definition of clear lending priorities. Overall annual commitments in the ACP are forecast to reach up to EUR 450 million under the Investment Facility - with due regard to the revolving character of this facility - and EUR 350 million under own resources over the 2008-2010 period. With regard to technical assistance, yearly commitments are likely to be around EUR 10m.

**Meeting with Management:** The Audit Committee meets regularly with the Management of the Investment Facility. At their last meeting in March 2008 the Audit Committee was reassured that all operations approved in 2007 were concurrent with the objectives set by the Member States. Discussions were also held about sustainability in the light of the relatively limited amount of equity investments as well as the importance of the due diligence process for such operations. The Audit Committee noted that the Investment Facility is represented either in the Investment Committee or in the Board of the various operations in which it invested. The monitoring issues were also analysed, as detailed in the next paragraph.

**Monitoring Aspects:** The Audit Committee was informed early in 2007 that the monitoring arrangements were to be reviewed not only from the perspective of overall resource requirements but also of the staff mix with a view to strengthening the capabilities in the area of project performance and improving efficiency.

The Audit Committee understands that the procedures and systems in place are to be further strengthened in order to ensure a consistent approach across the portfolio. An important element of the new approach will be the application, during 2008, of the Bank's loan grading system to the Cotonou portfolio, resulting in a classification of all ACP operations linked to a common review cycle and providing an overview of the state of the portfolio.

The Audit Committee is also aware of the competing demands for monitoring activities for sometimes very distinct purposes (e.g. accounting valuation, environmental reporting and project sustainability). The Audit Committee will require information in 2008/2009 about how these demands are prioritised and about the sufficiency of monitoring resources allocated for each task.

## *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. The Audit Committee assesses regularly the external auditor's independence, including the absence of any conflicts of interests.

The draft 2007 *Management Letter* received from the external auditor includes recommendations for the Investment Facility to perform reconciliations on a regular basis between the various systems used for recording and reporting the loans, as specified in the relevant policies in force and the need to automate the revaluation of the loans contracted in a currency other than Euro, at the year end. The Audit Committee will follow-up on the finalisation of the Management Letter and the implementation of the agreed action plans.

**Inspector General of the EIB:** The Inspector General, who reports to the President, is responsible for three functions which are key contributors to the assurance obtained by the Committee, namely Internal Audit, Fraud Investigations and Operations Evaluation. The Inspector General has free access to the Audit Committee and may request private sessions with the Committee, even if this was not the case in 2007/2008.

The Audit Committee is permanently informed about the alleged cases of wrongdoing and the ongoing investigations relating to Bank projects, including Investment Facility operations. The Audit Committee was satisfied with the approach taken by the Bank's Fraud/Investigation Unit in cooperation with OLAF in 2007/2008 vis-à-vis the reported cases of suspected fraud, and with the impairment provisioning in the accounts. However, the Audit Committee is concerned that some of the reported cases may have resulted from insufficient due diligence work or monitoring.

In their November 2007 meeting the Audit Committee received a presentation on an Internal Audit Report on "ACP Risk Capital Operations", in the presence of ACP/Investment Facility management who confirmed that action was being taken on the internal audit recommendations. The report provides agreed action plans for improvement in the monitoring process in the ACP/IF Department, including follow up on external reports, improvements in the management of equity participations and discusses the risks associated with databases operated in Excel. The Audit Committee will follow-up on the implementation of the recommendations from Internal Audit in 2008/2009.

**European Court of Auditors:** The Audit Committee noted that the Court did not carry out any Investment Facility related audits in 2007.

## **3. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2007 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE**

The Audit Committee examined the 2007 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 Committee noted, in relation to the 2007 financial statements:

- Income statement: The net profit for the year increased by 51% compared with 2006 (EUR 35.983 million against EUR23.7 million in 2006) due mainly to a similar increase in the net interest income.
- Balance Sheet: The Balance Sheet total increased during 2007 from EUR 711 million to EUR 1,077 million, covered almost in full by a corresponding increase in equity.
- Credit and interest rate risk: The Investment Facility disbursed exposure totals EUR 671 million at the end of 2007, increasing from EUR 401 million at the end of 2006.
- Impairment: Two operations were considered impaired for a total of EUR 4.4 million, of which EUR1.7 million were accounted for already as at 31 December 2006, thus resulting in an impairment charge of EUR 2.7 million in 2007.

