European Investment Bank

AUDIT COMMITTEE

Annual Report to the Board of Governors

For the 2010 financial year

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

For the 2010 financial year

Table of contents:

1. INTRODUCTION

The Audit Committee is established under the EIB Statute as a committee completely independent from the Board of Directors, with the Members and Observers being appointed directly by the Board of Governors. The Audit Committee is responsible for the auditing of the EIB accounts and verifies that the activities of the Bank conform to best banking practice. This report is addressed to the Board of Governors, in accordance with the Statute and Rules of Procedure, and provides details on the work of the Audit Committee in relation to the auditing of the 2010 financial statements, as well as on the other activities performed since the date of the previous Annual Report.

In relation to our responsibility for auditing the EIB's accounts, we have issued the Audit Committee's Annual Statements referring to the following financial statements for the financial year 2010:

- EIB Group consolidated according to IFRS[1];
- EIB Group consolidated under the general principles of the EU Directives;
- Bank statutory;
- Investment Facility[2];
- FEMIP Trust Fund;
- EU Africa Infrastructure Trust Fund; and
- Neighbourhood Investment Facility (NIF) Trust Fund.

In the statements the Committee confirms, to the best of its knowledge and belief that the financial statements prepared for these entities give a true and fair view of their financial position, of the results of their operations and of their cash flows for the year under review.

The Audit Committee held seven meetings over eleven days in 2010. In addition to auditing we focused our attention on the progress made by the EIB in complying with best banking practice and on the risk management activities of the Bank. The following chapters provide details about these areas.

2. EIB COMPLIANCE WITH BEST BANKING PRACTICE

The Framework for EIB compliance with best banking practice (the Framework) was established jointly by the Audit Committee and the Bank's services in 2010, following the adoption of the new EIB Rules of Procedure, which require the Audit Committee to verify compliance with best banking practice. We discussed in detail with the Bank's services the verification procedures as well as the practical modalities for maintaining and updating the Framework and the roles and responsibilities with regard to implementation in detail with the Bank's services.

2.1 Implementation and verification methodology

The Framework is based on a hierarchical set of reference documents (e.g. EU Treaty, including the Bank's Statute, EU Directives, international standards, guidance and principles issued by regulatory bodies – collectively referred to as "standards" further in this report) that are considered relevant at a certain point in time and the status of EIB compliance is measured against the requirements in those reference documents. In discussions with the Bank's services, the Audit Committee updates the Framework on an annual basis. The Framework also covers the system of implementation, updating and verification – details of which are provided below.

The Audit Committee met with each of the key Directorates to review the progress made by the Bank in the *implementation* of the Framework and discussed the possible updates of the Framework. The starting point for each discussion was an annual self-assessment of compliance undertaken by each of the Directorates. The meetings aimed at highlighting:

(i) The areas where full compliance had not been achieved at the last self-assessment and the progress made, for each of the applicable standards, towards full implementation;

[1] International Financial Reporting Standards.
[2] The Audit Committee submits a separate report to the Board of Governors regarding its work in relation to the Investment Facility.

(ii) Developments in standard setting (new standards and reformed standards); and

(iii) New EIB internal developments and their possible relevance to the standards (e.g. to see whether new standards become relevant to EIB as new products/initiatives are developed or whether there is a change in compliance).

To complement assurances given by Directorates, the Audit Committee requested three actions from Internal Audit (IA).

1) The audit of the process of updating the procedure manuals - IA was asked to obtain evidence that:

- An evaluation was performed by the Directorates in order to determine what changes were needed in the procedures manuals, guidelines or process flows so as to comply with best banking practice, as established in the latest version of the Framework.
- Where it was determined that a change was needed, the respective manuals/guidelines or process flows were updated, following the normal document change and process change requirements of the Bank.

The objective of this type of audit is to examine the action taken by the Bank in the direction of compliance. IA finalized a first audit of this type in 2011.

2) In future audits planned by IA which tackle a specific area of the Framework (e.g. liquidity risk management, market operations), IA should aim to test controls linked to the reference standards and provide an opinion on compliance. The audit tests will be designed by IA, on a case by case basis, to verify that the principles or more specific requirements of a certain reference document have been incorporated by the Bank in its activities.

IA has the experience in each of the Bank's activities to enable it, when informed by the Framework, to formulate tests and conclusions on compliance.

3) A third type of assurance will be provided by IA through the updates of the Internal Control Frameworks (ICF), since the ICF should capture all the changes resulting from the harmonization with best banking practice. The audit opinion and the representation by management to the internal auditor in relation to the ICF have been adapted to specifically refer to compliance with best banking practice.

2.2 Review of specific areas in 2010-2011

The Audit Committee noted with satisfaction the progress made by the Bank in aligning to best banking practice in the areas of liquidity risk management, market operations, payment systems and rogue trading. Out of 44 key requirements identified in these four areas, 39 are implemented (89%), with the remaining being under review.

Following the ECB agreement giving EIB access to the Eurosystem liquidity operations the Bank is reporting periodically on its liquidity position to *Banque Centrale de Luxembourg* (BCL), which also undertook an on-site assessment of the liquidity risk management at the EIB. The report finds that overall the procedures for managing liquidity and liquidity risk are well established and advanced and identifies some areas for improvement. The Audit Committee is following-up on the implementation of the BCL recommendations.

