

Board of Auditors’ Annual Report to the Board of Governors

for the period ended 31 December 2018

Board of Auditors

European Stability Mechanism

1. Introduction

The Board of Auditors of the European Stability Mechanism (the “ESM”) is established pursuant to Article 30 of the Treaty establishing the ESM (the “Treaty”) and Article 24 of the ESM By-Laws (the “By-Laws”). The members of the Board of Auditors are appointed by the Board of Governors, on the basis of Article 30 (1) of the Treaty and Article 24 (1) of the By-Laws.

The Board of Auditors is an independent body. It inspects the ESM accounts and verifies that the operational accounts and the balance sheet are in order. Furthermore, it carries out independent audits in relation to the regularity, compliance, performance, and risk management of the ESM and

monitors as well as reviews the ESM’s internal and external audit processes and their results.

This report is addressed to the Board of Governors in accordance with Article 30 (4) of the Treaty and Article 24 (6) of the By-Laws and provides details on the audit work of the Board of Auditors, its audit findings in relation to the financial statements of the ESM and its conclusions and recommendations for the period from 1 January to 31 December 2018. This report will be made available also to the national parliaments and supreme audit institutions of the ESM Members, the European Court of Auditors, and the European Parliament.

2. Activities of the Board of Auditors

2.1. Meetings of the Board of Auditors

The Board of Auditors met on 10 occasions in 2018, during which it held regular discussions with the ESM management in relation to institutional developments and oversight issues.

During these meetings the Board of Auditors was provided with regular updates on the activities of the ESM and the ESM governing bodies, received presentations by the ESM management on specific topics requested by the Board of Auditors and met regularly with the internal and external auditors. It also held its own discussions in connection with the Board of Auditors’ core mandate to:

- review the integrity and adequacy of the financial statements and the related control framework,

- perform selective efficiency and effectiveness audits in relation to the regularity, compliance, performance, and risk management of the ESM in accordance with international auditing standards, and;

- monitor and review the ESM’s internal and external audit processes and their results.

Additionally, the Chairperson and Vice-Chairperson of the Board of Auditors met with the Board of Directors on 8 June 2018. Subsequently, the Chairperson of the Board of Auditors attended the annual meeting of the Board of Governors and met with the Chairperson of the Board of Governors to give briefings on the work and conclusions of the Board of Auditors.

From 31 December 2018 to the date of this report, the Board of Auditors continued its work as set out above, and held a further four meetings.

2.2. Scope of Activities

In line with its mandate, the Board of Auditors:

- reviewed the ESM Financial Statements for the period ended 31 December 2018 as drawn up by the Board of Directors on 26 March 2019. The ESM Financial Statements were prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003, and by Directive 2006/46/EC of 14 June 2006.
- noted that in accordance with the aforementioned financial statements, the net profit for the financial year amounts to €284.8 million. The balance sheet totals as at 31 December 2018 amount to €807.1 billion and consist on the asset side mainly of loans and advances to euro area member states (€89.9 billion), debt securities (€25.6 billion), subscribed capital called but not paid (€65.4 million) and subscribed capital ("authorized capital" according to Article 8 of the Treaty) not yet called and unpaid (€624.3 billion). The total shareholders' equity amounts to €707.3 billion. The total liabilities (€99.8 billion) are composed mainly of debts evidenced by certificates (€98.4 billion). The net profit for the financial year amounts to €284.8 million, mainly the result of interest receivable and similar income (€1.6 billion), and net profit on financial operations (€44.3 million), offset by interest payable and similar charges (€1.6 billion) and general administrative costs (€66.2 million).
- The notes to the financial statements indicate that in 2018 the ESM received from the Federal Republic of Germany and the French Republic €128.9 million and €86.7 million respectively, to compensate the ESM for a part of the negative interest charged on the cash held at their national central banks during 2017. With regard to events after the reporting period, the ESM received on 2 January 2019 and on 4 February 2019, €100 million from the French Republic and €135.4 million from the Federal Republic of Germany, following a political commitment to compensate the ESM for negative interest paid on the cash balances held with their respective national central banks during 2018. These amounts will be recorded as extraordinary income in 2019.
- monitored and reviewed external audit processes performed by Ernst & Young Société anonyme. This included a review of their risk assessments, audit working papers, and documentation with the assistance of a subject matter expert from the European Court of Auditors. Furthermore, the Board of Auditors reviewed the report addressed to the Board of Auditors issued by the external auditor in compliance with EU Regulation 537/2014 describing the audit process, scope, and its results.
- monitored and reviewed the internal audit processes and their results in accordance with Article 24 (4) of the By-Laws.
- reviewed whether, and how far, recommendations arising from the previous audit reports as well as Annual Reports to the Board of Governors were considered and implemented.
- met with the ESM Managing Director, members of the Management Board, and senior staff, to discuss and review relevant issues and developments. Particular focus was placed on the areas of risk inherent to the operations of the ESM.
- received at its request various written representations from the ESM management concerning issues of oversight.