**IFRS valuation:** The Audit Committee noted that all the assets of the Investment Facility are measured in accordance with IFRS principles; notably equity investments are measured at fair value, loans originated by the Facility are measured at amortised cost, using the effective yield method, less any provision for impairment or uncollectibility and derivatives are measured at fair value through income statement.

#### 4. CONCLUSION

Overall, the Audit Committee is satisfied that appropriate relations with management and Investment Facility staff exist to allow it to properly discharge its responsibilities.

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 2007 financial statements of the Investment Facility have been drawn up correctly and that they give a true and fair view of the 2007 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 12 March 2008.

**Date, 15 April 2008**

**M. DALLOCCHIO, Chairman**

**C. KARMIOS, Member**

**O. KLAPPER, Member**

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

**N. PHILIPPAS**

**E. MATHAY**

**J. RODRIGUES DE JESUS**



**European Investment Bank**

**Response of the Management Committee  
To the Annual Reports of the Audit Committee  
For the Year 2007**



## **RESPONSE OF THE MANAGEMENT COMMITTEE TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE FOR THE YEAR 2007**

### **1. Audit and control structures in the EIB**

The Management Committee is committed to a strong and effective audit and control structure for the EIB. 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.

Mutually constructive yet appropriately independent relationships exist between the Management Committee, Audit Committee, the external auditors and internal auditors. The Management Committee also fully collaborates with the European Court of Auditors in the audit of operations or funds which engage EU budgetary resources and which are implemented or managed by the Bank.

The Management Committee wishes to re-iterate that even though the Bank is not subject to formal supervision, it voluntarily submits itself to the main EU banking regulations, EU Policies and relevant accepted 'best practices'. The Bank has recently initiated a formal process to assess key emerging industry standards, and other practices which are identified as becoming generally accepted best practice within the banking sector, and their applicability to the Bank.

### **2. Developments within the Bank and within the Investment Facility in 2007-2008**

#### ***2.1 Corporate Governance, Transparency and Accountability***

Corporate responsibility and sustainable developments go hand in hand and therefore corporate responsibility through socially responsible activities and investments is a key element which underpins the EIB Strategy. The Bank's Corporate Responsibility Report now forms part of the Annual Report and gives qualitative insights into the EIB policies and practices related to corporate governance, transparency, accountability, compliance, integrity, ethical and social issues. In 2008, the Corporate Responsibility Report 2007 will be subject to an independent external review.

Increased transparency about the Bank's activities is being generated through a number of measures including: reinforced dialogue with Civil Society; application of the Disclosure Policy drawn up in 2006; a broader range of performance measures with a greater emphasis on future prospects and with substantial value-based information giving assurance on underlying systems; and adherence to new financial reporting requirements, notably IFRS 7 (see also section 2.6).

A public consultation on the review of the EIB's Anti-Fraud Policy started in 2007 and was concluded in early 2008. The consultation process has led to better structured and more clearly formulated anti-fraud policy and procedures which, in terms of best practice, are on par with those of the other International Financial Institutions. The consultation process identified a number of further actions which may lead to revisions to the policy and procedures. Additional proactive measures will be taken and appropriate resources will be made available to enable the policy to be implemented in the manner requested by the Audit Committee.

#### ***2.2 Achievement of Corporate Operational Plan 2007 targets***

The nature of EIB investment and its link to economic growth is changing in recognition of the fact that to foster true convergence, the economies in which the Bank operates need loans and risk-capital for infrastructure, plus also for knowledge-creation. The Bank has indeed responded to this through its objective to take 'more risk for more value-added' but has done so in a very controlled manner, primarily through the use of the Structured Finance Facility (SFF) and other risk-sharing products which, in recognition of their complexity, have taken substantial time to develop but are now becoming operational.

