



Letter by the Managing Director on the Annual Report of the Board of Auditors

Dear Chairperson of the Board of Auditors,

I would like to thank you for the Board of Auditors' Annual Report to the Board of Governors ("the Report") for the period ended 31 December 2013.

In 2013 the ESM management continued its intensive relationship with you, the Board of Auditors. Following the resignation of Mr Harald Noack, we welcomed the appointment of Mr Igor Ludboržs as a new member of the Board of Auditors nominated by the European Court of Auditors, and the election of Ms Katarína Kaszasová as Chairperson. A number of key staff members, including the ESM management, devoted a considerable amount of time to discuss with you relevant issues and developments, to submit written notes in response to your questions, and to provide cooperation and assistance during two Board of Auditors' audits. We have also provided administrative support for 11 meetings of the Board of Auditors in 2013 and four meetings in 2014 to date.

Since your first Annual Report to the Board of Governors in May 2013, the ESM has advanced further the development of its organisational policies and procedures and has achieved a marked improvement in its internal control and accounting environment. This substantial progress is acknowledged also in the Management Letter for the year ended 31 December 2013 by the independent external auditor PricewaterhouseCoopers, Luxembourg (PwC), who issued an unqualified auditor's report in respect to the ESM Financial Statements as of 31 December 2013.

In 2014 we will continue the efforts to build our risk management and control framework with

the aim of meeting the best practice established by the international financial institutions, while taking into account also the unique mandate of the ESM as the permanent crisis resolution mechanism for the countries of the euro area. During this period of maturing, the recommendations noted in your Report are particularly useful as they provide us with valuable guidance and help us set the priorities in the process.

I now turn to the detailed recommendations noted in the Report, on which the ESM management would like to provide the following comments:

Follow Up of 2012 Board of Auditors Annual Report to the Board of Governors

• EU regulatory framework

It is noted that the Board of Auditors reiterated "its strong recommendation that the ESM adopts the EU regulatory framework as its own". The ESM management will seek further clarification from the Board of Auditors regarding the meaning of the term "EU regulatory framework" as it is rather broad and does not reconcile directly with the ESM's status as an intergovernmental international financial institution which is not part of the EU Treaties.

The ESM regulatory frame of reference is the Treaty Establishing the European Stability Mechanism ratified by the 18 euro area Member States, and the By-Laws adopted by the Board of Governors. The ESM is currently in the process of finalising its internal policies and procedures with the aim of developing an internally-cohesive framework aligned with the ESM Treaty and By-Laws.

- **"Three lines of defence" concept**

The re-organisation of the ESM Risk department in April 2014 completed the design of the ESM three lines of defence governance model and achieved a clear separation between the first and second lines of defence. The re-organisation was endorsed by the Board Risk Committee and implemented the Board of Auditors' recommendation noted in your Risk Management Audit Report dated 7 April 2014.

The embedded Operational Risk and Counterparty Risk functions were centralised in the Risk department and the first line of defence roles for the Asset and Liability Management (ALM) and Middle Office teams were further defined. The Head of Risk covers all risks faced by the organisation and hence operates as a Chief Risk Officer.

The staffing of the second line of defence will be completed during the upcoming months with the recruitment of several additional risk officers who will support the established senior risk management team.

- **"Fit for purpose" assessment of the accounting framework**

In May 2014 the ESM management completed the first periodic "fit for purpose" analysis of the adopted ESM accounting framework, as recommended by the Board of Auditors. The assessment was performed using internal resources as well as accounting expertise of Deloitte, Luxembourg. We concluded that the approved ESM accounting framework (EU Accounting Directive with the Banking Directive) fits the specific purpose of the ESM, its political mandate and long term financial assistance strategy, while providing all the relevant information to the addressees of the Financial Statements. The above assessment was presented to the Board of Auditors on 13 May 2014.

- **ESM Procurement Policy**

As discussed last year, the EU Directive on Public Procurement specifically sets forth that it is not applicable to international organisations or international financing institutions, where the public contracts concerned are fully financed by that organisation or institution.

