

CORPORATE

# Audit Committee Annual Reports

for the year 2017



European  
Investment  
Bank



*The EU bank*



**AUDIT COMMITTEE**

**Annual Report to the Board of Governors**

**For the 2017 financial year**

**AUDIT COMMITTEE****ANNUAL REPORT TO THE BOARD OF GOVERNORS****For the 2017 financial year****Table of Contents**

<b>EXECUTIVE SUMMARY.....</b>	<b>3</b>
<b>1 INTRODUCTION .....</b>	<b>5</b>
<b>2 KEY OBSERVATIONS .....</b>	<b>7</b>
<b>3 OUTCOME OF EXTERNAL AUDITING ACTIVITIES.....</b>	<b>12</b>
<b>4 COOPERATION WITH THE AUDIT BOARD OF THE EUROPEAN INVESTMENT FUND.....</b>	<b>15</b>
<b>5 AUDIT COMMITTEE PERFORMANCE EVALUATION EXERCISE .....</b>	<b>16</b>
<b>6 INTERNAL AUDIT, INSPECTORATE GENERAL, RISK MANAGEMENT AND COMPLIANCE.....</b>	<b>17</b>
<b>7 EIB COMPLIANCE WITH BEST BANKING PRACTICE.....</b>	<b>21</b>
<b>8 FOCUS AREAS GOING FORWARD .....</b>	<b>26</b>
<b>9 CONCLUSION .....</b>	<b>27</b>

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## EXECUTIVE SUMMARY

The Audit Committee is responsible by Statute for the auditing of the European Investment Bank's ('EIB' or 'the Bank') Financial Statements (including those of the mandates as per section 1.2); the verification that the Bank's activities conform to best banking practice ('BBP'); and the oversight of the proper conduct of the Bank's operations, in particular, with regards to risk management and monitoring.

This report, addressed to the Board of Governors, provides details on the work performed by the Audit Committee, its key observations, recommendations and conclusions, since the date of its previous Annual Report, issued in May 2017.

The conclusion at the end of this report presents the outcome of the Audit Committee's work in relation to the three areas within its responsibility. The conclusion also summarizes the main actions the Audit Committee requests of the Bank's Management Committee (Section 9). The Audit Committee also highlights some focus areas for its work going forward (Section 8).

As a result of its work performed during 2017 and 2018 the Audit Committee formulates the following key observations in this report. These are namely:

- the importance of ensuring the long-term financial strength and sustainability of the EIB and maintaining its AAA rating in an environment of uncertain geopolitical, economic policy, regulatory and macroeconomic developments (Section 2.1),
- the need to review and enhance the EIB Group's Internal Control and Risk Management environment in view of the changing size and evolving complexity of EIB Group activities (Sections 2.2 and 6),
- the need to achieve full implementation of best banking practice including in areas where pervasive compliance gaps remain (Sections 2.3, 6 and 7), and
- the need to perform a comprehensive review and then revamp the credit approval and related decision-making process at EIB (Sections 2.4).

The Audit Committee believes, as reported in its 2015 and 2016 Annual Reports that all Members of the Management Committee should be able to act objectively, critically and independently, and that unorthodox combinations of responsibilities, such as the responsibility for the oversight of both first and second line of defence activities, should cease. The Audit Committee takes note that the Bank is considering clarifying the responsibilities at the level of the Management Committee and expects progress during 2018.

The Audit Committee has issued and submitted to the Board of Governors its Annual Statements for the Financial Statements of EIB as at 31 December 2017, as listed below:

- Statement by the Audit Committee on the EIB's unconsolidated Financial Statements prepared in accordance with the general principles of the 'Directives',
- Statement by the Audit Committee on the EIB Group<sup>1</sup>'s consolidated Financial Statements prepared in accordance with the general principles of the 'Directives', and
- Statement by the Audit Committee on the EIB Group's consolidated Financial Statements prepared in accordance with the International Financial Reporting Standards as adopted by the European Union.

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<sup>1</sup>At 31 December 2017, the EIB Group is composed of the EIB and its subsidiaries, the European Investment Fund and EU Microfinance Platform FCP FIS. Further information on the composition of the EIB Group is available in note E.1 to the EIB Group Consolidated Financial Statements, prepared under the general principles of the EU Directives and note B.4.1 to the EIB Group Consolidated Financial Statements, prepared in accordance with IFRS, as adopted by the EU.

Based on work undertaken and the information received, including an unqualified opinion from the external auditors on the above Financial Statements of EIB, the Audit Committee concludes that the Financial Statements, as set out in section 1, adopted by the Board of Directors present a true and fair view of the financial position of the Bank as of 31 December 2017 and of the results of its operations and cash-flows for 2017 in accordance with the applicable accounting framework.

The Audit Committee carried out its work during 10 meetings held over 20 business days. During its meetings regular discussions took place with representatives from the Bank's services, including Members of the EIB's Management Committee, the Secretary General, Risk Management, Transaction Management and Restructuring, Internal Audit, Inspectorate General, Compliance, Financial Control, Operations, Finance, IT, Legal, Personnel, as well as the external auditors, KPMG.

Matters presented to the Audit Committee by EIB services were corroborated by the Audit Committee's own review of supporting documentation deemed necessary together with, where required, the Audit Committee's own analyses of matters arising.

The Audit Committee also met on two occasions with the Audit Board of the European Investment Fund ('AB of EIF'). Furthermore, the Audit Committee and the AB of EIF initiated several joint internal audits which contributed to strengthening the cooperation between the two audit bodies (Section 4).

During 2017, the Audit Committee also conducted a performance evaluation of its activities to further improve its effectiveness (Section 5).

## **1 INTRODUCTION**

The Audit Committee is established under European Investment Bank Statute as a committee independent from the Board of Directors. Its Members (and Observers, as the case may be) are appointed by, and report directly to, the Board of Governors.

This report is addressed to the Board of Governors in accordance with the EIB Statute and Rules of Procedure. This report provides details on the work performed, key observations, recommendations and conclusions, by the Audit Committee since the date of its previous Annual Report, May 2017. The Audit Committee held 10 meetings over 20 business days in 2017 (2016: 11 meetings over 19 business days).

### **1.1 Composition and competence of the Audit Committee**

At the date of this report, the Audit Committee comprised six Members and two Observers. Members and Observers are appointed for a non-renewable mandate of six consecutive financial years on the basis of their qualifications.

Both the Members of, and the Observers to, the Audit Committee are required to demonstrate the pre-requisite experience and expertise in the field of financial, audit or banking supervision, in both the private and public sectors. The CV's of the Members of, and Observers to, the Audit Committee are available on the EIB's website.

### **1.2 Outcome of Audit Committee Work**

#### **1.2.1 Financial Statements of EIB Group**

As required by Article 12 of the EIB Statute, the Audit Committee shall confirm that the financial statements, as well as any other financial information contained in the annual accounts as adopted by the Board of Directors, present a true and fair view of the financial position of the Bank in respect of its assets and liabilities, and of the results of its operations and its cash flows for the financial year under review. The Audit Committee is also responsible for the auditing of the EIB's accounts.

The Audit Committee has issued and submitted to the Board of Governors its Annual Statements for the Financial Statements of EIB as at 31 December 2017, as listed further below. Based on the statutory governance structure of the EIB and the European Investment Fund, the Audit Committee underlines that its work, and its Statements on the EIB Group Consolidated Financial Statements thereon, is formed solely upon the work performed by the external auditor and the respective external audit opinion issued by KPMG on the EIB Group Consolidated Financial Statements.

The Annual Statements of the Audit Committee to the Board of Governors were issued in respect of:

a) EIB Group <sup>2</sup> Financial Statements	<ol style="list-style-type: none"> <li>1. EIB statutory, under the general principles of 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 ('EU Directives'),</li> <li>2. EIB Group consolidated, under the general principles of the EU Directives, and</li> <li>3. EIB Group consolidated, prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.</li> </ol>
b) Mandates and trust funds Financial Statements	<ol style="list-style-type: none"> <li>4. Investment Facility;</li> <li>5. EU-Africa Infrastructure Trust Fund; and</li> <li>6. Neighbourhood Investment Facility (NIF) Trust Fund.</li> </ol>

### 1.2.2 Verification of compliance with applicable Best Banking Practice at EIB

As required by Article 24 of the of the EIB's Rules of Procedure, the Audit Committee shall verify that the activities of the Bank conform to the applicable Best Banking Practice ('BBP'), hereafter referred to as the 'BBP Framework'.

During 2017, the Audit Committee has carried out its annual verification exercise by reviewing and discussing the outcome of the annual self-assessment of compliance with the BBP Framework, drafted and presented to the Audit Committee by the EIB services concerned. The assessment of compliance with the BBP Framework is an iterative process. Bank's services are required to propose the inclusion of new or revised practices to the BBP Framework and to ensure that the EIB is compliant from the date when such requirements become effective. Further information is provided in Section 7 of the report.

<sup>2</sup> At 31 December 2017 the EIB Group is composed of the EIB and its subsidiaries, the European Investment Fund and EU Microfinance Platform FCP FIS. Further information on the composition of the EIB Group is available in note E.1 to the EIB Group Consolidated Financial Statements, prepared under the general principles of the EU Directives and note B.4.1 to the EIB Group Consolidated Financial Statements, prepared in accordance with IFRS, as adopted by the EU.



## 2 KEY OBSERVATIONS

The Audit Committee, in accordance with the responsibilities assigned to it by the EIB Statute, highlights the following key observations:

### 2.1. Preserving the financial strength and sustainability at the core of the EIB's business model

The EIB is affected by geopolitical events. The UK's decision to trigger Article 50 and with it the imminent departure of a major shareholder will have a significant impact on the Bank, in particular on its capital base and future lending capacity. For the time being, the UK remains both a member of the European Union and a shareholder of the EIB. The UK subscribed 16.11% of the EIB's capital, accounting for EUR 3.5bn of the paid-in capital and EUR 35.7bn of the Bank's callable capital. In addition, as of the end of 2017, aggregate loan exposures to projects located in the UK amounted to EUR 43bn.

Europe and the EU remain in the midst of yet more profound change. Many elements affecting the EIB's role and its future options will be externally influenced, including financial market regulation and, critically, political decisions that are taken at EU level on the future direction of the EU.