Capital requirements. The Bank is broadly compliant with the Capital Requirement Directive – the CRD, on the level and quality of capital as well as on other elements such as capital adequacy disclosure. Regarding the trading book, its Value at Risk model is compliant with the best banking practices; however, regarding its credit risk model more work needs to be done about the internal ratings coverage, if the Bank wants to continue calculating its capital requirements under the advanced internal ratings approach. The EIB will have to allocate sufficient resources to ensure full portfolio coverage by the end of 2012, as now envisaged; otherwise the advanced method would have to be applied only to the lines of business or sectors with appropriate rating coverage, while the foundation approach would be applied to others. Internal Rating Models were also the subject of an internal audit, fully endorsed by the Committee, which pointed to the need for changes in the definition of default and for further statistical analysis to support model calibration. It also requested an extension of the stress-testing scope and a complementary quantitative analysis of the collateral. The IA report also recommended the establishment of an Internal Rating Methodology Maintenance Committee.

Human resources. The Bank is complying with the principles of sound compensation as the variable part of the remuneration is relatively small and was never linked to results so far. Moreover, the Management Committee's remuneration is fixed, decided by the Board of Governors, and does not include a bonus or any equity payments. The Audit Committee encouraged the Bank to document the rules and processes for implementing the remuneration strategy, what should be considered as an "appropriate" balance between the variable and fixed portion of the remuneration and how to appropriately remunerate control functions and risk management functions, where performance may be less easily measured than in front office functions. It also recommended the Bank to implement controls to ensure that the mandatory two weeks minimum holiday rule is verifiably respected by staff.

Business continuity. The Bank is following the best practice in the area, namely the British Standard BC 25999-1 and the Business Continuity Management (BCM) Good Practice Guidelines published by the British Continuity Institute. The business continuity philosophy at the EIB is centred on the safeguarding of human life – the most important asset of the Bank. As part of our verification routine, we visited the EIB Resilience Center and took note of the arrangements in the larger context of the Business Continuity Strategy. In the same context, we took note of the move of the IT production applications to two outside centres, which is addressing an earlier recommendation of the Audit Committee related to software interruptions. An internal audit concluded positively on BCM at EIB with recommendations to increase staff and management awareness of business continuity issues and to ensure an appropriate level of participation in business continuity exercises.

Corporate governance. The Statute of the Bank, which is an integral part of the EU Treaty, has primacy over other texts in the area of governance, in particular when it comes to internal organization of the Bank. With this in mind we reviewed the current arrangements with the Bank and made suggestions in line with the recommendations of the "Principles for Enhancing Corporate Governance" issued in March 2010 by the Basel Committee on Banking Supervision (BCBS). These include, for example, a recommendation for the Director General of Risk Management (RM) to be able to address the Risk Policy Committee of the Board in the absence of any other permanent representative of the Bank. However, the Audit Committee meets the RM Head and staff frequently and RM responds to requests made by the Audit Committee, and we find that this is an appropriate alternative to the BCBS recommendations, given the particular way in which the EIB is organized. The Audit Committee itself has consulted an external expert in governance matters on its own self assessment processes.

Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT). The Audit Committee was pleased to note that the Bank commissioned an internal audit of this area; we will follow-up the implementation of the audit recommendations, in particular those calling for awareness training and for IT filtering tools.

2.3 Conclusions

An explicit requirement of the Statute, the verification of EIB compliance with best banking practice by the Audit Committee is of paramount importance, with additional members being added to the Committee to ensure the task is adequately carried out. This complex exercise started two years ago with the establishment of the Framework and continued last year with guidance on practical implementation, verification and maintenance. Continued attention will be devoted to the coordination with the Bank's services so as to enable the Audit Committee to discharge its role of verifying compliance with best banking practice. After the first cycle of implementation, the Audit Committee confirms that the Bank is fully committed to implementing the best banking practice and to fill gaps, when and where gaps have been identified, due to new developments or to other circumstances.

3 RISK MANAGEMENT ACTIVITIES

Understanding the risk profile and the risk appetite of the Bank is key for the success of our work. We draw up our work plan with the objective of obtaining a good understanding of the Bank's activities throughout the year. We then formulate questions and request specific analyses in order to assess the risk impact of the various developments in the Bank, including of new products and initiatives.

In obtaining assurance in relation to risk management activities, the Audit Committee interacts with the services responsible for managing risks and focuses on specific technical points. In addition to regular reviews of various risk reports, over the past period the Audit Committee has looked at topics such as capital adequacy, internal rating models and foreign exchange risk. The analysis of sovereign exposures, including European sovereign exposures, was also regularly on the agenda of the Committee.

<u>Stress testing.</u> Aware of the stress testing developed at EIB at the beginning of the crisis, we drew attention to the fact that the risks emerging in 2010 were of a different nature. Recognizing the difficulty of designing the stress tests and clarifying that stress testing should not be mistaken for estimates or forecasts we provided guidance in terms of scenario and methodology sourcing. We received assurances that continuous stress testing was performed.