The Bank achieved each of its Key Performance Indicator (KPI) targets and it is notable that disbursements exceeded the target by EUR 6.5bn or 18% - partly because the attractiveness of the Bank's terms increased after the credit crisis struck in mid-2007. With its AAA rating, the Bank followed an ambitious and successful borrowing policy generating a funding advantage of EUR 406m (Net Funding Result - NFR) on a borrowing programme of EUR 54.725bn. The full financial benefit in terms of NFR obtained by the Bank through its borrowings on the capital markets has been transferred to its lending customers.

### **2.3 Strategic consolidation for 2008**

The Corporate Operational Plan (COP) 2008-2010 confirmed the intention to consolidate the strategic lending and non-lending priorities set in prior years for 2008 and articulates how the EIB is responding to external and internal challenges.

In defining the COP, the Bank critically reviewed the ratio of effort/resources which it should dedicate to each of its future operating activities. This review has resulted in the setting of performance targets which are considered to be an optimum blend for the Bank to continue to serve EU policy objectives and to ensure good staff morale. The Management Committee will continue to ensure that audit procedures for new facilities are assessed on a timely basis.

A review of the capital position has been undertaken in 2008. On the basis of the net surplus growth targets set in the COP 2008-2010 and current capital situation, the Bank should not need a capital increase before 2010 and it should be able to fund this capital increase from internally generated reserves. Once the Lisbon Treaty is ratified, the need for a capital increase could be further delayed for up to three years as the lending ceiling will be redefined with reference to subscribed capital and reserves not dedicated to support specific activities (such as the SFF).

### **2.4 Organisation**

The Strategy and Corporate Centre (SCC) comprises four departments: Strategy, Management and Financial Control (SMC), Information Technology (IT), External Communications (COM) and Buildings, Logistics and Documentation (BLD).

The IT department was integrated into SCC in May 2007. The remaining stages of the Integrated Strategic Information System (ISIS) project have started and a new IT Strategy is being finalised which dovetails with the Bank's overall strategic direction and its decision-making and performance measurement approach.

One of the main aims of the organisation of the SMC department is to allow for a better integration of internal and external accounting and reporting, ultimately to ensure improved coherence and consistency. Nevertheless, in this context, the Bank agreed with the recommendation of the Audit Committee and has already reviewed the reporting lines for Financial Control to the satisfaction of the Audit Committee. The respective obligations of the Director General SCC and the Head of Financial Control will be published in the form of a Charter for Financial Control.

### **2.5 Risk Management Activities**

#### **2.5.1 Response to the credit crisis**

The crisis of the sub-prime market in the US in mid-2007 resulted in a severe liquidity squeeze and in an associated widening of credit spreads. In spite of the deterioration in financial market conditions and the on-going market turbulence, so far, the Bank has not suffered any meaningful adverse consequence.

EIB continues to closely follow the developments concerning the monoline insurers, particularly their down-grading and the discussion of a possible split of the monolines' activities and/or portfolios.

The EIBs exposure to financial institutions also continues to be monitored on a case-by-case basis for counterparts most directly affected by the current crisis. This has led to the adoption of certain risk mitigating measures, such as suspension of Single Signature, Single Risk (SSSR) sub-limits for new business, review of Treasury lines and request of security in line with contractual arrangements.

Treasury investment in Asset Backed Commercial Paper (ABCP) and Asset Backed Securities (ABS) is monitored and managed with strict limitation of overall exposure and scope with immediate exclusion of any instruments below the highest ratings.

The vast majority of loan substitutes carry a rating of AAA and so far there has been no material change in the credit quality of this portfolio. The underlying portfolios of the ABS are exclusively European risks, mainly SMEs and Mortgages that have not been impacted by the current US sub-prime crisis.

### **2.5.2 The Bank's Basel II project**

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"). The project feasibility and complexity were defined and it has been supported by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg acting as a technical advisor, with the Bank maintaining its independence about the ultimate methodological framework. The Bank's Basel II implementation project is nearing completion. The procedures and activities for on-going voluntary compliance with Basel II will be reviewed for continued effectiveness.

### **2.5.3 Business Continuity Planning**

A formal approach to Business Continuity Management (BCM) ensures that the EIB has a response to major disruptions that threaten its survival or the continuity of its core business activities. A number of IT application upgrades have been successfully implemented in 2007 and there has been no unplanned IT or other service interruptions in 2007. A comprehensive test of the IT Disaster Recovery Plan was undertaken successfully in early 2008 and testing of the remainder of the Business Continuity Plan will be concluded by mid-2008.