Therefore the ESM designed a procurement framework that fits its legal status as international organisation. In the implementation of the ESM Procurement Policy, we aimed to meet the best practice of corporate procurement in the international financial

institutions. As part of this effort, the ESM is a member of the Network on Procurement in International Organizations (NPIO) and the organisation of EU Agency and Institution Procurement Officers and Assistants.

One of the practical implications of the ESM's role as a crisis resolution mechanism is the requirement for the ESM to operate efficiently and effectively, including in the area of corporate procurement. The timely procurement of services, supplies and works required for the ESM operations is not consistent with the lengthy procurement procedures pursuant to the EU Directive. The ESM Procurement Policy observes the fundamental principles of the EU Directive for fair treatment, transparency, mutual recognition and proportionality, while reflecting also the specific context of the ESM.

Findings

- **Board of Auditors' Report on the 2013 Financial Statements**

The ESM management recognises the importance of effective internal controls which provide the foundation for the safe and sound operation of the organisation. Significant improvements were achieved in 2013. In 2014 and in future years, the ESM will continue to mature its entity-level and process-level controls. During the extensive tests of controls performed by the independent external auditor as part of the 2013 statutory audit, there were no exceptions to note. The PwC Management Letter for the year ended 31 December 2013 also does not contain any new findings/recommendations and all three issues noted in 2012 are now considered partially closed.

In this context, we do not share the Board of Auditors' assessment that the organisation "continues to face challenges in reaching standard practice".

- **External audit – procurement process for the external auditor**

In 2013 the ESM management performed a detailed assessment of the performance of the external auditor following the 2012 statutory audit. Based on the satisfactory outcome of the assessment and after taking into account the considerable time and resources required for a new procurement process and the subsequent transition to a new external auditor, the ESM recommended to the Board of Governors that the PwC engagement should be automatically renewed for the 2013 statutory audit.

In response to the Board of Auditors' request, the PwC audit team for the 2013 statutory audit was reinforced with leading specialists from the PwC practices in Germany, UK and Luxembourg.

Over the next couple of months, the ESM will perform a procurement process for the selection of an external auditor for the 2014 statutory audit and will submit to the Board of Governors a proposal for appointment of the auditor. The ESM will invite the Board of Auditors as observer in order to ensure full transparency and quality of the process.

- **External audit – Board of Auditors' access to audit documentation**

Despite the legal complications related to granting access to the Board of Auditors to the working papers of the external auditor, PwC reported to the Board of Auditors in detail on its audit plan, audit procedures and the results of its work. We understand that during the meeting at the PwC premises on 1 April 2014, PwC addressed all questions raised by the Board of Auditors and provided the requested electronic files with audit evidence.

The ESM management will specifically reflect the Board of Auditors' requirement for access to the working papers of the external auditor in the upcoming procurement process and as an element of the engagement for the 2014 statutory audit and onwards.

However, we would like to alert the Board of Auditors that this requirement is not a standard industry practice and may potentially impede the appointment of an external auditor of good international repute.

- **External audit – Board of Auditors' recommendation for long form report**

Regarding the Board of Auditors' recommendation for the external auditor to issue a long form report, we recall that this topic was discussed during the joint Board of Directors and Board of Auditors meeting in Rome on 13 June 2013. The Board of Directors supported the view that a long form report would not be suitable for the ESM as an international financial institution. Furthermore, such long form report and related additional audit procedures may not be within the scope of the external auditor's mandate pursuant to the ESM By-Laws.

Long form reports are generally required by national bank supervisors for banking institutions. In 2013 the external auditor complemented the ESM's statutory audit report with an additional "special topic report" on an

area relevant to the financial reporting process as noted in the PwC Management Letter.

- **Audit access to services provided by third parties**

We take note of the Board of Auditors recommendation to ensure unlimited audit access regarding services provided by third parties. The ESM has developed a standard "right to audit" legal clause and has been successful in gradually introducing the clause in contracts with key suppliers. Our ability to impose this clause on independent counterparties, however, may not always be successful despite the ESM's efforts in this regard.