<u>Foreign exchange risk</u>. We also requested a review of the foreign exchange exposures, to ensure that the drop in value of the EURO did not increase operational risk. Acknowledging that foreign exchange exposures are hedged, the Committee suggested that a retrospective analysis of the hedges could be done to see if they were effective. A comprehensive analysis of the foreign exchange risk was undertaken with the EIB Risk Management, in response to these questions, outlining the EIB policies but also the potential foreign exchange impact on the core indicators (i.e., the gearing ratio, the CAD ratio, the callable bonds, the general loan reserve and the special activities reserve).

<u>Internal rating models.</u> Internal Audit is reviewing annually the implementation of the Capital Requirements Directive (CRD) at EIB. Recommendations issued at the end of 2010 included the need for a review of the definition of default and for further statistical analysis to support model calibration and for a complementary quantitative analysis of the collateral portfolio. An extension of the stress-testing scope is also envisaged, by establishing a simplified but fully-fledged framework that derives its scenarios from a macro-economic framework to assess the impact on the EIB portfolio.

In view of the audit findings, the Audit Committee recommended the Bank to either consider allocating more staff resources to the CRD implementation, in order to significantly improve the model, or use the foundation approach, namely making use, on the one hand, of the EIB's probabilities of default and, on the other hand, of the regulatory parameters for loss given default and exposures at default. It was also suggested that, in absence of resources, the advanced method is applied only to certain lines of business or sectors (see comments in section 2.2 above).

<u>Liquidity risk management.</u> Taking note of the BCL assessment (see section 2.2 above), the Audit Committee recommended that the Bank should undertake an impact assessment of the liquidity coverage ratio as presented in the Basel Committee document issued in December 2010. The Audit Committee would examine the calculations in order to decide whether the use of the LCR is appropriate or not at the EIB.

<u>EIB cartography of risk</u>. The Audit Committee identified, in its 2007 Annual Report, the need for a risk gap analysis, a recommendation which was reiterated to the Bank in 2009. The cartography has been established by the Bank, addressing - in a first stage - credit, operational and market risks (including liquidity risk). In a second phase strategic, reputation, compliance and legal risks should be integrated in the cartography, with a priority given in 2011 to the compliance risks.

The cartography itself pointed to certain gaps, which are to be addressed in the near future, such as the need to implement internal ratings for derivative and treasury counterparts or the input data quality problems identified upon analysis of the market risk.

The Audit Committee provided guidance for further development and fine tuning of operational risk, advising the Bank to use available information, including internal audit findings, and data from other banks, in addition to statistical elements. When completed, the cartography should be a forward looking document, with action to be taken for the identified gaps and with a clear timetable for implementation and the Committee expects the cartography to become a basis for strategic discussion in the Bank, on risk acceptance and choice of mitigants.

4. AUDITING ACTIVITIES

4.1 Review of Audit Work

In its work, the Audit Committee relies on the external and internal auditors, from which it receives assurance on the accuracy of financial reporting and confirmation of the effectiveness of the internal control mechanisms. In addition, the Audit Committee obtains a representation letter from the President, which is itself based on internal support letters from the Bank's services, confirming management's responsibility for establishing and maintaining an efficient internal control structure and its responsibility for the preparation and fair presentation of the financial statements.

4.1.1. External auditors

The day-to-day audit work is delegated to KPMG, the external audit firm designated by the Audit Committee and reporting directly to us.

In the context of the 2010 audit planning three priority audit areas were identified:

- lending, where an increase in the credit risk was noted (as confirmed also by the Risk Reports);

- treasury, including derivative instruments, where specialist input was to be used to verify the fair value calculations; and

- the controls surrounding the financial reporting process.

We held discussions with the auditors throughout the year, in order to keep ourselves permanently briefed on the audit progress and the audit and accounting issues. This resulted in a no surprise audit. We conducted a private interview with KPMG before giving our clearance on the various financial statements. We received assurances that the audit process went as planned, with full support from the Bank services. The Audit Committee was satisfied with the results of the external audit work, which enable it to formulate its own conclusions to the Board of Governors.

The Audit Committee is also responsible for ensuring the external auditors' independence. In 2010, KPMG was engaged to perform one activity outside the scope of the Framework agreement for audit services. The engagement authorised by the Audit Committee was in relation to a proactive investigation review. The Audit Committee reaffirms the Bank's policy adopted in 2002, which is to avoid the use of its auditors for consultancy services. The Bank should consider whether a more stringent policy, banning completely all non-audit services, ought to be adopted.

4.1.2. Internal Audit and Fraud Investigation

The internal oversight function at the Bank is headed by the Inspector General (IG) and comprises four lines of service: internal audit, fraud investigation, operations evaluations and complaints mechanism. Although there is no direct reporting line, the Audit Committee has a privileged relation with the Inspector General and the Head of Internal Audit who may request private sessions with the Committee and have unrestricted access to it. The Audit Committee meets regularly with IG and examines IA reports and ongoing cases with the Fraud Investigations Unit.

The Audit Committee paid particular attention to the audit of internal procurement, where IA made recommendations for enhanced segregation of duties and strengthening of controls. The Audit Committee is monitoring the implementation of audit recommendations, all of which have been accepted by the Bank.

The Audit Committee has received full support from IG/IA in relation to the verification of best banking practice implementation (see above). The expectation is that all audits of an area included in the Framework will look at the integration of best banking practice in the Bank activities.

