

European Stability Mechanism



ESM MANAGEMENT COMMENTS ON BOARD OF AUDITORS' ANNUAL REPORT TO THE BOARD OF GOVERNORS

for the period ended 31 December 2015

Dear Chairperson,

I would like to thank you for the opportunity to provide management comments on the Board of Auditors' Annual Report to the Board of Governors for the period ended on 31 December 2015.

During the past year, the ESM management met on a regular basis with the Board of Auditors continuing our collaborative relationship. In 2015, the Board of Auditors held nine meetings and met once with the Board of Directors. 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. To date in 2016, the Board of Auditors has held four meetings.

During these meetings, the Board of Auditors was regularly updated on ESM activities, the work of the ESM governing bodies, and other relevant issues and developments. Key staff members and the ESM management devoted considerable time and effort to discussing relevant issues, submitting written notes in response to questions raised, and providing any other cooperation and assistance needed for the successful discharge of the mandate of the Board of Auditors.

The Board of Auditors also met regularly with the Internal Audit function 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 of 31 December 2015 (the "Financial Statements") as well as the working papers of the external auditor on the statutory audit of the Financial Statements. Subsequently, the Board of Auditors prepared a report in respect of the Financial Statements which is included in the ESM 2015 Annual Report along with the Financial Statements and the external auditor's report.

In 2014, the ESM performed a competitive procurement procedure for the selection of an independent external auditor for the financial years 2014–2016. On this basis, the Board of Governors appointed on 8 December 2014, PricewaterhouseCoopers, Société coopérative, Luxembourg ("PwC") as the independent external auditor of the ESM for a three-year term. In 2017, upon the completion of such term, the ESM will complete a new competitive procurement procedure to select an independent external auditor.

AUDIT PROCEDURES CONDUCTED

Audit procedures conducted by the Board of Auditors

The ESM is subject to significant independent audit oversight throughout the year, as well as at year-end. In addition to the annual statutory audit by the independent external auditor, the Board of Auditors carried out review procedures in accordance with Article 30 (3) of the ESM focusing, among other subjects, on the audit of the ESM funding operations and follow-up of the audit of the ESM lending operations.

In line with Article 24 (5) of the ESM By-Laws, the Board of Auditors designated two subject matter experts from the German Supreme Audit Institution (Bundesrechnungshof) to support its audit work.

The ESM provided all the necessary cooperation and support required for the successful completion of these audits.

The Internal Audit function had full unrestricted access to the Board of Auditors and confirmed that there were no impairments to the function's independence and objectivity throughout the year.

There were six meetings between the Internal Audit function and the Board of Auditors in 2015 and four further meetings to date in 2016. The Internal Audit function reported to the Board of Auditors on the results of the internal audits conducted; the progress in implementing the Annual Audit Plan; and, on a quarterly basis, the implementation status of the internal audit recommendations as well as the recommendations issued by the Board of Auditors and the independent external auditor.

Audit procedures conducted by the independent external auditor

Audit procedures conducted by the Internal Audit function

During the past year, the Internal Audit function performed six audits and reported that the 2015 Audit Plan approved by the ESM management and presented to the Board of Auditors was completed. One planned audit in the area of procurement was postponed to 2016 due to the establishment of the new ESM Procurement Policy in May 2016. This change in planning was presented to the Board of Auditors and approved by the ESM management.

No high-risk internal audit recommendations were outstanding as of year-end 2015. The ESM management will continue its sustained efforts to ensure the timely closure of internal audit recommendations, including those classified as medium and low risk.

The independent external auditor PwC carried out the statutory audit and issued an audit report confirming that based on the audit, the financial statements give a true and fair view of the financial position of the ESM as of 31 December 2015, and of the results of its operations and its cash flows. The independent external auditor conducted the audit in accordance with the International Standards on Auditing as adopted for Luxembourg by the Commission de Surveillance du Secteur Financier.

As part of its annual audit, PwC also reviewed the principal internal control procedures in place to ensure the accuracy and reliability of the ESM accounting records and the safekeeping of assets. PwC also confirmed that unlimited access to documents and staff had been granted and noted good cooperation by the ESM management.

ESM Internal Control Framework

The ESM recognises the importance of effective internal controls that provide reasonable assurance that the institution can deliver on its mandate, prevent losses, and prepare reliable financial statements free from material misstatements. Since the last Board of Auditors' Annual Report to the Board of Governors for the year 2014, the ESM successfully completed the establishment of a comprehensive internal control system, complementing the existing internal controls over financial reporting established since 2013. To achieve this, the ESM completed a major institution-wide project to which it dedicated significant internal and external resources during 2014 and 2015.

In line with the commitment made to the Board of Directors, the ESM aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations. The ESM internal control system comprises entity level, process level, and information technology controls, consistent with the nature, complexity and risks inherent in ESM activities. The ESM internal controls cover all ESM departments and are underpinned by the three lines of defence governance model established by the Board of Directors in the High Level Principles for Risk Management.

I now turn to the detailed recommendations issued in the Board of Auditors' Annual Report to the Board of Governors. In line with Article 24 (8) of the ESM By-Laws, the ESM management would like to provide the following comments:

1.1. ESM 2015 Financial Statements – ESM Internal Control Framework

As noted earlier, the ESM completed the establishment of its Internal Control Framework over the past year.

Internal controls are now fully embedded into the "business as usual" activities of the ESM together with appropriate monitoring processes that ensure that the Internal Control Framework responds to changes in the ESM environment and is kept up to date.

