

European Stability Mechanism



ESM management comments on the Board of Auditors' Annual Report to the Board of Governors

for the period ended 31 December 2018

Dear Chairperson,

I would like to thank you for the Board of Auditors' Annual Report to the Board of Governors for the period ended on 31 December 2018. The ESM management highly appreciates the independent oversight provided by the Board of Auditors and

welcomes the report and its recommendations and conclusions.

I would like to use this opportunity to provide management comments as well as an overview of the audit oversight the ESM was subject to in 2018.

Overview of the dialogue with the Board of Auditors

During the past year, the ESM management met on a regular basis with the Board of Auditors, which held 10 meetings at the ESM. Additionally, the Chairperson of the Board of Auditors met with the Board of Directors on 8 June 2018. The Board of Auditors also maintained an exchange with the Board Risk Committee and was kept informed about its activities. The Chairperson of the Board of Auditors also met with the Chairperson of the Board of Governors and attended the annual meeting of the Board of Governors on 21 June 2018.

During these meetings, the Board of Auditors was regularly updated on ESM activities, the decisions of the ESM governing bodies, and any other relevant issues and developments. Key members of ESM staff and management devoted considerable time and effort to discussing relevant topics, submitting presentations, and providing any other cooperation and assistance needed for the successful discharge of the mandate of the Board of Auditors. Furthermore, dedicated introductory sessions were organised for the new Board of Auditors' members appointed by the Board of Governors for non-renewable terms of three years: Irena Petruškevičienė, appointed upon proposal of the Chairperson of the Board of Governors as of 8 October 2018; Noel Camilleri, appointed upon nomination by the Supreme Audit Institution of Malta as of 8 October 2018; and, most recently, Tommaso Fabi, appointed upon proposal of the Chairperson of the Board of Governors as of 1 April 2019.

The Board of Auditors also met regularly with the internal audit function in closed sessions and monitored and reviewed the work and independence of the external auditor.

As part of its mandate, the Board of Auditors also reviewed the ESM financial statements as at 31 December 2018 (the "financial statements") as well as the working papers of the external auditor related to the statutory audit of the financial statements. Subsequently, the Board of Auditors issued a report in respect of the financial statements, which will be included in the *ESM 2018 Annual Report* along with the financial statements and the external auditor's report in respect of these financial statements.

Independent audits conducted by the Board of Auditors

In addition to the annual statutory audit by the external auditor and the internal audits performed by the internal audit function, in 2018 the Board of Auditors carried out two audits of the ESM in accordance with Article 30 (3) of the ESM Treaty. The Board of Auditors conducted these audits with the assistance of subject matter experts designated in line with Article 24 (5) of the ESM By-Laws.

As such, an audit of the external consultancy services used by the ESM was completed in April 2018 with the assistance of two subject matter experts from the French Supreme Audit Institution. Secondly, the

Board of Auditors carried out an audit of the ESM internal control framework with the assistance of six subject matter experts from the European Court of Auditors. It was finalised in July 2018.

The ESM management has already initiated actions to address the recommendations from the Board of Auditors' 2018 audit of external consultancy services. Specifically, by the end of 2019 the ESM plans to complete the enhancement of the documentation linked to the sourcing and monitoring of external consultancy services and establish reports providing further detail and classification of external consultancy expenditures.

Furthermore, in line with the Board of Auditors' recommendations on the ESM internal control framework, we will review the organisational aspects of the framework in the context of the three lines of defence governance model, which was established by the Board of Directors in the High Level Principles for Risk Management of the ESM. A review in this regard will be conducted by the internal audit function during the course of this year. We will also benchmark the ESM's approach to internal controls, based on the Basel Committee's Framework for Internal Control Systems in Banking Organisations, against other international best practice standards. In parallel, we will continue documenting and reviewing operating processes and procedures as well as the related internal controls across all areas of the organisation.

Audit procedures conducted by the internal audit function

During the past year, the internal audit function performed seven audits and one consulting activity and reported that the 2018 audit plan was achieved. The audit plan prioritised the main risks faced by the institution while providing coverage of all areas of activity over time.

For each audit performed, the internal audit function also tested the design and operating effectiveness of the internal controls for the activities in scope. In addition, the internal audit function also performed its annual review of the ESM entity-level controls.

As in prior years, ESM management will continue its sustained efforts to ensure the timely closure of

internal audit recommendations, particularly those relating to high risk matters.

The internal audit function had full, unrestricted and confidential access to the Board of Auditors and confirmed that there were no impairments to the function's independence and objectivity throughout the year. The internal audit function reported to the Board of Auditors on the results of the internal audits, the progress in implementing the 2018 Audit Plan, and, on a quarterly basis, the implementation status of the recommendations issued by the internal audit function and the Board of Auditors.

Audit procedures conducted by the independent external auditor

On 15 June 2017, the Board of Governors appointed Ernst & Young Société anonyme, Luxembourg ("Ernst & Young") as an independent external auditor of the ESM for a term of three years, renewable once for an additional three years.

During 2018, Ernst & Young carried out the annual statutory audit and issued an audit report confirming that the financial statements gave a true and fair view of the financial position of the ESM as of 31 December 2018 and of the results of its operations and its cash flows. This audit opinion is also consistent with the additional report issued by the external auditor to the Board of Auditors. Furthermore, Ernst & Young confirmed that no matters came to its attention that would require comment in a Management Letter and therefore no such letter would be issued in 2018.

The statutory audit was conducted in accordance with the requirements of Regulation No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities, the Luxembourg Law of 23 July 2016 concerning the audit profession, and the International Standards on Auditing as adopted for Luxembourg by the Commission de Surveillance du Secteur Financier. As part of the annual statutory audit, Ernst & Young also reviewed the internal control procedures in place to ensure the accuracy and reliability of the ESM accounting records and the safekeeping of assets.

In addition to the statutory audit of the financial statements, the ESM accounts were also subject to limited review procedures required for the issuance of comfort letters by the external auditor in connection with the issuance of US-dollar denominated bonds.

The Board of Auditors met with Ernst & Young representatives on three occasions in 2018. During these meetings, the Board of Auditors extensively discussed with Ernst & Young the ongoing audit processes and their results. Furthermore, the Board of Auditors reviewed the audit working papers of the external auditor related to the statutory audit of the financial statements with the assistance of a subject matter expert from the European Court of Auditors.

On 26 March 2019, the external auditor presented to the Board of Directors the external auditors' report in respect of the financial statements. The external auditors' report will also be presented to the Board of Governors at its annual meeting on 13 June 2019.

Ernst & Young confirmed, to both the Board of Auditors and the ESM management, compliance with the relevant ethical requirements regarding its independence. Ernst & Young also confirmed that unlimited access to documents and staff had been granted and noted good cooperation by the ESM management.

The extensive audit oversight of the ESM is complemented by a comprehensive system of

internal controls, which are embedded in the daily operations of the ESM. Such internal controls comprise entity-level, process-level, and information technology controls, consistent with the nature, complexity and risks inherent in ESM activities.

Internal controls are subject to scrutiny by management and periodic independent review by the internal audit function, the external auditor, and the Board of Auditors. In addition, the Board of Directors, directly and through the Board Risk Committee, holds periodic discussions with the ESM management on the status of the ESM internal controls.

In closing

ESM management is highly appreciative of the constructive feedback, reports, and recommendations that the Board of Auditors has provided in 2018 and in previous years. We will continue to support the mutually constructive, yet appropriately independent, relationship between the ESM and the Board of Auditors.

I look forward to continuing our good working relationship in the future.

Klaus Regling
Managing Director