Investigation activities have been strengthened during the past year, with staff resources being added to the function, with the first proactive investigation reviews completed with good results and with a new case management system being implemented. The fraud awareness training program is continuing, a direct consequence perhaps being an increased number of potential investigation leads received by IG. A revision of the anti-fraud policy is also due, as planned when the policy was introduced three years ago.

4.1.3. European Court of Auditors

The Audit Committee had its annual meeting with the European Court of Auditors, a useful occasion for exchanging information on the progress of various audits undertaken by the Court. The need for increased and timelier communication regarding the audits planned by the Court was emphasised, to allow the Audit Committee to provide its support more effectively. The discussions also covered other subjects of common interest, including the new supervisory arrangements for financial services at European level, governance implications of auditors' self-assessments and the audit and discharge procedures of the various third party mandates administered by the EIB.

It was recognised that, in the context of an increased volume of business for the EIB, the cooperation with the EC is also likely to increase, which necessarily implies more interaction with the Court of Auditors, under the auspices of the Tripartite Agreement.

4.2 The Financial Statements as at 31 December 2010

The Audit Committee has examined the three sets of accounts issued by the EIB[3] and those of the Investment Facility, the FEMIP Trust Fund, the EU-Africa Infrastructure Trust Fund and the NIF Trust Fund for 2010.

The Bank continues to publish two sets of consolidated financial statements, prepared under IFRS and EU Accounting Directives respectively, a situation which will be reviewed at the end of 2011. In the meantime the Bank should continue to monitor the IFRS developments, in particular the finalisation of IFRS 9, the standard replacing IAS 39 ("Financial Instruments: Recognition and Measurement") in order to assess if the current volatility in the IFRS accounts is likely to be reduced. For the time being, the new standard is not yet endorsed by the EU.

The key elements of the various financial statements are presented below.

4.2.1.EIB

Statutory financial statements (non-consolidated): The Audit Committee noted that the profit recorded for the financial year is EUR 2,117 million, increasing by 12.8% compared with 2009. The annual increase in the volume of loans to customers other than the credit institutions was 14%, from EUR 199 billion outstanding at the end of 2009 (EUR 174 billion at the end of 2008) to EUR 227 billion outstanding at the end of 2010, which is comparable with the previous year's increase. The balance of the loans and advances to credit institutions at the end of 2010 was EUR 156 billion, compared to EUR 136 billion at the end of 2009 (EUR 134 billion at the end of 2008), while the new balance sheet total is EUR 420 billion.

Consolidated financial statements prepared under the EU Accounting Directives. The Group result reported under the framework of the EU Accounting Directives is a profit of EUR 2,098 million, the difference of EUR 19 million compared with the statutory result being explained by the EIF result and consolidation adjustments (the difference at the end of 2009 was EUR 12 million). The balance sheet total is also very close to the value in the statutory accounts (EUR 420 billion rounded).

Consolidated financial statements prepared under IFRS. The total adjustment required to "translate" the consolidated financial statements prepared under the EU Accounting Directives into financial statements prepared under the IFRS accounting framework was EUR 547 million, bringing the consolidated result under IFRS for 2010 to EUR 2,645 million. This is in contrast with the situation at the end of 2009, when the IFRS adjustment had a negative impact of EUR 4.1 billion, reducing the

[3] EIB statutory financial statements (non-consolidated), EIB consolidated financial statements prepared in accordance with IFRS and EIB consolidated financial statements prepared in accordance with the EU Accounting Directives.

consolidated result under IFRS to a loss of EUR 2,280 million. In 2008, the IFRS adjustment had a positive impact of EURO 4.7 billion, increasing the consolidated result under IFRS to a profit of EUR 6,356 million. The volatility demonstrated by these results is mainly due to the effects of the application of the Fair Value Option (FVO), in accordance with IAS 39 “Financial Instruments: Recognition and Measurement”, to loans, borrowings and ALM swaps. Fair value accounting (or mark-to-market) refers to accounting of the value of an asset or liability based on the current market price of the asset or liability, or for similar assets and liabilities, or based on another objectively assessed "fair" value. Mark-to-market accounting can make values on the balance sheet change frequently, as market conditions change. However, since the policy of the Group is to hold all financial instruments involved until maturity, any positive or negative impact will be completely neutralised at the end of the life cycle of the respective instruments.

4.2.1.Trust Funds

The Audit Committee has asked the Bank to review the discharge procedures for the various Trust Funds under its management, with a view to eliminating inconsistencies in the approval process and thus a possible legal risk to the Bank. A first step is that the respective financial statements will not be published in the EIB Annual Report, thus achieving significant paper savings, but the main objective is to avoid confusion, as these are not part of the Bank or Group financial statements.

<u>FEMIP Trust Fund</u>. The statement of comprehensive income shows a total comprehensive loss of EUR 1.43 million (compared to a total comprehensive loss of EUR 2.25 million in 2009 and a loss of 0.6 million in 2008), which is mainly attributable to projects financed for an amount of EUR 1.41 million, while the interest and similar income generated roughly covered the costs and losses.

<u>EU-Africa Infrastructure Trust Fund.</u> The total comprehensive loss for 2010 is EUR 9.6 million, compared to a total comprehensive loss for 2009 of EUR 22.7 million, mainly explained by a comparable decrease in the cost of projects financed (from EUR 22.3 million in 2009 to EUR 8.4 million in 2010).