The EIB is a market driven financial institution, and not a budget based EU Institution. As a result, it relies on efficient and sustainable access to market funding in order to provide financing to projects on reasonable terms. Investor confidence (institutional and private investors) in the EIB is derived from both the financial strength of the Bank and the strength and support from the EU Member States as shareholders. The maintenance of the EIB's AAA rating is, therefore, of strategic importance to the EIB being able to sustainably deliver its Treaty based mission and role.

Economic, regulatory and macroeconomic developments which might have an impact on the EIB's funding activity remain, however, out of the control of the EIB.

It is in light of these uncertain events that the Board of Directors of the Bank exceptionally approved a one-year Operational Plan for 2018, rather than a three-year one. This decision was the result of the need to respect the timeline of Article 50 negotiations between the UK and the EU, and it being deemed untimely by EIB's shareholders to make definitive assumptions concerning its activities in 2019 and 2020.

In addition, current business and market assumptions expect that the Bank's annual Net Surplus<sup>3</sup> will decrease quite markedly over the period 2018-2020. The EIB's annual Net Surplus, allocated to own funds, and has historically served as a second source of funding and capitalisation for the Bank. In turn the EIB, as a market driven financial institution, has capital constraints which affect the overall scale of financing volumes, its risk appetite and dictate what proportion and type of financing can be undertaken.

The Audit Committee is of the view, however, that the financial strength of the EIB can in part be safeguarded by effective, proactive and timely response to these external factors.

The Audit Committee has been assured that Management is already focusing on its readiness to address the potential impacts of geopolitical, economic policy, regulatory and macroeconomic developments on the EIB's future business plans and strategy. In addition, Management must have a priority to:

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<sup>3</sup> The EIB's Operating Framework and Operational Plan 2018.

- maintain cost discipline and a flexible approach to manage the cost base over time,
- adapt product pricing,
- ensure sustainability of the Bank, and, last but not least,
- closely monitor the evolution of the Bank's capital adequacy.

The Audit Committee takes note that the Management's attention is focused on the potential significant impacts triggered by the streamlining of existing activities, the inclusion of new products or high-risk individual transactions, and the need to consider mitigating measures to offset these impacts in order to preserve the Bank's portfolio, reputation, and ultimately its business model.

The Audit Committee expects that the conclusion of the BBP review initiated by the Bank in 2016 should see the continued close focus by Management on fully implementing the BBP Framework, and ensure that all necessary actions are undertaken to close existing gaps. Furthermore, the Audit Committee considers that the implementation of BBP is a precondition of preserving EIB's financial strength and sustainability.

Certain EIB practices do not yet fully comply with the requirements of best practice and in some areas, pervasive compliance gaps remain. Further information on the status of the BBP Framework implementation by the Management of the EIB is disclosed in Section 7 of the report.

## **2.2 Enhancements to the EIB Group's Internal Control and Risk Management Environment in view of the changing size and complexity of EIB Group activities**

The European Investment Bank is the majority shareholder of the European Investment Fund ('EIF'); together the EIB and the EIF form the main part of the EIB Group.

The EIB Group has seen a marked change in the nature, volume, risk profile and complexity of its business over recent years under the European Fund for Strategic Investment ('EFSI'), with a trend towards an increasing number of smaller operations backed by the EU guarantee under EFSI. There has also been a significant increase of mandates under management on behalf of third parties such as the European Commission and in the provision of advisory services.

In addition, the EIF deploys various mandates on behalf of the EIB, including the Risk Capital Resources (RCR) and EIB Group Risk Enhancement Mandate (EREM). The combination of both EIB's shareholding in the EIF and the management by EIF of EIB funds under mandates currently represents approximately 11 percent of the EIB's total regulatory capital requirements, which is expected to increase further in the coming years as a result of the EIB Group's deployment of EFSI 2.

As roughly over half of the EIB staff has joined over the last five years, integrating new employees while ensuring delivery of the Bank's objectives, against the backdrop of a rapidly evolving operating environment, has been and remains challenging.

The Audit Committee considers that this rapid expansion of activities and capacity has not necessarily been matched by relevant adaptations in business structure or processes. To this end Management needs to ensure that internal processes, especially related to IT, cyber security and risk management, as well as corporate risk culture are reviewed as a matter of priority to see that they are fit to meet the demands and challenges of the EIB Group going forward.

Furthermore, the EIB is also obliged through the implementation of the BBP Framework to play its role as majority shareholder of the EIF by seeking ways to enhance the oversight and management of risk, processes and internal controls from a group perspective. Existing gaps, essential elements of compliance with group related BBP requirements, need to be addressed, and include:

- review of the terms of reference of the EIB Group's compliance, risk management and internal audit functions,
- enhance the capacity for the EIB Group to capture and aggregate all material risk data across the EIB including the EIF, a significant subsidiary of EIB, in a manner which allows group monitoring, as well as appropriate risk management in the EIB Group as a whole, and
- enhance the existing group risk oversight and reporting controls, including the implementation of a group-wide approach to liquidity risk management, and further extend the scope of the existing Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP) documents to address fully EIB Group considerations.

At the level of the Bank itself, the Audit Committee also retains the following internal control and risk environment related recommendations from its 2015 and 2016 Annual Reports. The Audit Committee asks that these recommendations be addressed as a matter of priority:

- the Management of the EIB should ensure that an effective and sound risk culture is promoted and that all EIB employees, including those new to the EIB, are aware of their own responsibilities in relation to risk management, compliance and internal control environment,
- the Management of the EIB should look to establish a complete map of risks, roles and responsibilities and see that the three lines of defence model is effectively deployed across the Bank, so that conflicts of interest are appropriately managed,
- the Prudential Risk Appetite Framework approved by the Board of Directors in December 2015 should be extended without further delay to a full Risk Appetite Framework which considers non-financial risks (such as conduct, IT and cyber risk, AML) and addresses group considerations,
- risk appetite limits set out in the EIB Risk Appetite Framework in 2015 ought to be effectively translated into first line of defence activities, so as to embed prudent risk taking into the EIB's risk culture and in the day to day management of risks,
- The risk appetite limits in the EIB Risk Appetite Framework which have no defined boundaries should be further enhanced and defined, in particular in relation to large exposures and liquidity. This is especially important in view of the changing strategy of the Bank, which involves higher overall risk-taking.

Looking forward, the Audit Committee understands that the EIB intends to reorganise its development activities outside the EU into a specialised part of the Bank which may eventually develop into a financially self-sustainable subsidiary to be consolidated on group level.

The Audit Committee strongly recommends that for any future group structure the Bank considers centralisation at group level of functions such as Internal Audit, Risk Management, Compliance, Corporate Services (e.g. IT and Personnel) and Finance, and that such a structure facilitates compliance with group related BBP requirements from the outset.

### 2.3 Compliance with applicable Best Banking Practice Framework

During 2017, the Audit Committee has carried out its annual verification exercise by reviewing and discussing the outcome of the annual self-assessment of compliance with the BBP Framework, drafted and presented to, the Audit Committee by the concerned EIB services.

The assessment of compliance with the BBP Framework is an iterative process. Bank's services are required to propose the inclusion of new or revised practices to the BBP Framework and to ensure that the EIB is compliant from the date when such requirements become effective. Further information about areas where full compliance is not yet achieved is provided in Section 7 of the report.

In addition, the Audit Committee believes that all Members of the Management Committee should be able to act objectively, critically and independently, and that unorthodox combinations of responsibilities, such as the responsibility for the oversight of both first and second line of defence activities, should cease.

The Audit Committee takes note that the Bank is considering changes to the organisation at service level and possible future appropriate segregations at the level of the Management Committee and expects progress during 2018.

In this context, the Audit Committee takes note of the clarification that the Management Committee Members with second line of defence oversight will coordinate related policy matters to be submitted to the Management Committee. Furthermore, the Audit Committee notes that the second line of defence aspects concerning individual operations shall be discussed at the Management Committee as a whole in the presence of the respective services.

### 2.4 Comprehensive review and revamp of the credit approval and related decision-making process at EIB

In 2017, at the request of the Audit Committee an Internal Audit ('IA') review of the Bank's lending appraisal and approval process was performed.

The internal audit found that, in view of the increasing volume and complexity of loan operations, which is coupled with a changing risk offer (e.g. EFSI), the current credit approval and related decision-making process of the EIB should undergo a comprehensive review in order to:

- align it with best practices as applicable,
- respond to the changing business offer of the Bank, and
- apply the duty of care vis-à-vis the Bank's mandators.

Specific high risk rated findings were raised in respect of the: (i) governance of the credit approval and related decision making process; (ii) split of responsibilities between Operations and Risk Management; (iii) comprehensiveness of the analysis underlying the decision-making process and the extension of loans; and (iv) consistency of financial spreading<sup>4</sup>.

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<sup>4</sup> Financial spreading refers to the level of industrialisation and standardisation of the credit process. No mandatory use of standardized financial analysis tools and absence of IT-based solution for spreading financial information.

The Audit Committee is concerned by the nature and extent of the findings reported. The appraisal and approval of the EIB's lending operations is one of the core processes of the Bank. In view of the evolving nature, size, volume and complexity of the EIB's operations, the Audit Committee considers that the loan appraisal and approval process and respective control environment does not appear to be able to cope with the current business needs and is evidence of pressure on services. Thus the credit approval and related decision-making process of the EIB needs to be revamped.

The Audit Committee requests that the Management Committee oversees and expedites the timely implementation of all of the findings raised in the IA report on the Bank's lending appraisal and approval process. The Audit Committee will closely monitor the implementation of IA's recommendations by the Management Committee.

### 3 OUTCOME OF EXTERNAL AUDITING ACTIVITIES

In its work, the Audit Committee relies on the external and internal auditors and where appropriate, on the work of external experts, from which it receives assurance on the accuracy of financial reporting and confirmation of the effectiveness of the internal control processes and procedures.

In addition, the Audit Committee obtains a representation letter from the President of the Bank, signed based upon internal support letters from the Bank's services, confirming Management's responsibility for establishing and maintaining an efficient internal control framework, as well as its responsibility for the preparation and fair presentation of the Financial Statements.

#### 3.1 Audit Committee oversight of the external audit process

As set out in the Article 26.2 of EIB's Rules of Procedure, the audit of the Financial Statements is assigned by the Audit Committee to the external auditor.

The external auditor of the EIB appointed by, and reporting directly to the Audit Committee is KPMG Luxembourg, Société cooperative ('KPMG'), a Luxembourg entity and a member firm of the network of independent firms affiliated with KPMG International Cooperative.