As such, internal controls are subject to scrutiny by management and periodic independent review by the Internal Audit function as well as the external auditor. On such basis, the Managing Director issues an annual management report on the effectiveness of internal controls to the Board of Directors and the Board of Auditors. Any material or significant deficiencies identified during the management assessment are noted in the report together with management action plans to address them. Based on the 2015 management assessment of internal controls, no material or significant deficiencies have been identified as of 31 December 2015.

1.2. External Audit – Management Letter Recommendations

In 2015, the ESM successfully implemented and closed the two outstanding recommendations from the 2014 PwC Management Letter related to a) the strengthening of the internal control environment, and b) the accounting system and organisation.

No new findings or recommendations were issued in the 2015 PwC Management Letter.

As an annex to the Management Letter, PwC also prepared a Special Topic Report which reviewed the design and operating effectiveness of the IT general controls implemented in the areas of IT Security, Program and System Changes, and IT Operations.

No exception was identified in this regard other than what had been reported by the ESM in its quarterly review on the service provider's IT General Controls.

1.3. Internal Audit – "Right to audit" clause for external service providers

In line with the recommendation of the Board of Auditors, the ESM has developed a standard "right to audit" clause and has been successful in gradually introducing this legal clause into contracts with key suppliers. The ESM has also progressed considerably in its negotiations of such a clause with the remaining existing supplier. The ESM will also strive to include the "right to audit" clause in all

future outsourcing arrangements. The ESM's ability to incorporate such a clause depends however, on the counterparty's agreement, which may not always be forthcoming despite sustained efforts by the ESM.

1.4. Audit of the ESM Funding Operations

Funding Strategy

In 2012, the ESM Board of Directors approved the ESM Diversified Funding Strategy as the key framework for ESM issuance activities. The main objectives of the Diversified Funding Strategy are to safeguard the ESM access to a broad investor base, both to maintain market access even under difficult market conditions and to ensure the flexibility needed to manage any liquidity risks.

In 2015, the ESM rolled out a dedicated project to analyse whether issuance activities could be further optimised regarding the balance of funding costs and liquidity risk within the framework of the Diversified Funding Strategy. In this context, the ESM developed several analyses and tools in order to simulate and evaluate alternative funding strategies over a set time horizon.

However, irrespective of the further usage of analytical models, it is important to bear in mind that market conditions and investor demand are ultimately the key factors that determine the ability of the ESM to raise the needed funds on the market.

Use of auction-based funding format

The Diversified Funding Strategy entails the use of a variety of maturities and issuance formats, including syndications and auctions. Both these formats have different characteristics which are suitable for specific circumstances, depending on market conditions, the involved execution risks and the executable sizes.

The ESM will continue to use syndications as its core issuance channel. This format is best suited to provide for the ESM needs in terms of flexibility (e.g. to accommodate unpredictable disbursement timelines and sizes), volume and frequency. In line with the Board of Auditors recommendation, the ESM will keep using the auction format for short-term funding (three and six months bills). This leads to some efficiency gains (e.g. the reduction of banking fees). For long-term funding, the ESM is in a unique position. It is the only international financial institution that uses auctions in the long end. The ESM has benefitted from this issuance channel and will continue to use it when appropriate as it makes the ESM more diversified, efficient and attractive as an issuer.

1.5. Follow-up of the audit of lending operations

The Early Warning System for the ESM lending portfolio is a requirement of the ESM Treaty and is reflected in the ESM High Level Principles for Risk Management and the ESM Risk Policy. The Early Warning System seeks to monitor the ability of a Member to cover upcoming payments to the ESM, and thus to prevent a situation where a repayment default could trigger a surprise capital call for the ESM Members.

Following the Board of Auditors' audit of the ESM lending operations, the ESM introduced several amendments to the Early Warning System procedure to address the Board of Auditors' recommendation in this regard. These amendments included for example the extension of projection horizons and a more frequent reporting format, in order to further strengthen the current implementation of the procedure. The amended procedure was endorsed by the Board Risk Committee on 26 November 2015 and approved by the Board of Directors on 18 March 2016. As noted by the Board of Auditors, the ESM has thereby addressed the recommendation in this regard.

1.6. Follow-up of previous Board of Auditors' Annual Reports to the Board of Governors

Review of the ESM Procurement Framework

In response to the recommendation of the Board of Auditors, the ESM management reviewed various alternatives to further align its procurement framework with the EU Directive on Public Procurement. As mandated by the Board of Directors the ESM implemented a "substance over form" alignment which is commensurate with its special mandate, relative size, and operating model.

Adoption of the "EU Regulatory Framework"

The ESM has also noted that the Board of Auditors reiterated its recommendation that "the ESM adopts the EU regulatory framework as its own". As already outlined in previous years, this frame of reference does not reconcile directly with the ESM status as an intergovernmental international financial institution outside the EU framework. The ESM regulatory frame of reference is the ESM Treaty ratified by the 19 euro area Member States, and the ESM By-Laws, as adopted by the Board of Governors.

Conclusion

In closing, I hope that the above comments are helpful in providing the ESM management's perspective on the matters raised, and in illustrating the successful implementation of the Board of Auditors' recommendations. The ESM is appreciative of the constructive feedback and support that the Board of Auditors has provided over the past year. Going forward, the ESM will continue to foster the mutually constructive, yet appropriately independent relationships among the ESM management, the Board of Auditors, as well as the internal and external auditors.

The ESM management continues to be confident that its policies, procedures and staff will succeed in delivering on the ESM mandate and in ensuring effective control mechanisms.

I look forward to continuing our good working relationship in 2016 and beyond.

Luxembourg, 3 June 2016

Klaus Regling

Managing Director