The <u>NIF Trust Fund</u> financed projects for a total value of EUR 1.34 million, incurring a total comprehensive loss of EUR 1.97 million for the year.

5. ISSUES OF FOCUS FOR THE AUDIT COMMITTEE LOOKING FORWARD

The Audit Committee will continue to monitor the implementation and verification of the Framework for EIB compliance with best banking practice as it believes that the Framework could play an important role in positioning the Bank for a supervisory perspective.

<u>Developments in the EIB mandate and structure</u>. The Audit Committee is following the discussions regarding the EIB mandate outside the EU and will analyse the risk impact of a potentially changing role for the Bank.

In terms of risk monitoring, we will continue to devote significant attention to:

- The stress tests performed by the Bank for various risk scenarios;
- The analysis of country risk exposures;
- The evolution and valuation of certain assets, in particular government bonds – or equivalent – held in securities portfolios or as collateral for loans.

Auditing will remain a key point of focus for the Audit Committee. In this area the Committee will monitor the interaction between internal and external auditors, with a view to providing audit synergies and leveraging the findings of each of the two audit functions. The Audit Committee will follow-up the external developments in the areas of audit and corporate governance in general.

6. CONCLUSIONS

Based on work undertaken and the information received (including an unqualified opinion from the external auditors on the financial statements and a representation letter from the Management of the Bank), the Audit Committee concludes that the financial statements drawn up by the Board of Directors give a true and fair view of the financial position of the Bank and of the results of its operations and cash-flows for 2010, in accordance with the applicable accounting framework.

The Audit Committee is able to extend the same conclusion to the financial statements of the FEMIP Trust Fund, the EU-Africa Infrastructure Trust Fund and the Neighbourhood Investment Facility 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 was able to carry out its work to fulfil its statutory mandate under normal, unrestricted conditions. The Audit Committee is satisfied that the audit assurance obtained during the meetings, corroborated by the review of the documentation presented, and its own analyses sustain its conclusions. On this basis, the Audit Committee issued its annual statements as of the date of signature of the audit report by the external auditors and of the adoption by the Board of Directors.

The Audit Committee had a balanced work approach during the year in terms of focus, objectives and means utilised to obtain the necessary assurance. The Committee believes that it has retained appropriate standing within the Bank, and that it has maintained appropriate relations with management and Bank staff, while remaining independent from the Bank at all times. In 2010 the Audit Committee received the expected support from the Bank's services, thus being able properly to discharge its responsibilities.

Date, 6 April 2011

G. SMYTH, Chairman **E. MATHAY, Member** **J. RODRIGUES DE JESUS, Member**

D. NOUY, Member **J. GALEA, Member** **M. ÜÜRIKE, Member**

European Investment Bank

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

INVESTMENT FACILITY

For the 2010 financial year

<u>AUDIT COMMITTEE</u>

ANNUAL REPORT TO THE BOARD OF GOVERNORS

ON THE INVESTMENT FACILITY

For the 2010 financial year

<u>Table of contents:</u>

1. INTRODUCTION - the 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 issues a statement each year confirming, to the best of its knowledge and belief that the financial statements prepared for the Investment Facility give a true and fair view of its financial position, the results of its operations and of its cash flows for the respective year, in accordance with the accounting framework applied by the Bank (see section 3 for more details).

The Audit Committee is established under the EIB Statute as a committee completely independent from the Board of Directors, with the Members and Observers being appointed directly by the Board of Governors. This report from the Audit Committee to the Board of Governors provides a summary of the Committee's work focused more specifically on the Investment Facility during the period since the last annual report date.

2. AUDIT COMMITTEE REVIEW

The assurance expressed by the Audit Committee is based essentially on the external audit performed by KPMG, but also 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. The Risk Report for the Investment Facility prepared by the Bank services was also shared with us. The Audit Committee obtains an understanding of the activities and risks associated with the various developments by reviewing regular management reports and by interacting regularly with the relevant Bank services involved in the IF activities.

2.1. Operational context

A certain slowdown in the IF activity has been noted, meaning that the volumes were slightly below the levels in previous years when a marked increase reflected the response to the financial crisis and requests by Member States for some frontloading.

Meetings with Management

The Audit Committee met on several occasions during the past year with the Management of the Investment Facility, who offered details about the recent developments and future orientations for the Investment Facility, and also on the Bank's activities in the ACP region in general, based on the Cotonou Risk Report and on the new rules for own resource lending in ACP countries approved by the Board (own resource lending is a way of leveraging the activities in the region covered by IF).

The Board approved a proposal to increase EIB's public sector lending limits under the EUR 2bn Cotonou II Agreement (which makes available EIB resources guaranteed by EU Member States) and requested that risk-assumption or sharing on eligible private sector lending be aligned with that under other mandates. As a result, the EIB will consider taking commercial risk on private sector operations in the ACP region in accordance with its standard risk policy guidelines.

Monitoring Aspects

Due diligence process and controls have been improved over the last few years in line with the Bank's overall greater focus on areas such as compliance and following experiences with difficult or sometimes fraudulent projects. For operations falling under the framework of the European Financing Partners Agency Agreement, and although it reserves the right to object, the Bank relies to a large extent on the due diligence process of its EFP partners (FMO, AFD/Proparco, DEG, etc.) under such (EFP) Facilities. This is a differentiating feature compared to the traditional monitoring of IF projects.