The Audit Committee took note of the audit methodology and approach set out in KPMG's annual audit plan, where the following priority audit areas, including key areas of judgement and estimation in the Financial Statements, were identified:

- lending, including valuation of the loan portfolio,
- treasury, including valuation of the Bank's treasury assets, borrowings and derivatives portfolios and related disclosures in the Financial Statements,
- venture capital, including valuation of private equity investments,
- information technology, including data quality and governance,
- the use of experts in the audit, and
- the financial reporting process, in particular, in relation to the IFRS consolidated Financial Statements and the proper application of both new and revised IFRS accounting standards.

The Audit Committee received regular updates during the reporting period on the status of implementation of IFRS 9 Financial Instruments that will apply as of 1 January 2018. The new IFRS 9 standard includes revised guidance on the classification and measurement of financial assets, a new expected credit loss model for calculating impairment and new hedge accounting principles.

The Audit Committee was also briefed by KPMG in respect of enhanced external auditor reporting requirements, applicable for the first time for the financial year ending 31 December 2017, which include:

- the communication of Key Audit Matters in the independent Auditor's Report, which provide a description of the most significant assessed risks of material misstatement, including those due to fraud, a summary of auditor's response to those risks, and key observations arising with respect to those risks,
- the submission by the external auditor of a more comprehensive report directly to the Audit Committee, including:
  - more detailed information on the results of the audit,
  - disclosure of quantitative level of materiality applied to perform the statutory audit, materiality level(s) for particular classes of transactions, account balances or disclosures, and qualitative factors used to determine materiality, and

- where applicable the reporting and explanation of judgments about events or conditions identified during the audit that may cast significant doubt on the entity's ability to continue as a going concern and whether they constitute a material uncertainty, and provide a summary of all measures that have been taken into account when making a going concern assessment.

In discharging its responsibilities in respect of the oversight of the external audit of the Bank's Financial Statements, the Audit Committee:

- monitored the execution of KPMG's audit plan through regular meetings with senior members of the audit team, including the lead audit engagement partner. The Audit Committee met with KPMG at 8 of the 10 Audit Committee meetings held in 2017,
- was briefed on the progress and outcome of the audit procedures, in particular in relation to the priority audit areas set out above, together with the identification and reporting of Key Audit Matters as set out in KPMG's independent auditor's reports on the Bank's Financial Statements,
- read and discussed the content of regular written reports submitted to it from the external auditor, addressing the various stages of the external audit process and including audit methodology and audit approach, the results of audit testing, levels of materiality, audit differences, significant matters arising from the audit process and auditor independence,
- discussed the following: KPMG's recommendations which are reported in KPMG's Management Letter to the Bank, as well as the status of the implementation of prior year recommendations, and
- received assurance from the external auditor that the audit process was achieved as planned, with support from the Bank's services.

The Audit Committee was satisfied with the results of the external audit work, which enabled it to formulate its own conclusions, as enumerated in its Statements to the Board of Governors that accompany the Bank's Financial Statements, listed in Section 1 above. The Audit Committee will make sure that the external auditor's annual audit plan for 2018 focuses further on the findings linked to the credit approval and related decision making process at EIB.

### **3.2 Audit Committee monitoring of external auditor independence**

The Audit Committee is responsible for reviewing and monitoring the independence of the external auditor, in line with the requirements of the prevailing EU Regulation<sup>5</sup>. The Audit Committee received and discussed details of the various safeguards in place at KPMG to maintain auditor independence. The Audit Committee received written confirmation from KPMG that the members of the audit team remained independent within the meaning of regulatory and professional requirements and that the objectivity of the audit team, including the audit, was not impaired.

As an additional safeguard to maintaining auditor independence, the Bank's general policy is not to allow the incumbent external auditor to undertake work outside the scope of the Framework agreement for audit services. The Audit Committee confirms that KPMG was not engaged to perform non-audit services for the Bank during the year ended 31 December 2017.

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<sup>5</sup> Regulation EU 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.

### 3.3 Facilitating the future rotation of the external auditor

The Audit Committee retains the findings raised in its 2016 Annual Report. In view of restrictions on the provision of non-audit services by audit firms to audit clients and in order to facilitate the process for the future and timely rotation of the EIB's external auditor, the Audit Committee recommends:

- that a list of the contracts of professional service firms, typically eligible to tender for external audit services to be provided to the EIB Group, is maintained and reported on a regular and ongoing basis to both Management of the Bank and the Audit Committee; this list should also include the duration of such contracts,
- to define a process addressing how the EIB Group may best balance, oversee and manage its approach towards the use of contracts awarded to professional service firms for consultancy work, and the need for such external audit firms to adhere to rules regarding rotation.

Without prejudice of the economic operators' freedom to participate in EIB Group published procurement procedures for the provision of non-audit services, the EIB Group should monitor that well before the launch of the next published call for tender for external audit services, the professional services firms typically eligible to bid for external audit services are free from conflicts of interest that may otherwise restrict these firms' capacity to provide external audit services to the EIB.

Furthermore, the process, to include ongoing monitoring and reporting of existing and future potential contracts awarded to professional services firms, needs to be finalised as matter of priority, in view of the:

- extent of existing, ongoing and pipeline contracts and framework agreements currently in place between the EIB and professional service firms typically eligible to tender for external audit services,
- need for the Audit Committee to retain its capacity to initiate, in consultation with the Management Committee, rotation of the incumbent auditor, and for the EIB Group to see that there would be a sufficient number of professional services firms free from conflict to submit offers for the contract, and
- need for external audit firms to adhere to rules regarding rotation.



#### **4 COOPERATION WITH THE AUDIT BOARD OF THE EUROPEAN INVESTMENT FUND**

In light of the significant increase in the volume of activities of the EIB, together with the increase in the volume of business under mandates managed by the EIF on behalf of the EIB, the Audit Committee and Audit Board of the EIF have further increased their collaboration.

In 2017, a 'Cooperation Paper' was signed between the Audit Committee and Audit Board of EIF, setting out the framework for discussing common issues and coordinating actions that have an impact on the consolidated Financial Statements of the EIB Group and group policies. The Cooperation Paper also formalises the ways in which the two bodies cooperate and transparently communicate on the activity, governance and control environment of both institutions.

Two joint meetings took place in 2017 between the Audit Committee and Audit Board of the EIF. Shared matters of interest were discussed, including the outcome of joint internal audits, EIB Group compliance, the provision of certain shared services, the coordination of the external audit mandate, and where appropriate, included common working practices.

## **5 AUDIT COMMITTEE PERFORMANCE EVALUATION EXERCISE**

In 2017 the Audit Committee initiated a performance evaluation exercise, which included a review of the adequacy of its terms of reference, roles and responsibilities, forums of discussion, relationships with stakeholders and communication, with a view to highlight skills and/or knowledge gaps and to identify areas in which the Audit Committee and its processes might become more effective.

The Audit Committee also requested feedback from stakeholders who interact with the Audit Committee on a regular basis, including the Bank's Management, representatives from services and the external auditor, KPMG.

As a result of this performance evaluation exercise, the Audit Committee will initiate an action plan to take onboard the outcome of the performance evaluation and will work towards improving further its effectiveness.

## **6 INTERNAL AUDIT, INSPECTORATE GENERAL, RISK MANAGEMENT AND COMPLIANCE**

The Internal Audit, the Inspectorate General, the Risk Management and the Compliance directorates within EIB retained an unrestricted access to the Audit Committee during 2017 year and may also request private sessions with the Audit Committee.

### **6.1 Internal Audit**

The Internal Audit Directorate is an independent function within the EIB with a direct reporting line to the Bank's President. The Audit Committee met with the Head of IA at 8 of the 10 meetings held in 2017. The salient features of IA reports issued and received were examined and discussed, and updates of the status of implementation of the related agreed action plans (AAPs) given. The draft IA work plan for 2018-2020 was also addressed.

The Audit Committee was informed about the outcome of an external independent quality review performed in respect of the effectiveness of IA's processes, practices and standards in view of its mission and role set out in the Internal Audit Charter. The Audit Committee took note of the outcome of the evaluation, together with key conclusions and recommendations raised.

Finally, the status of implementation of IA AAPs was monitored. The timely implementation of AAPs is a key indicator that the internal control environment is adequately maintained and is also an evidence of an effective and sound risk culture. The Audit Committee highlights the decline in the timely implementation of IA AAPs. The Audit Committee expects that the Management Committee takes immediate action to expedite the closure of existing overdue AAPs and to oversee the timely implementation of actions recommended by IA.

### **6.2 Inspectorate General**

The Inspectorate General ('IG') comprises three lines of service: fraud investigations, operations' evaluations and the complaints mechanism.

The Audit Committee met with the Inspector General at 4 of the 10 meetings held in 2017. The Audit Committee examined and discussed with the IG the on-going cases under their remit. The Audit Committee advised IG to improve the feedback loop where lessons learnt from these investigations are reported back to EIB services. The Audit Committee received presentations of the updated Fraud Investigations Charter and Fraud Investigations Annual Report, and the outcome of selected proactive integrity reviews together with proposals to review the proactive integrity review methodology.

The Audit Committee was also provided with an overview of the work of Operations Evaluation Division and the results of selected operations' evaluations.

### **6.3 Risk Management**

The Audit Committee dedicated significant time during the reporting period, at each meeting, to discuss, evaluate and assess the Bank's risk management practices. The Audit Committee met at nine of the 10 meetings held with the Risk Management ('RM') and Transaction Management and Restructuring ('TMR') Directorates in 2017. In obtaining assurance in relation to risk management activities, the Audit

Committee discussed and made recommendations to the Bank's RM and TMR Directorates at these meetings.

The Audit Committee focused on topics such as credit risk assessment and monitoring, liquidity risk management, capital adequacy requirements, capital planning, operational risk assessment and monitoring. The Audit Committee addressed different aspects of risk management and regularly reviewed the monthly risk report and dashboard, and the quarterly risk outlook.

In addition, the Audit Committee discussed and provided comments on the EIB's Group Risk Management Disclosure Report, the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP) documents.

### **6.3.1 Credit risk**

The Audit Committee held discussions throughout the year with Management concerning the trends of key risk indicators such as the capital adequacy ratio; the evolution of loan grading; the use of internal models and underlying assumptions; large exposures and concentration risk; the quality of the loan origination process based on a specific case study and lessons learned; non-compliance events; 'watch listed' loans; and loan arrears.