For example, the ESM was not in a position to influence the decision of the European Investment Bank (EIB) to decline the ESM's "right to audit clause". We believe that this decision was dictated by the status of the institution and its relevant protection and immunity. Nevertheless, in practical terms the work of EIB Third Party Accounting Services which provide outsourced accounting services to the ESM is reviewed by the ESM external auditor as part of the annual statutory audits.

- **Staffing of the internal audit function**

The internal audit function of the ESM was in place since the inauguration of the organisation on 8 October 2012. Following the departure of the initial internal auditor in February 2013, we have swiftly arranged for Ernst & Young, Luxembourg, to provide interim internal audit services until the new internal auditor joined the organisation at the beginning of July 2013.

In 2013, the ESM internal auditor had the mandate and budget to engage external parties to support the audit work. As of the beginning of June 2014, the internal audit function is staffed with two experienced auditors who continue to have the option and allocated resources to use external experts in order to complete the annual internal audit plan agreed with the Board of Auditors. This combined sourcing model allows for increasing the resources and using the necessary technical skills for specialised audits, if needed. One of the practical implications of the ESM's role as a crisis resolution mechanism is the requirement for the ESM to operate efficiently and effectively, including in the area of corporate procurement. The timely procurement of services, supplies and works required for the ESM operations is not consistent with the lengthy procurement procedures pursuant to the EU Directive. The ESM Procurement Policy

observes the fundamental principles of the EU Directive for fair treatment, transparency, mutual recognition and proportionality, while reflecting also the specific context of the ESM.

- **Risk Management audit – reorganisation of the risk function**

As noted above, the proposed reorganisation of the ESM risk function was endorsed by the Board Risk Committee in April 2014. All embedded risk functions were centralised in the Risk department, first and second line of defence teams were clearly delineated, and a revised organisational chart of the risk function has been submitted to the Board of Auditors.

- **ESM Transitional Investment Portfolio**

The Transitional Investment Portfolio ("TIP"), together with the investment guidelines applicable to it, was approved by the Board of Directors on 29 November 2012 and complies with the requirements on prudent investment put forward in Article 22 of the ESM Treaty. The TIP was described in detail in the ESM Diversified Funding Strategy dated November 2012. Details of the TIP holdings and their accounting treatment appear also in the 2013 Financial Statements.

The TIP was designed to address the transitional aspects related to the emergence of the ESM as a new issuer in financial markets and the continued activity of the EFSF. The TIP is a one-off initiative related to establishing the ESM as a new issuing entity and will be closed in December 2014.

- **Recommendation for specific policy on reputational risk**

The ESM Communication's team undertakes a number of activities to monitor and mitigate the ESM's reputational risk, including permanent media monitoring, regular contacts and face-to-face meetings with journalists covering the ESM and related issues in a European and international context. The Chief Spokesperson regularly attends all Internal Risk Committee meetings and when necessary, there is an escalation of reputational risk issues to the Board Risk Committee.

In 2014 we will implement the Board of Auditors' recommendation to align the reporting and follow-up on reputational risk incidents with the already established process for reporting of internal operational risk events. Furthermore, draft amendments to the High Level Principles for Risk Management have been prepared to include a definition of reputational risk and will be submitted to the Board of Directors for approval later in 2014.

- **Risk management vacancies, risk management elements and policies under development**

We consider the items noted by the Board of Auditors to reflect a natural further development of the ESM risk management framework as would be expected in any organisation. Strict prioritisation has focused attention to date on the key risks. The list of developments in progress shows that we continue to improve. We expect that the available risk management vacancies will be filled before the end of 2014.

- **Standard "right to audit" clause**

As noted above, the ESM will strive to include its standard "right to audit" clause as a prerequisite for all future outsourcing arrangements. However, we recognise that we may not be able to obtain agreement from other international financial institutions, such as the EIB, which provide services to us.

I hope that the above comments are helpful as they provide the ESM management's perspective to the issues raised, illustrate the progress the ESM has made on many of the Board of Auditors' recommendations, and confirm our strong commitment to continue the maturing of the ESM. I would like to thank you again for your valuable recommendations and I am looking forward to continuing our good working relationship in 2014 and beyond.

Klaus Regling
Managing Director
European Stability Mechanism