Financial Guidelines and Procedures

The Bank adopted in 2010 a first set of unified IF Financial Guidelines and Procedures, consolidating various existing financial rules and practices that evolved over time.

The objective of these Financial Guidelines and Procedures, which became necessary as the number and complexity of operations increased over the years, is to complement the range of existing guidelines applicable to the IF, such as operational guidelines, equity investment guidelines or credit risk policy guidelines.

2.2. Review of Audit Work

External auditors (KPMG)

The external auditors report to the Committee, which delegated to them the day-to-day work concerning the audit of the financial statements. In order to be able to rely on the work performed by the external auditors, the Audit Committee has properly monitored their activity, by requesting oral and written reports, by reviewing the external auditor's deliverables and making further inquiries and through a formal interview before the sign-off of the accounts.

We held discussions with the auditors throughout the year, in order to keep ourselves briefed on the audit progress and the audit and accounting issues. We conducted a private interview with KPMG before giving our clearance on the various financial statements. We received assurances that the audit process went as planned, with full support from the Bank services.

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

Inspector General

The internal oversight function at the Bank is headed by the Inspector General (IG) and comprises four lines of service: internal audit, fraud investigation, operations evaluations and complaints mechanism. Although there is no direct reporting line, the Audit Committee has a privileged relation with the Inspector General and the Head of Internal Audit who may request private sessions with the Committee and have unrestricted access to it. The Audit Committee meets regularly with IG and examines IA reports and ongoing cases with the Fraud Investigations Unit.

The Audit Committee is also informed about any alleged cases of wrongdoing and ongoing investigations relating to Bank projects, including Investment Facility operations. We also discuss with Internal Audit all the significant audit recommendations and agreed action plans, together with the unit responsible for implementation. No specific audits in relation to the Investment Facility have been performed by the EIB Internal Audit during the reporting period.

The Internal Control Framework (ICF) for IF has been reviewed by the Bank's services in 2010, with no modifications to the processes and risks / key controls. The ICFs are established, under the IA supervision, by the EIB functional units in order to record, classify and document the existing controls and examine whether these controls are sufficient for the proper operation of the business processes.

European Court of Auditors

The Audit Committee has not received from the European Court of Auditors any audit reports or audit notifications related to the Investment Facility in 2010.

3. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2010 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE

The Audit Committee examined the 2010 financial statements of the Investment Facility and has interviewed the external auditors, in the presence of the Bank's management and in private, in order to obtain an understanding of the audit procedures applied.

The Committee noted, in relation to the 2010 financial statements:

- Income statement: The Investment Facility recorded a profit of 35 million in 2010 compared to a loss of EUR 22 million in 2009. That is mainly due to the change in impairment on loans and receivables. The income from fee and commissions increased significantly (Note 6). The net result from financial operations (which was a positive EUR 9 million) turned into negative EUR 15 million in 2010. Lastly, the net interest and similar income increased from EUR 50 million in 2009 to EUR 54 million in 2010.
- Balance Sheet: The Balance Sheet total increased during 2010 from EUR 1,289 million to EUR 1,555 million.
- Credit risk: The Investment Facility had disbursed exposure totalling EUR 1,039 million at the end of 2010, increasing from EUR 858 million at the end of 2009.
- Impairment: Some impairment adjustments on loans recorded in previous years were reversed, reducing the balance of impairments from EUR 98 million at the end of 2009 to EUR 77 million at the end of 2010.

Basis of accounting: In accordance with the "Investment Facility Management Agreement, the Bank prepares financial statements guided by International Public Sector Accounting Standards or International Accounting Standards as appropriate (Article 7, paragraph 3 of the IF Management Agreement). The accounting framework used follow the International Financial Reporting Standards (IFRS) except for the disclosure requirements for financial instruments imposed by IFRS 7.

4. CONCLUSION

In meeting its responsibilities in 2010 the aim of the Audit Committee was to achieve a balanced approach in terms of focus, issues handled and means utilised to obtain the necessary assurance. 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. We have received full cooperation from the Investment Facility during the reporting period.

Based on the work undertaken and the information we have received (including the opinion from the external auditor on the financial statements and a representation letter from the Management of the Bank), we conclude that the 2010 financial statements of the Investment Facility have been drawn up correctly and that they give a true and fair view of the 2010 results and financial status according to the accounting principles applicable to the Investment Facility. On this basis, we signed our annual statement as of 10 March 2011, the date on which the EIB Board of Directors has approved the submission of the IF financial statements to the Board of Governors.

Date, 6 April 2011

G. SMYTH, Chairman **E. MATHAY, Member** **J. RODRIGUES DE JESUS, Member**

D. NOUY, Member **J. GALEA, Member** **M. ÜÜRIKE, Member**

European Investment Bank

Response of the Management Committee

To the Annual Reports of the Audit Committee

For the Year 2010

RESPONSE OF THE MANAGEMENT COMMITTEE

TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE

FOR THE YEAR 2010

Table of Contents

1 CORPORATE GOVERNANCE AND INTERNAL CONTROL

The Board of Directors has the overall responsibility for maintaining a sound system of internal control that supports the achievement of Bank's policies, aims and objectives while safeguarding the funds and assets of the Bank in accordance with the responsibilities assigned to the Board of Directors within the Statute of the European Investment Bank. For the purposes of this report, the European Investment Bank and Investment Facility are collectively referred to as the "Bank" and the "Bank" with the European Investment Fund (EIF) are collectively referred to as the "EIB Group".