The Audit Committee sought further explanations concerning the monitoring of operations reported on the 'watch list', loans where specific provisions were accounted for and loans where contractual clause related events had occurred. Furthermore, as a result of a case study concluded in 2017 in relation to some loan operations, the Audit Committee requested that a targeted review is performed by IA of the credit approval and related decision-making process within the Bank whose outcome is presented in Section 2.4.

In addition, the risk appetite limits set out in the EIB's Risk Appetite Framework need to reflect the risk-taking practices of the Bank and to be effectively translated into first line of defence activities, so as to be embedded in the day to day management of risks. The risk appetite limits in the EIB Risk Appetite Framework which have no defined boundaries should be further enhanced and defined, in particular in relation to large exposures and liquidity. This is particularly important in view of the changing strategy of the Bank, which involves higher overall risk-taking.

### **6.3.2 Liquidity risk**

The Audit Committee reviewed and discussed the results of the Bank's key liquidity risk metrics throughout the reporting period, which include the Liquidity Coverage Ratio (LCR). The Audit Committee received an overview of updates to the Bank's Liquidity Risk Framework which included the status of the Bank's implementation of the Net Stable Funding Ratio ('NSFR').

The Audit Committee discussed and provided comment on the Bank's first iteration of an ILAAP report, and requested improvements in areas such as liquidity metrics, with special focus on LCR, limits used in the risk appetite framework, expansion of analysis of off-balance sheet liquidity risks, and governance of liquidity contingency procedures. The Audit Committee also asked EIB to focus more on the group dimension and better incorporate liquidity risks of the EIF in the ILAAP document.

The Audit Committee received a separate report and presentation on the business purpose of using different types of derivatives (e.g. interest rate, FX, etc.), together with more detailed explanations of the impact of derivatives on liquidity risk. Furthermore, a signed agreement is in place between the EIB and the Banque Centrale du Luxembourg ('BCL') establishing the framework for the assessment of the Bank's liquidity situation and liquidity risk management, as the Bank participates in the Euro System liquidity operations. The last onsite liquidity assessment of the BCL at the EIB took place in 2015.

### **6.3.3 Capital planning and capital requirements**

The Audit Committee met with RM staff at each meeting to monitor and discuss the evolution of the Bank's Capital Adequacy ratio ('CAD'). The Audit Committee also received a presentation of the CAD impact of implementing regulatory and on-going modelling developments.

The Audit Committee subsequently asked that the capital impact of implementing remaining BBP Framework gaps also be estimated. With reference to capital planning, the Audit Committee provided comments on the EIB's 2016 Internal Capital Adequacy Assessment Process document and requested improvements in a number of areas. The Audit Committee clarified that it expects EIB to hold extra capital for risks not covered in Pillar 1, on top of the regulatory capital requirements.

The Audit Committee requested to review the calibration of the capital charge in Pillar 2 for the interest rate risk in the banking book. The Audit Committee has also requested EIB to be more forward looking in its capital planning and analyse the impact of discontinuing the internal modelling approach for operational risk (AMA), as well as the impact of other regulatory changes in view of the finalization of post-crisis reforms by the Basel Committee on Banking Supervision and the EU banking reform package<sup>6</sup>.

The combination of both EIB's shareholding in the EIF and the management by EIF of EIB funds under mandates currently represents approximately 11 percent of the EIB's total regulatory capital requirements, which is expected to increase further in the coming years as a result of the EIB Group's deployment of EFSI 2. The Audit Committee expects that the capital planning is enhanced along the lines of the EIB Group and that it would include EIF activities.

The Audit Committee also invited EIB to extend the existing time horizon for capital adequacy projections in the ICAAP report. Further detail on the work performed by the Audit Committee in relation to the prudential risk related requirements together with the assessment of the status of implementation of the BBP Framework is detailed in section 7.

## **6.4 Compliance Function**

The Office of the Chief Compliance Officer (OCCO) comprises four organisational units (OCCO Divisions of Operations, Monitoring and Corporate, and the Data Protection Office) as well as the Procurement Compliance, Regulatory & Tax teams.

The Audit Committee, at five of its 10 meetings held, met with the Group Chief Compliance Officer. Topics that were discussed include: the implementation of the AML-CFT Framework; respective revisions to processes; workflows and IT upgrades; status of the 'legacy' project where a comprehensive revision of

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<sup>6</sup> The EU banking reform package of November 2016: [http://eur-lex.europa.eu/resource.html?uri=cellar:9b17b18d-cdb3-11e6-ad7c-01aa75ed71a1.0001.02/DOC\\_1&format=PDF](http://eur-lex.europa.eu/resource.html?uri=cellar:9b17b18d-cdb3-11e6-ad7c-01aa75ed71a1.0001.02/DOC_1&format=PDF).

the Know Your Customer ('KYC') records of existing and new counterparties was ongoing. In addition, the upcoming regulatory changes on data protection and implementation at the EIB were also presented by the Data Protection Officer.

The Audit Committee commended that OCCO, the EIB Group Compliance function, and EIF Compliance have concluded a Framework of Cooperation which can serve as model for other functions.

The Audit Committee was also updated on EIB Group's approach to regulatory developments and international standards in the area of tax transparency and tax good governance. The Audit Committee received a detailed presentation of the EIB's Policy towards weakly regulated, non-transparent and uncooperative jurisdictions ("NCJ Policy") and Tax Sensitive Jurisdictions (TSJ) and the respective changes made to the Bank's processes and due diligence controls.

Finally, in July 2015 the Audit Committee requested that the main parties responsible within the Bank initiate a review of the Bank's whistleblowing policy. The existing whistleblowing policy dates from 2009 which currently may not reflect best banking practice requirements. The Audit Committee received an update of the status of the project from OCCO in late 2017. The Audit Committee expects that the revision of the Bank's whistleblowing policy be expedited and concluded by mid-2018.

## 7 EIB COMPLIANCE WITH BEST BANKING PRACTICE

### 7.1 Verification by the Audit Committee of EIB implementation of the BBP Framework

The effective implementation of BBP serves to protect the EIB and keep it safe and sound. The implementation of procedures to ensure EIB Compliance with BBP is in the first instance, the responsibility of the EIB's Management Committee. The Audit Committee, in accordance with the responsibilities assigned to it by the EIB's Statute, verifies the Bank's compliance with applicable Best Banking Practice.

The EIB has established a framework of applicable best banking practice - the BBP Framework, based on a hierarchical set of reference BBP documents, e.g. EU Treaties, the EIB's Statute and Rules of Procedure, EU Banking Directives and Regulations, guidance and principles issued by, or best practice adopted by global and EU regulatory bodies e.g. BCBS, EBA, ESMA and ECB – collectively referred to as “standards” in this report. EIB's compliance with Best Banking Practice is assessed against these documents. On the basis of proposals from the Bank's services, the Audit Committee approves updates to the BBP Framework, as well as assesses and verifies their implementation on an annual basis, the outcome of which is provided below in a summary form.

In 2017, the Audit Committee carried out its annual verification exercise by reviewing and discussing the outcome of the annual self-assessment of compliance with the BBP Framework, drafted and presented to the Audit Committee by the concerned EIB services. In addition to verifying the on-going maintenance of areas where the Bank achieves full compliance with the BBP Framework, discussions of the self-assessment of compliance with the respective EIB services aimed at highlighting:

- areas where full compliance had not been achieved at the last self-assessment, and the progress made to fulfil it for each applicable standard,
- developments in standard setting, including new standards and reformed standards, and
- new EIB internal developments and their possible relevance to the standards, namely to identify and decide whether new standards become relevant to EIB as new products and/or initiatives are developed or whether there is a change in compliance.

The Audit Committee considers that compliance with the BBP Framework constitutes an integral part of the internal control environment, including processes and working procedures, as well as the daily working practices of the Bank.

To complement the self-assessments reported by Directorates, the Audit Committee has requested that IA include within the Internal Audit Annual Plan the audit of at least one area of the BBP Framework each year, with the specific objective of providing assurance regarding the integration of BBP into the corresponding internal written procedures of the Bank. The Bank's services are required to propose the inclusion of new or revised practices to the BBP Framework and to ensure that the EIB is compliant from the date such requirements become effective.

Furthermore, when planning and performing individual internal audit assignments, the Audit Committee requested the Internal Audit to incorporate and perform tests of controls linked to specific BBP standards, with a view to providing further assurance in the form of an IA opinion on compliance.

With reference to Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT) BBP requirements, in early 2016 an IA report highlighted the need to address Know Your Customer ('KYC') requirements of a number of existing counterparties, where AML/KYC documentation had not always been consistently obtained or appropriately maintained. The Audit Committee notes and commends the conclusion of a project in 2017 to address the KYC requirements of this existing portfolio of counterparties and operations. The Audit Committee took note of the on-going implementation of the AML-CFT Monitoring Framework, consisting of: (i) pillar 1 with proactive reviews of operations and reactive reviews driven by the presence of new ML-FT risk factors which will include an enhanced automated screening tool, and (ii) pillar 2 - a compliance testing programme with the aim to assess the adequate design and effectiveness of existing compliance controls (initial focus on AML-CFT controls).

## **7.2 EIB oversight of Best Banking Practice**

The assessment of compliance with the BBP Framework is an iterative process. The Bank's services are required to propose the inclusion of new or revised practices to the BBP Framework and to ensure that the EIB is compliant from the date such requirements become effective.

The Audit Committee reiterates its recommendation from its 2015 and 2016 Annual Reports that in the context of the EIB's current review of the BBP process, the EIB should seek to implement a holistic and forward-looking approach to the implementation of Best Banking Practice. The oversight function should ensure that impact assessments and the onboarding of new requirements as well as the central maintenance of a full overview of adherence to Best Banking Practice requirements are carried out.

The review of the BBP process initiated by the Management Committee in 2016 is ongoing; the review serves as a means to provide clarification to key stakeholders of the purpose and applicability of BBP, once endorsed and approved by the Management Committee, the Board of Directors and the Board of Governors.

The Audit Committee has been consulted by the Bank on the BBP review process which was initiated in 2016 and supports the Bank's intention to establish a new holistic framework which:

- is based on high-level best banking practice guiding principles, setting out the purpose and applicability of BBP at the EIB in view of its Statutory mission,
- comprises a BBP book that will set out best banking practice determined as either not applicable or requiring adaption in view of the EIB's mission, and including mitigating measures based on a "comply or explain" approach,
- includes an Applicability Assessment Procedure, ensuring consistent, timely identification and assessment of the relevant BBP rules, and
- covers a BBP rules repository including all relevant EU Legislative Acts and Guidelines with which the EIB has voluntarily decided to comply.