2.3. Audit procedures conducted by the Board of Auditors

In addition to the annual statutory audit by the independent external auditor and the audits performed by the internal audit function, the Board of Auditors carried out several audit procedures in accordance with Article 30 (3) of the Treaty and Article 24 (4) of the By-Laws. During 2018 these audit procedures focused on:

1. **External consultancy services** (with the assistance of subject matter experts from the French Supreme Audit Institution). The audit work was finalised in April 2018.

The audit procedure reviewed the services provided by external consultants to the ESM. The review assessed the procurement and related contractual procedures in the selection of such services, as well as their performance monitoring and the resources committed.

The audit found that:

- There were no significant discrepancies. However, the audit recommended that the ESM should enhance the documentation linked to the sourcing and monitoring of external consultancy services. Furthermore, changes to ESM systems and procedures needed to be added to provide further detail and classification of external consultancy expenditures.

2. **ESM internal control framework** (with the assistance of subject matter experts from the European Court of Auditors). The audit work was finalised in July 2018.

In October 2014, the ESM Board of Directors supported the implementation of the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations ("Basel Principles"). In line with this mandate, in 2015 the ESM completed the establishment of a comprehensive system of internal controls aligned with the Basel Principles, while taking into account the specific mandate and operating model of the ESM.

Against this background, the audit assessed whether the ESM had designed and implemented an appropriate internal control framework in line with the ESM Treaty and best practices for financial institutions.

The audit found that:

- The ESM was committed to the Basel Principles as a general framework for internal controls, while taking into account its specific mandate and legal framework.
- There was wide coverage of ESM activities via documented procedures which were systematically reviewed in accordance with the internal procedure for the maintenance of the ESM internal control framework and monitoring of internal controls.
- At the same time, it recommended that the ESM reassess organisational aspects of the framework in the context of the three lines of defence governance model. Furthermore, the ESM should enhance or update the documentation of several activities, and perform a benchmarking of its approach to other international best practice standards.

The findings were agreed upon with the ESM management. During the course of the year, the Board of Auditors was provided with progress updates by the ESM management. Several of the recommendations issued were already addressed by 31 December 2018.

In Closing

In the period under review, the ESM was in its sixth year of full operation.

The Board of Auditors considers that during the year it adopted a balanced work plan in terms of focus, objectives, and means used to obtain the necessary assurance required for the discharge of

its mandate. The Board of Auditors also confirms that it received the expected full support from ESM management.

The Board of Auditors will continue to monitor the implementation of its audit recommendations and those of the internal audit function.

Appendix - composition of the Board of Auditors

According to Article 30 (1) of the Treaty, the Board of Auditors is to have five members, appointed by the Board of Governors. In line with Article 30 (1) of the Treaty and Article 24 (1) of the By-Laws, two members are appointed upon proposal of the Chairperson of the Board of Governors, two members upon nomination by the supreme audit institutions of the ESM Members based on a rotation system and one upon nomination by the European Court of Auditors. The members of the Board of Auditors are as follows:

- Mr Tommaso Fabi, appointed upon proposal of the Chairperson of the Board of Governors (from 1 April 2019), replacing Mr Günter Borgel whose non-renewable term had come to an end.
- Ms Irena Petruškevičienė, appointed upon proposal of the Chairperson of the Board of Governors (from 8 October 2018), replacing Mr Jean Guill whose non-renewable term had come to an end.
- Mr Noel Camilleri, appointed upon nomination by the Supreme Audit Institution of Malta (from 8 October 2018), replacing Mr Andrew Harkness whose non-renewable term had come to an end.
- Mr Francois-Roger Cazala, appointed upon nomination by the French Supreme Audit institutions (Cour des Comptes) (from 8 October 2016). Mr Cazala has been serving as Vice-Chairperson of the Board of Auditors since 21 February 2017.
- Mr Kevin Cardiff, appointed upon nomination by the European Court of Auditors (from 17 December 2016). Mr Cardiff has been serving as Chairperson of the Board of Auditors since 21 February 2017.