The Management Committee, under the supervision of the Board of Directors, has the day-to-day responsibility for the system of internal control which is based on an ongoing process designed to identify the principal risks to the achievement of policies, aims and objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively, and economically. In this regard, the Management Committee continues to seek measures to enhance the risk management, audit and other internal control structures of the Bank.

The Management Committee and Bank services meet with the Audit Committee during the year and the Bank endeavours to respond promptly to requests of the Audit Committee. The Bank services have maintained a collaborative approach in supporting the work of the Audit Committee and continue to foster mutually constructive, yet appropriately independent, relationships between the Management Committee, Audit Committee, the internal auditors and external auditors. The Bank commits to maintain this collaborative approach to enable the Audit Committee to execute its responsibilities in line with its statutory provision and respecting the areas of focus identified by the Audit Committee.

In addition to an annual external audit of the financial statements under the discharge rules of the Statute, a number of the Bank's activities under partnership agreements are also subject to separate external audit scrutiny. Furthermore, various audit procedures are required in connection with certain bond issues. As both a Community body and a financial institution, the Bank also cooperates with other independent control bodies such as the European Court of Auditors, European Anti-Fraud Office (OLAF) and the European Ombudsman. As such, the Bank is subject to significant independent review throughout the year, as well as at the year end.

The Bank has a balanced approach to 'risk taking' and adopts an active approach to the mitigation of risk. The Management Committee remains satisfied that the major risks to which the Bank is exposed, as identified through the risk management and internal control framework, have been reviewed and systems, policies and/or procedures have been established to manage those risks. Overall internal controls and procedures are effectively designed and operated to provide reasonable assurance on the integrity, legality and timeliness of the underlying transactions and processes of the annual financial statements. To further enhance the Bank's approach to risk management, in 2011, the Bank will work closely with the newly established Board of Directors committee on credit risk policy.

2 BEST BANKING PRACTICE

The Bank continues to submit itself voluntarily to the applicable requirements of core EU legislation and relevant standards applicable to the banking sector. The Bank is also committed, through its statute, to the implementation of relevant accepted best banking practices as defined within a framework established by the Audit Committee in consultation with the Bank's services. These best practices are complementary to the legislation and rules that are directly applicable to the Bank.

The Bank continually seeks full compliance with current relevant best banking practices, as defined within the framework, and areas for further compliance have been identified and actions, reviews or investigations are underway to address them. The Bank recognises that evolution in banking activities will require continuous review of the best banking practices and commits to the revision, if necessary, of the Bank's associated compliance measures.

2.1 Capital Requirement Directive

Supported by an increase in resources, the Bank is confident that the gaps noted by the Audit Committee will be totally closed by the end 2012, in accordance to its internal compliance work plan. Specifically key decisions approved in late 2010, such as the reorganisation and enlargement of the Transaction Management and Restructuring directorate, will reinforce

monitoring and rating coverage. In compliance with Basel II rating coverage requirements, the Bank is in the process of ensuring an annual re-rating of all exposures on which calculation of capital requirements are made based on internally estimated risk parameters.
The compliance work plan also includes an update of the default definition, the introduction of additional quantitative and qualitative internal model validation methods and further development and integration of the stress testing framework.

2.2 Human Resources

The Bank maintains a robust network of controls, processes, reviews and principles that ensure the management of staff remuneration is in line with good practice. Furthermore, the Board of Directors retains a dedicated sub-committee for remuneration and pension. The variable component of staff compensation packages is not available to members of the Management Committee. The definition and distribution of this variable component has been reviewed and approved by the Board of Directors in December 2010; the new rules will apply to variable component related to the year 2011. This review incorporates all appropriate factors and recommendations, in line with the underlying Bank principles of prudent risk taking, including a balanced, fair and appropriate remuneration of middle-office, back-office and support functions.

The Bank has established controls to govern mandatory minimum holiday for all staff. Implementation and compliance will be closely monitored by the Bank in due course.

2.3 Business Continuity

The EIB believes its commitment to clients, staff, markets and other stakeholders is important and thus continually seeks to proactively recognise and respond to business disruption. Although it is not possible to guarantee that people and systems will always be available in the event of a disaster or significant business disruption, the Bank trusts that its planning is consistent with industry best practices. The Business Continuity lifecycle incorporates regular updates of the Business Continuity Policy, Business Impact Analyses, Business Continuity Strategy and other related documents. The Business Continuity Steering Committee, responsible for overall governance and responsibility in this area, now committed to a formal meeting once per year. The Steering Committee has confirmed that the participation to Business Continuity awareness sessions shall be mandatory for key staff listed in the Business Continuity Plans and that Continuity Plans will be established for External Offices in response to recent activity experienced by the Bank in politically unstable regions.

2.4 Anti-Money Laundering and combating the Financing of Terrorism

As with all forms of fraud and corruption, the Bank maintains a zero tolerance policy towards money laundering and the financing of terrorism. Improvements will continue to be made to the Bank's operations and controls.