The Audit Committee welcomes the progress and efforts made towards compliance with applicable BBP Framework. The Audit Committee also expects that the BBP framework becomes fully operational in 2018.



The Bank should also see that the oversight function of the BBP Framework is established as a matter of priority. The function should address the applicability, impact assessments, onboarding of new requirements as well as the central maintenance of relevant BBP Framework documents.

### **7.3 Areas where full compliance has not yet been achieved**

The Audit Committee has met and discussed with the Bank's services the status of implementation of the BBP Framework and the results of the annual verification process focusing in particular on progress made during the year in closing remaining compliance gaps. Areas where full compliance has not yet been achieved are listed in the following sections.

#### **7.3.1 Prudential Risk Management**

Areas under responsibility of the RM Directorate include compliance with the Capital Requirements Directive and the Capital Requirements Regulation ('CRD/CRR'), and current guidelines and practices adopted by the Basel Committee on Banking Supervision (BCBS), as well as the European Banking Authority (EBA). The Audit Committee commends the work carried out by RM during the reporting period to see the closure of certain compliance gaps. This includes the first iteration of an ILAAP, the approval by the Board of Directors of a Recovery and Capital Contingency Plan, as well as the preparation and completion of the periodic ICAAP document and the EIB Group Risk Disclosure Report ('Pillar 3 Report').

The most recent version of RM's BBP work plan presented to the Audit Committee identified 18 active projects as well as 4 projects on hold, with 11 of these projects considered to be high priority, 7 medium and 4 low.

Projects that remain to be implemented to address existing BBP requirements include:

- enhancements to the stress testing framework and internal stress testing capacities,
- the expansion of the Prudential Risk Appetite Framework to cover non-financial risks and to embed the existing metrics into 1<sup>st</sup> Line of defence activities,
- enhancements to large exposures related processes to capture connected clients, as well as defining the limits in the risk appetite framework,
- implementing a BBP compliant method for Pillar 2 capital charge for interest rate risk in the banking book,
- implementing a BBP compliant method for Pillar 2 capital charge for FX Risk in the banking book, and
- the management of intra-day liquidity risk.

Projects that remain to be implemented to address future BBP requirements include:

- changes to capital adequacy requirements for the calculation of Operational Risk, by discontinuing reliance on internal models,
- refinements to the Net Stable Funding Ratio calculation to be based on EU parametrisation, and
- the implementation of a revised securitisation framework.

In addition, the Audit Committee expects that the Bank addresses in 2018 the comments raised by the Audit Committee in 2017 in relation to the 2016 ICAAP and ILAAP documents.

In view of the forthcoming requirements of EU banking reform<sup>7</sup>, as presented by the European Commission in November 2016, the EIB should conclude and present the results of impact assessment, together with action plans to ensure future compliance.

The EIB should also prepare an action plan detailing how it intends to address and implement the changes required by the recently finalized Basel III reforms (BCBS)<sup>8</sup>. The Audit Committee urges the Bank's Management Committee to ensure that momentum gained by the Risk Management Directorate over recent years be maintained, and that efforts to implement key BBP projects continue. The Audit Committee will continue to monitor progress with RM's work plan during the forthcoming reporting period.

### **7.3.2 Corporate Governance**

The Audit Committee is aware that the Bank's Statute retains precedence to the BBP Framework with regards to the organisation, composition and nomination to the Bank's governing bodies. The general orientation of the Bank therefore is to apply the BBP requirements to the extent possible, when not contradictory to the Bank's legal texts.

The Audit Committee encourages the EIB to proactively bridge the respective BBP gaps, whilst being mindful of the primacy of the Bank's Statute.

The Audit Committee regrets that progress has not yet been made by EIB to change the existing combination of responsibilities amongst certain Members of the Management Committee. The Audit Committee reiterates its prior years recommendation that all members of the management body should be able to act objectively, critically, independently and avoid potential conflicts of interests. In order to achieve that, unorthodox combinations of responsibilities, for example responsibility for the oversight of both first and second line of defence activities, should cease.

The Audit Committee takes note that the Bank is considering changes to the organisation at service level and possible future appropriate segregations at the level of the Management Committee and expects progress during 2018.

In this context, the Audit Committee takes note of the clarification that the Management Committee Members with second line of defence oversight will coordinate related policy matters to be submitted to the Management Committee. Furthermore, the Audit Committee notes that the second line of defence aspects concerning individual operations shall be discussed at the Management Committee as a whole in the presence of the respective services.

### **7.3.3 Remuneration policies and practices**

Articles 74 and 75 of the Capital Requirements Directive IV require that "remuneration policies and practices are consistent with and promote sound and effective risk management" as well as the need of an "oversight of remuneration policies". Furthermore article 450 of the CRR describes the disclosure

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<sup>7</sup>The EU banking reform package of November 2016: [http://eur-lex.europa.eu/resource.html?uri=cellar:9b17b18d-cdb3-11e6-ad7c-01aa75ed71a1.0001.02/DOC\\_1&format=PDF](http://eur-lex.europa.eu/resource.html?uri=cellar:9b17b18d-cdb3-11e6-ad7c-01aa75ed71a1.0001.02/DOC_1&format=PDF).

<sup>8</sup>Basel III reforms by the BCBS of December 2017: <https://www.bis.org/bcbs/publ/d424.pdf>

requirements of the remuneration policy. Both CRD IV and CRR rules are complemented by wider European Banking Authority guidelines on sound remuneration policies (EBA/GL/2015/22), effective on 1 January 2017. These Guidelines address remuneration related topics, including remuneration governance, remuneration structure, performance assessment, material risk takers - identified staff and disclosure requirements.

The Audit Committee noted the assessment of the current EIB remuneration practices against prevailing BBP requirements performed by Personnel. The Bank needs to address the gaps identified in this area as a matter of priority. The Audit Committee stresses that the EIB needs to ensure that it is compliant with BBP requirements from the date they become effective and that the necessary actions to address existing BBP requirements, where determined to be applicable, are implemented.

## 8 FOCUS AREAS GOING FORWARD

The EIB is affected by geopolitical events. The UK's decision to trigger Article 50 – and with it the imminent departure of a major shareholder – will see a significant impact on the Bank's capital base and future lending capacity. The EU remains in the midst of yet more profound change<sup>9</sup>. Many elements affecting the EU Bank's role and its future options will be externally influenced, including financial market regulation and political decisions which are taken at EU level on the future direction of the EU.

The outcome of these uncertainties will undoubtedly shape the future orientation of EIB. The Audit Committee understands that Management's current focus is on: readiness to address potential impacts on future business plans, the prioritization of cost discipline and flexibility to manage the cost and revenue base over time, IT strategy (e.g. best use of digitalisation and automation) and cyber security, together with close monitoring of the evolution of the Bank's capital adequacy. To meet these challenges Management is also rethinking its current organizational set up and future strategic orientations. The Audit Committee will follow these developments carefully.

In the coming year the Audit Committee will focus closely on initiatives undertaken to enhance the EIB Group's Internal Control and Risk Management Environment. These will include actions to further develop EIB Group oversight, the establishment of a complete map of risks, roles and responsibilities and to see that the three lines of defence model is effectively deployed across the Bank, including addressing the findings coming from the comprehensive review on Lending Appraisal and Approval Process.

With regards to the EIB's compliance with BBP, the Audit Committee will continue to take an active interest in the BBP Framework review process, the conclusion of which should help to clarify to key stakeholders the purpose and applicability of best banking practice and assist the Bank to focus attention and resources on achieving full compliance, and ensuring its readiness for future requirements.

The Audit Committee, as part of its statutory responsibilities, will also monitor and review the actions undertaken by the EIB's services to close the remaining BBP compliance gaps. Furthermore, as a result of the EU banking reform package, and most recently the finalization of the Basel III reforms, additional BBP requirements will enter into force in the coming years, which the EIB will need to comply with.

In terms of financial reporting and external audit related considerations, new International Financial Reporting Standards (IFRS) will enter into force, notably IFRS 9 Financial Instruments, as well as IFRS 15 Revenue from contracts to customers, which will apply as of the financial year beginning on 1 January 2018 and 1 June 2018, respectively. Preparing for the impact of these standards has very much been underway in 2017 which has required considerable time and resource efforts from EIB. In 2018, the Audit Committee will liaise with both the EIB's services and the external auditor to oversee the first time application of these new standards.

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<sup>9</sup> [https://ec.europa.eu/commission/white-paper-future-europe/white-paper-future-europe-five-scenarios\\_en](https://ec.europa.eu/commission/white-paper-future-europe/white-paper-future-europe-five-scenarios_en)

## 9 CONCLUSION

The Audit Committee was able to carry out its work at EIB to fulfil its statutory mandate under unrestricted conditions.

With reference to the Financial Statements, the Audit Committee is satisfied that the audit assurance obtained during the meetings, corroborated by the review of the documentation deemed necessary, 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 of the Financial Statements by the Board of Directors.

Based on work undertaken and the information received, including an unqualified opinion from the external auditors on the EIB's Group Financial Statements, and a representation letter from the Management Committee of the Bank, the Audit Committee concludes that the Financial Statements, as set out in section 1 (namely, the EIB's unconsolidated and consolidated Financial Statements under the EU Directives and the EIB's consolidated Financial Statements under the IFRS10), adopted by the Board of Directors present a true and fair view of the financial position of the Bank as of 31 December 2017 and of the results of its operations and cash-flows for 2017 in accordance with the applicable accounting framework.

The Audit Committee is able to extend the same conclusion to the Financial Statements, as of the same date, of the EU-Africa Infrastructure Trust Fund, the Neighborhood Investment Facility Trust Fund and the Investment Facility as these are covered to a large extent by the EIB's own risk control systems and internal and external audit arrangements.