### **2.5.4 Risk identification and assessment**

The Audit Committees identifies that banking risks are addressed by the Risk Management Directorate and that operational risks are covered at process level via the Internal Control Frameworks. By the end of 2008, the Management Committee will further consider the Bank's risk profile and review the overall approach to risk as recommended by the Audit Committee. In the meantime, it is highlighted that the Directors General are responsible for ensuring appropriate systems for identification, management and reporting of other risks at Directorate level. Each member of the Management Committee also has defined functional and institutional responsibilities and provide supervision of all service level risk management activities to ensure that the Bank's overall risk profile is tolerable.

## **2.6 Application of International Financial Reporting Standards (IFRS)**

The Bank will continue not to adopt IFRS in the statutory accounts until there is a broad consensus among a significant majority of the Member States on such introduction. From the Bank's perspective, there continues to be a lack of internationally-accepted and precise implementation guidelines for some aspects of IFRS, introducing a degree of subjectivity in the interpretation thereof. Furthermore, 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. The IFRS Project Team exists to oversee the response to further changes in this area.

The financial statements of the EIF, EIB Group, the Investment Facility, FEMIP Trust Fund and EU-Africa Infrastructure Trust Fund are prepared under IFRS. IAS 39 has a particular 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 operate in countries where there is a lack of mature market valuations.

This issue of volatility in results due to application of the fair value option in IAS 39 was further compounded in 2007 due to the credit-crisis. In the 2007 consolidated financial statements, the result on financial operations, which mainly comprises the net results on derivatives, loans and borrowings, with application of the fair value option under IAS 39, decreased by EUR 1 409 m. A further EUR 243 m negative impact arose due to IAS 39 application principally to the specific provision for credit risk and impairment losses on shares and other variable-yield securities.

The Management Committee has continued to observe advances in EU policies with respect to other IFRS accounting standards and particularly those related to:

a) 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 is now included in the financial statements.

b) IFRS 7 Disclosure for financial Instruments: which requires an entity to group its financial instruments into classes of similar instruments and, when disclosures are required, make disclosures by class. [IFRS 7.6] The two main categories of disclosures required by IFRS 7 are:

- (i) Information about the significance of financial instruments.
- (ii) Information about the nature and extent of risks arising from financial instruments.

The EIB Group's application of these standards has been subject to the due process and scrutiny of external audit.

In 2007, and in agreement from the competent EIF decision-making bodies, the external auditor of the Bank was also appointed external auditor of the EIF.

### ***2.7 Findings of the European Court of Auditors***

As noted in 1. above, the Bank collaborates with the European Court of Auditors (ECA) in the audit of operations or funds which engage EU budgetary resources and which are implemented or managed by the Bank. On behalf of the Bank, the Management Committee appreciates the attention afforded by the Audit Committee to the recent ECA audit on Bank activities in the Mediterranean. The Management Committee concurs with the Audit Committee's observation that any examination or audit of achievement of the objectives for activities in the Mediterranean countries should identify with the political aspects of the Bank's mandate.

### ***2.8 Investment Facility Policies and Procedures***

The policies and procedures applied to the work of the Investment Facility (IF) are designed with due attention to the obligations agreed with third party contributors to the IF, the specific operating risks plus the development and financing needs in the countries of operation.

The Cotonou Partnership Agreement was revised in 2005 and in 2007, the Bank's lending conditions in ACP countries were reviewed to allow a more flexible use of Own Resources towards financing of operations with higher risk profile. In 2008, enhancements have also been made to the monitoring systems and procedures for projects in the ACP countries.

The need for aid in the IF countries of operation is huge but resources are scarce and must be applied to projects where impact will be significant. The Development Impact Assessment Framework (DIAF) introduced in 2006 was further enhanced in 2007 and renamed the Economic and Social Impact Assessment Framework (ESIAF). The ESIAF is intended to ensure consistent assessment and measurement of the specific impact indicators throughout the project cycle.