3 RISK MANAGEMENT

As a matter of priority, the Bank continues to review and improve its risk management methodology. The Bank maintains a robust framework for the continuous assessment of credit risk, through close monitoring of key indicators including Basel II capital adequacy ratios, asset quality distribution for existing portfolio and new business, evolution of Watch List, risk concentration measures and ratings migration for the universe of target clients. In line with the new Statute, the Bank revised the reserves framework and introduced a General Loan Reserve and a Special Activities Reserve to replace the notional Fund for General Banking Risk. The Bank shall continue to follow the analysis of sovereign exposures, including European sovereign exposures, and to manage operational activity accordingly.

3.1 Specific Risk Management Activities

Stress Testing
The EIB undertakes regular credit risk parameters sensitivity and liquidity stress tests as part of its governance and control framework. Furthermore, following the EU-wide stress testing exercise, the EIB performed a shadow calculation based on comparable assumptions. The stress testing results indicated that the EIB would remain sufficiently capitalised under the assumed adverse macro-economic conditions. A similar exercise will be performed again in

2011, when the updated guidelines become available, and within this process of alignment with Best Banking Practice the Bank will continue the development and integration of the stress testing framework for credit, financial and operational risks.

Foreign exchange risk

The foreign exchange risk position of the Bank has been subject of comprehensive analyses. One analysis gauged the potential impact on the Bank's main risk indicators, such as the gearing ratio, capital adequacy ratio and general reserve, under a significant variation in exchange rate of the euro to the two largest EIB traded currencies namely the US dollar and sterling. The second analysis explored the effectiveness of hedging future margins in both US dollars and sterling over the three-year operational planning horizon. The results of the analytical work supported the conclusion that the potential impact on the Bank's main risk indicators is relatively limited and hedging of future margins in US dollars and sterling reduces the sensitivity of the Bank's revenues to changes in foreign exchanges making the revenue outlook more predictable over the operational planning horizon.

Internal Rating Models

Following the recommendation of internal audit an Internal Rating Models Maintenance Committee was established and now operational. The Committee comprises a cross-section of representatives of the relevant departments within the Bank and is chaired by the Risk Management Director General. Key activity to be undertaken under the auspices of the Committee include addressing gaps identified in the implementation of the Capital Requirements Directive.

Liquidity risk

In December 2010, the Basel Committee on Banking Supervision issued a further document on liquidity risk that modifies and refines the definition of the Liquidity Coverage Ratio. These modifications and refinements shall require some interpretation and adaptation for their application to the specific business model and characteristics of the EIB. The Bank has commenced the component analysis of the revised ratio and discussions are ongoing with the European Commission as to the acceptability of such adaptations. The Bank has also engaged with the Banque Centrale de Luxembourg to receive their clear interpretation of the ratio components and its consequent calculation. Despite doubts concerning the applicability of the ratio to the EIB, the Bank intends to monitor the ratio during an observation period and to put in place the necessary systems and resources to ensure that it is in a position to adopt the use of the ratio, if deemed feasible and appropriate, in a short period of time.

In line with the observations of the Banque Centrale de Luxembourg during their EIB liquidity assessment, the Bank has recently introduced a short-term liquidity ratio that monitors the liquidity of the Bank over a three-month perspective horizon.

Cartography of Risk

A cartography of risk report is a recently introduced requirement for banks operating in certain countries, e.g. in France, and the EIB produced its first report in January 2011. The cartography process at the Bank aims to:

- identify key risks, classified and mapped to relevant processes, faced by the Bank
- analyse and assess these risks
- examine residual exposures against the risk policies of the Bank.
- identify appropriate mitigating actions to be undertaken

The EIB cartography of risk report incorporated responses to observations made by the Audit Committee and will be produced annually in line with best practice. The scope of 2011 cartography of risk report will be broadened beyond credit, market and operational risks for example to include compliance risk. The report will be distributed to the Board of Directors to be used as a component of corporate governance and strategic discussion.

4 SPECIFIC AUDIT RELATED ACTIVITIES

4.1 Trust Fund Discharge Procedures

On an annual basis, the Bank is required to undertake certain financial reporting responsibilities for several mandated operations such as Joint Actions, Trust Funds and facilities. These socalled “discharge procedures” can be full or partial in nature. All discharges require an independent audit and varying levels of disclosure although full discharge procedures also require presentation and approval by the Bank’s governing bodies. The Bank will explore options to simplify discharge procedures both for any new mandated operations and for existing ones. A retroactive review and application may be made to existing mandates that carry full discharge procedures but only on a case by case basis due to existing contractual obligations.

5 THE INVESTMENT FACILITY

The Bank is entrusted with the management of the Investment Facility (IF), financed by the EU Member States’ budgets. Resources from the IF, alongside the Bank’s own resources (OR), are utilised in the finance of operations in the African Caribbean and Pacific Countries (ACPs) and in the Overseas Countries and Territories (OCTs). The operations flowing from the IF and the Bank’s own resources are complementary in nature. IF operations typically focus on the riskier market segment of private sector projects that would normally not meet the prudential requirements set under the financing of OR supported operations.

5.1 Common platform for Management and Internal Controls

The key transactions and internal activities related to the management of the IF are handled by the same processes, procedures and infrastructure of the Bank. Hence key management and internal controls, particularly in regard to risk management, internal audit, human resources, treasury and financial reporting are the same as those applied to the operations of the EIB. External mandates, including those of the IF, are subject to external audit.