With reference to the Audit Committee's verification of the Bank's compliance with Best Banking Practice, the Audit Committee dedicated significant time throughout the year to oversee the BBP work performed by the Bank, which is under the responsibility of the Management Committee. Attention is raised to the following BBP related matters and prior year recommendations noted in the main sections of this report, where action is required from by the Management Committee:

- Ensuring the long term financial strength and sustainability of the EIB and maintaining the AAA credit rating is paramount in an environment of uncertain geopolitical, economic policy, regulatory and macroeconomic developments. The EIB's financial strength and sustainability is preserved in part by the implementation of best banking practice. The conclusion of the ongoing BBP review should ensure the continued close focus by Management on fully implementing the BBP Framework,
- Certain EIB practices in the areas of EIB Group oversight, prudential risk management, corporate governance and remuneration policy and practices do not yet fully reflect the requirements of best banking practice, and in some areas pervasive compliance gaps remain. The Management Committee should ensure that all necessary actions are undertaken to close existing BBP gaps. In addition, EIB should seek to implement a holistic and forward-looking oversight of Best Banking Practice,

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<sup>10</sup> EIB's Financial Statements under the EU Directives comprise each unconsolidated and consolidated the balance sheet as at 31 December 2017, the profit and loss account and the cash flow statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information; the EIB's consolidated Financial Statements under IFRS comprise the consolidated balance sheet as at 31 December 2017, the consolidated income statement, the consolidated statement of profit or loss and other comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies and other explanatory information.

- The Audit Committee encourages EIB to continue to proactively bridge the respective Best Banking Practice gaps, whilst maintaining the primacy of the Bank's Statute. The Audit Committee notes that Management has not yet taken the initiative to change the existing combination of responsibilities amongst the Management Committee and reiterates its view that existing combination of responsibilities among certain Members of the Management Committee should cease, and
- With reference to group risk considerations, the EIB is the majority shareholder of the European Investment Fund, which together forms the main part of the EIB Group. The EIF deploys, in addition, various mandates on behalf of the EIB, including the Risk Capital Resources and EIB Group Risk Enhancement Mandate. The combination of both EIB's shareholding in the EIF and the management by EIF of EIB funds under mandate currently represent approximately 11 percent of the EIB's total regulatory capital requirements. The EIB is obliged through the implementation of BBP to play its role as majority shareholder of the EIF by seeking ways to enhance the oversight and management of risk, processes and internal controls from a Group perspective.

To this end, and in order for the EIB to comply with BBP which includes EIB Group related requirements, the Audit Committee again recommends that:

- a review of the terms of reference of the Bank's compliance, risk management and internal audit functions be initiated and that this review extends to EIB Group considerations,
- EIB as a Group entity enhances its capacity to capture and aggregate all material risk data, including the EIF, a significant subsidiary of EIB, in a manner which allows group monitoring, and
- EIB enhances existing group risk oversight and reporting controls, including the implementation of a group-wide approach to liquidity risk management and further extends the scope of the existing Internal Capital Adequacy Assessment Process and Internal Liquidity Adequacy Assessment Process documents to fully address group considerations.

With reference to the Audit Committee's oversight of the internal control and risk management environment of the EIB as well as the mandate of the external auditor, attention is drawn to the following matters raised in the main sections of this report, where action is required from the Management Committee of EIB:

- the Audit Committee considers that the rapid expansion of the EIB Group activities has not been matched by relevant adaptations in business structure or processes. To this end Management needs to ensure that internal processes, especially related to IT, cyber security and risk management, as well as corporate risk culture are reviewed as a matter of priority to see that they are fit to meet the demands and challenges of the EIB Group going forward,
- the Management of the EIB should ensure that an effective and sound risk culture is promoted where all EIB employees are aware of their own responsibilities in relation to risk management, compliance and internal control environment. The Management of the EIB should look to establish a complete map of risks, roles and responsibilities and see that the three lines of defence model is effectively deployed across the EIB Group with clear policies,
- the Audit Committee is concerned by the nature and extent of the IA findings reported in respect of the EIB's lending appraisal and approval process. In view of the evolving nature, size, volume and complexity of the EIB's operations, the Audit Committee considers that the loan appraisal and approval process and respective control environment does not appear to be able to cope with the current business needs and is evidence of pressure on services. Thus the credit approval and related decision-making process of the EIB should undergo a comprehensive review and be revamped. The Audit Committee requests that the Management Committee oversees and expedites the timely implementation of all of the findings raised in the IA report on the Bank's

lending appraisal and approval process initiated in 2017. The Audit Committee will closely monitor the implementation of IA's recommendations by the Management Committee.

- the Audit Committee also highlights the decline in the timely implementation of internal audit AAPs at the end of the year. The Audit Committee asks that Management of the Bank take action to ensure the timely implementation of these AAPs by the Bank's services,
- in July 2015 the Audit Committee requested that the Bank initiate a review of the Bank's whistleblowing policy. The existing whistleblowing policy dates from 2009. The Audit Committee received an update of the status of the project from OCCO in late 2017. The Audit Committee requests that the revision of the Bank's whistleblowing policy be expedited and concluded by mid-2018, and
- the Prudential Risk Appetite Framework approved by the Board of Directors in December 2015 should be extended without further delay to a full Risk Appetite Framework which considers also non-financial risks (e.g. conduct, IT and cyber risk, AML) and should address EIB group considerations. Risk appetite limits set out in the Risk Appetite Framework ought to be effectively translated into the first line of defence activities, so as to embed risk taking into the EIB's risk culture and the day-to-day management of risk. In addition, risk limits in the Risk Appetite Framework should be further enhanced and defined, in particular in relation to large exposures and liquidity. Group risk requirements in relation to the EIF should be incorporated accordingly.

In order to facilitate the process for the future and timely rotation of the EIB's external auditor, the EIB Group should:

- establish a list of the contracts with professional service firms, typically eligible to tender for external audit services, are providing to the EIB Group. The duration of such contracts should also be compiled, and
- address how the EIB Group may best balance its approach towards the use and management of contracts awarded to these professional service firms for consultancy work, and the need for external audit firms to adhere to rules regarding rotation.

Finally, the Audit Committee considers that it has adopted a balanced work approach during the year in terms of focus, objectives and means utilised to obtain the necessary assurance, believes that it has retained appropriate standing within the Bank and has maintained appropriate relations with the Management Committee and the Bank's Staff, as well as external auditors and consultants, while remaining independent at all times. In 2017 the Audit Committee received the expected full support from the Bank's Management and services, thus the Audit Committee was able to properly discharge its responsibilities.

**Luxembourg, 22 June 2018**

**Signed by:**

**P. KRIER**

**D. PITTA FERRAZ**

**J. SUTHERLAND**

**J. DOMINIK**

**M. MACIJASKAS**

**V. IUGA**

**U. CERPS**

**J.H. LAURSEN**

**AUDIT COMMITTEE**

**Annual Report to the Board of Governors**

**Investment Facility**

**For the 2017 financial year**



**AUDIT COMMITTEE**

**ANNUAL REPORT TO THE BOARD OF GOVERNORS**

**ON THE INVESTMENT FACILITY**

**For the 2017 financial year**

**Table of contents:**

<b>1</b>	<b>INTRODUCTION - the role of the Audit Committee.....</b>	<b>32</b>
<b>2</b>	<b>AUDIT COMMITTEE REVIEW .....</b>	<b>32</b>
<b>3</b>	<b>THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2017 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE.....</b>	<b>33</b>
<b>4</b>	<b>CONCLUSION .....</b>	<b>34</b>

## **1 INTRODUCTION - the role of the Audit Committee**

The Audit Committee is responsible by Statute for the auditing of the European Investment Bank's ('EIB' or 'the Bank') Financial Statements, including those of the mandates; the verification that the Bank's activities conform to best banking practice ('BBP'); and the oversight of the proper conduct of the Bank's operations, in particular, with regards to risk management and monitoring.

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. The Audit Committee issues a statement each year, confirming to the best of its knowledge and belief, that the Investment Facility's ('IF') financial statements, prepared in accordance with the International Financial Reporting Standards as adopted by the European Union (IFRS), give a true and fair view of the IF's financial position and its cash flows for the year then ended (see section 3 for more details).

## **2 AUDIT COMMITTEE REVIEW**

The assurance expressed by the Audit Committee is based on the work of the external auditor performed by KPMG, but also on the fact that the IF relies on a number of systems provided by the Bank, notably the ones of: risk management, human resources management, treasury management and financial reporting. The Audit Committee obtains an understanding of the activities and risks associated with the various developments by reviewing management reports and by interacting with the relevant Bank services involved in the IF activities.

### **Meetings with Management**

The Audit Committee has met during the past year with the Management of the IF within the EIB, who provided details about the recent developments and future orientations for the IF and the Bank's activities in Africa, the Caribbean, and the Pacific (ACP) region in general. The IF portfolio, including the watch list, together with current project trends were discussed.

### **External auditors (KPMG)**

The external auditors responsible for the audit of the IF's financial statements are appointed by and report to the Audit Committee. In order to be able to rely on the work performed by the external auditors, the Audit Committee has properly monitored KPMG's 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.

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

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

## Internal Audit

The Internal Audit ('IA') Department is an independent function within the EIB with a direct reporting line to the Bank's President. The Head of IA retains unrestricted access to the Audit Committee and may request private sessions.

The Audit Committee met with the Head of IA at eight of the 10 meetings held in 2017. The Audit Committee discussed all the significant internal audit recommendations and agreed action plans, together with the unit responsible for implementation. The EIB's Internal Audit has performed no specific internal audits in relation to the IF during the reporting period.

## Inspectorate General

The internal oversight function at the Bank is headed by the Inspector General (IG). The Inspectorate General comprises of three lines of service: fraud investigation, operations evaluations and complaints mechanism. IG has a privileged relationship with the Audit Committee; the Inspector General retains unrestricted access to the Audit Committee and may request private sessions. In carrying out its responsibilities, the Audit Committee meets regularly with IG and examines IA reports and ongoing cases with the Fraud Investigations Division.

The Audit Committee met with the IG at four of the 10 meetings held in 2017. The Audit Committee examined and discussed with the IG the on-going cases under their remit. The Audit Committee advised IG to improve the feedback loop where lessons learnt from these investigations are reported back to EIB services. The Audit Committee received presentations of the updated Fraud Investigations Charter and Fraud Investigations Annual Report, and the outcome of selected proactive integrity reviews together with proposals to review the proactive integrity review methodology. The Audit Committee also received an overview of the work of the Operations Evaluation Division and the results of selected operations' evaluations. In addition, the Audit Committee was informed about any alleged cases of wrongdoing and ongoing investigations relating to Bank projects, including IF operations, if applicable.

## European Court of Auditors

The Audit Committee notes that the European Court of Auditors did not perform any audits related to the IF during the year ended 31 December 2017.

### 3 THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2017 AND THE ANNUAL STATEMENT OF THE AUDIT COMMITTEE

The Audit Committee examined the Investment Facility's 2017 financial statements, prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union 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.

#### Basis of accounting

In accordance with the Investment Facility Management Agreement ('the Agreement'), the Bank prepares financial statements guided by International Public Sector Accounting Standards or International Accounting Standards as appropriate. The accounting framework applied to the IF's financial statements is the IFRS as adopted by the European Union.

The financial statements of the Investment Facility comprise of the statement of financial position as at 31 December 2017, the statement of profit or loss and other comprehensive income, the statement of

changes in contributors' resources, the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information, the results of its operations and of its cash flows for the respective year, in accordance with the accounting framework applied by the Bank.

#### **4 CONCLUSION**

In 2017, the Audit Committee aimed 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. The Audit Committee has received full cooperation from the Management of the Investment Facility within the EIB during the reporting period.

Based on the work undertaken and the information received (including the opinion from the external auditor on the financial statements and a representation letter from the Management of the Bank), the Audit Committee confirms that the financial statements of the Investment Facility, which comprise the statement of financial position as at 31 December 2017, the statement of profit or loss and other comprehensive income, the statement of changes in contributors' resources, the statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information, give a true and fair view of the financial position of the Investment Facility as of 31 December 2017, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

On this basis, the Audit Committee signed its annual statement on the Investment Facility's 2017 financial statements, prepared in accordance with IFRS as adopted by the European Union, as of 15 March 2018, the date on which the EIB Board of Directors has approved the submission of the Investment Facility financial statements to the EIB Board of Governors.

**Luxembourg, 22 June 2018**

**Signed by:**

**P. KRIER**

**D. PITTA FERRAZ**

**J. SUTHERLAND**

**J. DOMINIK**

**M. MACIJAUSKAS**

**V. IUGA**

**U. CERPS**

**J.H. LAURSEN**

**AUDIT COMMITTEE**

**Response of the Management Committee  
To the Annual Reports of the Audit Committee  
For the 2017 financial year**

**RESPONSE OF THE MANAGEMENT COMMITTEE**

**TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE**

**FOR THE 2017 FINANCIAL YEAR**

**Table of Contents**

<b>1</b>	<b>INTRODUCTION.....</b>	<b>37</b>
<b>2</b>	<b>RESPONSE TO KEY AUDIT COMMITTEE OBSERVATIONS .....</b>	<b>37</b>
<b>3</b>	<b>INTERNAL CONTROL – AUDITING &amp; RELATED ACTIVITIES .....</b>	<b>41</b>
<b>4</b>	<b>RISK MANAGEMENT.....</b>	<b>43</b>
<b>5</b>	<b>BEST BANKING PRACTICE .....</b>	<b>45</b>
<b>6</b>	<b>THE INVESTMENT FACILITY.....</b>	<b>49</b>
<b>7</b>	<b>LOOKING AHEAD.....</b>	<b>50</b>
<b>8</b>	<b>CONCLUSION .....</b>	<b>52</b>

## 1 INTRODUCTION

- 1.1 Within the Bank's statutory framework, the Board of Directors has overall responsibility for maintaining a sound system of internal control that supports the achievement of the Bank's policies, aims and objectives while safeguarding its funds and assets. The Management Committee, under the supervision of the Board of Directors, has the day-to-day responsibility for the system of internal control based on ongoing identification, evaluation and management of the principal risks to the achievement of policies, aims and objectives.
- 1.2 The Audit Committee of the EIB is responsible for the auditing of the financial statements, verifying the implementation of Best Banking Practice (BBP) applicable to the Bank and ascertaining that the Bank's activities are conducted in a proper manner.
- 1.3 The Annual Reports of the Audit Committee are prepared annually and addressed to the Bank's Board of Governors, in line with the Statute of the Bank and the Rules of Procedure. The reports cover the results of its work since the date of the previous annual reports.
- 1.4 This document presents the response of the Bank's Management Committee to the points raised by the Audit Committee in its annual reports for the 2017 financial year.

## 2 RESPONSE TO KEY AUDIT COMMITTEE OBSERVATIONS

- 2.1 In recent years, the Bank's business has changed dramatically, particularly due to the increase in mandate activities, notably the European Fund for Strategic Investments (EFSI). The volume, diversity and complexity of the Bank's transactions as well as its customer base has been transformed. This level of change is coupled with an increasing number of prudential and non-prudential requirements impacting Group activities and cannot continue *ad infinitum*. As the EU economy moves into growth, the Management Committee believes it is time to take stock and engage with stakeholders to ensure alignment of ambitions and expectations. In these uncertain times, the Bank is more aware than ever of the need to secure financial sustainability and maintain its high credit rating – risk taking therefore continues to be exercised in a stringent manner, with an active approach to the mitigation of risk.

- 2.2 In its annual reports the Audit Committee highlighted observations related to four key areas on which the Management Committee elaborates as follows:

### **Preserving the Bank's Financial Strength**

- 2.3 The Management Committee agrees with the Audit Committee's assertion that maintaining the EIB's high quality rating is a natural precondition to the Bank being able to sustainably deliver its mission. It therefore reiterates its uncompromising commitment to maintaining the highest credit standing which is more important than ever in the face of current political events.
- 2.4 The EIB Group Operating Framework and Plan 2018 (Operational Plan) identifies the potential impacts of political, regulatory and macroeconomic developments on the Bank's future activities and articulates key aspects that will be pursued based on current knowledge and expected evolution. Financial sustainability, as well as the external environment were a key focus when defining the 2018 lending programme: the Bank strives for stability of earnings and preservation of the economic value of own funds, in order to ensure the self-financing of the Bank's growth in

the long term. Furthermore, it continues to manage its own available resources and risk bearing capacity, so as not to endanger its credit rating.

- 2.5 The EIB's high credit standing is mainly driven by its solid capital position, robust asset quality and evidence of shareholder support. In addition, the Bank's management shares the Audit Committee's view that the maintenance of the highest credit standing is inextricably linked to the implementation of BBP and sound risk management practices. As such, critical importance is placed on the adherence to those BBP applicable to the Bank.
- 2.6 A project to establish a holistic and forward looking oversight of BBP applicable to EIB and thus taking into account its role as a Treaty-based policy institution was initiated in 2016. Following extensive consultation with the Audit Committee, a set of BBP Guiding Principles will be submitted to the Board of Directors for approval in the first half of 2018, and subsequently to the Board of Governors under written procedure. The Guiding Principles set forth the BBP principles and assessment criteria, combined with adaptation requirements for determining and adapting BBP rules applicable to the EIB. A progress update on this project as well as actions, reviews or investigations underway to address elements for further compliance with BBP applicable to EIB are included in section 5.

#### **Enhancement of the Internal Control and Risk Management Environment**

- 2.7 The Management Committee acknowledges that the rapid change in the nature and complexity of its activities in recent years has not necessarily been matched by relevant adaptations in structure or processes. The maintenance and strengthening of the Bank's internal control and risk management environment and the promotion of a risk awareness culture amongst its employees remains of the highest priority. Indeed, 2018 marks a time for reflection on the Bank's structure and processes with a clear focus on accountability and compliance. The Management Committee commits to providing the Board of Directors and the Board of Governors with the relevant analysis and proposals in order to move forward with this agenda.
- 2.8 The Management Committee concurs with the Audit Committee's view that the promotion of a risk awareness culture throughout the organisation is paramount, and is clear in its message that risk management is the responsibility of all services, not just the named risk and control functions. To further support this message, and in line with the Audit Committee's recommendations, the responsibilities of all services in relation to each risk category are being reviewed and mapped in the context of the "Three Lines of Defence for Effective Risk Management and Control" (Three Lines of Defence) model. The Internal Control Framework documentation is being enhanced to clearly articulate how significant risks for each key process are being mitigated through the lines of defence. This continuous exercise serves to clearly map risks and to document responsibilities of first, second and third line of defence functions with the aim of further promoting a risk awareness culture throughout the Bank.
- 2.9 In 2015, the Board approved the first version of the Bank's Risk Appetite Framework (RAF) which formally defines and documents the level of risk that it is able and willing to incur in pursuing its activities in the context of its mandate and objectives. This was a first major step towards building a comprehensive and effective RAF. In order to further align to best banking practice and embed prudent risk taking into the EIB's risk awareness culture and day to day management of risk, further improvements to the RAF including the addition of non-financial (operational,



compliance, conduct and reputational) risks and the cascading down of some of the Bank's RAF metrics have been initiated. This is a Bank-wide project which will expand and refine the current RAF with an implementation period lasting until 2019.

- 2.10 The Management Committee is also supportive of the Audit Committee's recommendation to review the terms of reference of the Bank's control and risk functions within the context of the EIB Group. As part of on-going Group effectiveness and efficiency streamlining efforts, the membership of the Bank's Compliance and Control Committee, established in 2015 to monitor compliance and control risks has been expanded. In addition to the Group Chief Compliance Officer, the Inspector General and the Financial Controller, the Deputy Chief Executive of the European Investment Fund (EIF) and the Director General of the Risk Management Directorate are now full members of the Committee.
- 2.11 The enhancement of risk management processes and internal controls from a Group perspective is very much in the interest of the EIB, being the majority shareholder of the EIF. In this respect the Bank is in the process of revising the Group Risk Management Charter in order to subsequently ensure adherence to sound risk management principles at the Group level.

#### **Compliance with applicable Best Banking Practice Framework**

- 2.12 According to Article 12 of the EIB Statute, the activities of the Bank have to conform to Best Banking Practice (BBP). The Rules of Procedure refer to adherence to BBP "applicable to it" implying that the specificities of the EIB's business model warrant modified application of the regulatory requirements. Since the introduction in 2009 of the statutory requirement on BBP, the Audit Committee and the Board of Directors have identified the general framework which sets out the BBP reference documents applicable to the EIB, against which the Bank's compliance with BBP is assessed. The BBP framework is based on the hierarchy of relevant legal and regulatory rules consisting of the EU Treaties, EIB Statute and Rules of Procedure, EU banking directives and regulations and further standards and guidelines issued by regulatory bodies (such as BCBS). On the basis of annual self-assessments undertaken by the Bank's services, the Audit Committee approves updates to the BBP framework and verifies its implementation, the outcome of which it reports to the EIB's governing bodies on an annual basis.
- 2.13 The EIB adopts a transparent and proactive approach to conforming to those BBP applicable to it, and is convinced of the associated strategic and business benefits including, but not limited to:
- assurance to Members (i.e. the Member State shareholders) and other stakeholders that the EIB, as an EU body as well as a bank, is paying appropriate due diligence to EIB own funds and, as requested by the providers of, third party funds managed by it;
  - enhanced governance, transparency, accountability and control framework of the EIB in line with the expectations of the European Parliament;
  - the long-term financial sustainability and soundness of the EIB as a bank, as well as the stability and integrity of financial markets; and assurance to Members and other stakeholders that EIB's sustainability forecasts are measured according to industry norms;

- asset quality assurance through stress testing referenced to standards applied in supervised EU financial institutions;
  - enhanced strategic profiling with which to reinforce EU institutional strategic partnerships notably with the European Commission;
  - enhanced reputation and credibility among stakeholders in general, and in particular counterparts and other partners who may have obligations to only do business with entities who adopt certain sound banking practice and standards (e.g., other banks and other international financing institutions).
- 2.14 Details of the EIB's BBP implementation and verification methodology, as well as details of elements for further compliance and actions underway to address them are included in section 5.
- 2.15 The Bank acknowledges and agrees with the Audit Committee's view that members of the Management Committee should be able to act objectively, critically and independently in relation to oversight of first and second line of defence activities. The Management Committee approves policies and financing proposals as a collective body; its members are increasingly focusing on the sectoral oversights such as climate, SMEs, energy or transport. Furthermore, the Management Committee members overseeing second line of defence activities have confirmed that they are overseeing policy matters to be approved by the Management Committee. The Bank is planning a strategic review of the existing organisational structure, reporting lines and responsibilities at service level, as well as group risk considerations. In this ongoing context, the existing combination of Management Committee members' oversights will be examined and may include related adjustments.

#### **Internal Audit Review of the Lending Appraisal and Approval Process**

- 2.16 The points raised in the recent Internal Audit review of the Bank's lending appraisal and approval process, are of significant concern to the Management Committee and addressing the agreed action points is a key priority for 2018. The actions relating to the governance of the credit decision making process and its capacity will be considered in the context of the review mentioned in 2.7 above. Furthermore, the relevant first and second line services of the Bank are committed – through agreed actions – to develop a clear understanding of their roles with a view to strengthen the risk management framework.

### 3 INTERNAL CONTROL – AUDITING & RELATED ACTIVITIES

- 3.1 The Bank is subject to significant independent review throughout the year, as well as at the year end. 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 an EU 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.
- 3.2 In 2017 the Management Committee revised the Bank's Internal Audit Charter, a formal document defining the purpose, authority and responsibility of the Internal Audit function. The charter was updated to reflect the establishment of Internal Audit as an autonomous department in 2016 with direct reporting of the Head of Internal Audit to the President, the transfer of responsibility for the Internal Control Framework to Financial Control and the authority of the Audit Committee to request ad-hoc assignments. A further update of the Charter will be initiated in 2018 in order to include a reference to Group wide audits.
- 3.3 During 2017, the EIB Audit Committee and the EIF Audit Board signed a "Cooperation Paper", which introduced the concept of "joint audits in areas of mutual relevance to both institutions" - several planned Bank audits were therefore enlarged as pilot Group-wide audits. The Group audit enhancements, as well as two special request audits significantly impacted the achievement of the 2017 Internal Audit Plan. As a consequence, certain assignments originally planned to commence in 2017 were postponed to 2018/2019. The relevance of BBP in the overall work of Internal Audit and the number of specific assignments continued to grow in 2017, with approximately 17% of resources allocated to this area.
- 3.4 As in prior years, the Management Committee continues to place strong emphasis on the timely clearance of Internal Audit Agreed Action Plans (AAPs), particularly those relating to high priority matters. The Management Committee is aware that the performance on overdue agreed action plans both in terms of the absolute number and relative percentage remains unsatisfactory compared to recent years. The need for an organisational commitment to respect agreed resolution dates is (and will continue to be) regularly reiterated to Directors General, and a process for close monitoring and follow up is being put in place within the Bank's Secretariat General.
- 3.5 The 2018-2020 Internal Audit plan was approved by the Management Committee following consultation with the Audit Committee. The Audit Plan is derived from a Bank-wide risk assessment, which seeks to ensure periodic audit coverage of all major risk areas. Audits are targeted at prioritising the main risks facing the Bank while at the same time providing broad coverage of the main areas of activity. For the first time the plan was presented with a Group perspective. Several audits will form a common component in both EIB and EIF Audit Plans and these audits will be conducted and communicated with a Group focus. Group audits planned for 2018 include Group Risk Management and Compliance / Anti-Money Laundering and Know Your Customer processes. Bank specific aspects to be covered in 2018 include reviews of Loan Pricing and Cost Management, with BBP reviews planned on the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP), the

Risk Management BBP Project and the Basel / Capital Requirements Directive (CRD) – Credit Risk Model Review.

- 3.6 The Management Committee have received the external independent quality review of the effectiveness of the Bank's Internal Audit processes, practices and standards. The review, performed by Deloitte in 2017, concluded that Internal Audit generally conforms with the Institute of Internal Auditors Standards and Codes of Ethics. Furthermore, the report highlighted that many of the best practices consistent with internal audit functions across the financial services industry have been adopted. Recommendations on areas for improvement will be addressed by Internal Audit and progress will be monitored by the Management Committee throughout 2018.
- 3.7 The Internal Controls & Assertion Division within Financial Control was created in 2016 in order to strengthen the Bank's second line of defence. The Division took over responsibility for monitoring the appropriate implementation and maintenance of the Internal Control Framework across all Directorates. The Internal Control Framework Policy, maintenance procedures and tools are being developed and formalised, reinforcing the internal control environment, aligning practices to international standards and promoting a Bank-wide risk awareness culture.

## 4 RISK MANAGEMENT

### General Risk Management Approach

- 4.1 In order to maintain the Bank's financial stability, as reflected by its high credit rating, risk taking at the EIB is exercised in a stringent manner. As such, robust risk management processes are maintained and risks are accepted up to a level where these risks are aligned with the Bank's risk appetite, i.e. the amount of risk that it is willing and able to take in the pursuit of its public mission and objectives.
- 4.2 The Board of Directors is kept informed of the on-going risk-related developments, including the potential impact of changes in market circumstances, on EIB's financial stability and overall business model through monthly and quarterly risk and risk management outlook reports. Within the Board of Directors, the Risk Policy Committee meets no less than four times per year (in 2017, 8 times) to review the Bank's policies with regard to credit, market and liquidity risks. The risk reports are reviewed and discussed by the Risk Policy Committee as well as with the Audit Committee.

### Specific Risk Management Activities

#### Capital Planning and Capital Requirements

- 4.3 The Bank uses a CRD IV/CRR compliant methodology to measure its capital adequacy (CAD). The CAD ratio and other capital and leverage metrics are monitored on an on-going basis to ensure that the risk profile of the EIB is maintained within its RAF limits.
- 4.4 To the extent possible, depending on the status of existing and forthcoming prudential regulation and related guidance, the Bank assesses its capital adequacy on a forward looking basis as well as at a particular point in time. The Bank will continue to quantify the impact of upcoming regulatory changes on its CAD ratio in a forward looking manner. CAD projections are included in the Bank's Operational Plan and the monthly risk reports.
- 4.5 Further improvements are expected to be made to the Bank's next ICAAP document. As recommended by the Audit Committee, the Bank has enhanced the definition and justification for the materiality assessment for individual risk types and enlarged the definition of capital adequacy to other capital-related risk appetite metrics of the RAF, such as the gearing ratio and the regulatory leverage ratio.
- 4.6 During 2017, the Bank carried out the first internal Bank-wide Macroeconomic Stress Testing (MEST) exercise. The overall exercise was based on an internally developed macroeconomic scenario, which was applied consistently across all considered risk types. The MEST stress test results show the robustness of the EIB's capital position and will be incorporated in the ICAAP 2017 report.
- 4.7 Further information on the Bank's work plan with respect to capital adequacy requirements is also provided in section 5 below.

#### Credit Risk Monitoring

- 4.8 Due to the uncertain external environment and the challenges this poses for future planning, the Bank will continue to take a prudent approach and only make commitments within acceptable risk boundaries. The high levels of higher risk activities benefitting from the EFSI / EU budget first

loss portfolio guarantee will be sustained, notably under EFSI 2.0. The Bank will seek new initiatives with similar risk mitigation techniques in order to remain aligned to its risk appetite. The Bank's strong control and monitoring functions will continue to ensure that activity levels are financially sustainable. The focus on continuous assessment of credit risk is evidenced by low levels of impaired loans and the decreasing trend of loans on the watch list.

#### Liquidity Risk Monitoring

- 4.9 Liquidity risk is managed prudently in order to ensure the regular functioning of the Bank's core activities in both normal and stressed conditions. The adequacy of the Bank's liquidity buffer is monitored through liquidity ratios and other indicators, which have to remain within conservative pre-defined limits. As part of the liquidity risk management process, the Bank monitors its prospective cumulative funding gaps, leading to funding recommendations to limit annual re-financing needs. Within the framework of its eligibility for Eurosystem operations, the Bank provides information on liquidity matters to the Central Bank of Luxembourg to enable them to fulfil their formal role as the independent oversight body in relation to the Bank's liquidity situation.
- 4.10 During 2017 several key enhancements were made to the Bank's internal liquidity risk framework. These included:
- Completion of the set-up of official Early Warning Triggers and Risk Appetite Boundaries for the Liquidity Coverage Ratio (LCR), hence finalising the related aspects in the RAF;
  - The calculations of the Net Stable Funding Ratio (NSFR) in line with the Basel Committee on Banking Supervision (BCBS) guidelines have been reviewed by external consultants and are fully compliant with the BCBS methodology;
  - The first ILAAP report (end 2016) was issued according to the applicable guidelines published by the European Banking Authority. The second ILAAP report (end 2017) will be further expanded to better reflect EIF in the liquidity position of the Bank;
  - An analysis of the implications of the use of derivatives on liquidity risk has been prepared and the findings discussed with the Audit Committee;
  - The Bank performed a "snap drill" of EIB's contingency liquidity procedure and has subsequently reviewed and revised its Contingency Funding Plan document which will be submitted to the Board for approval in due course;
  - Liquidity stress testing has been enhanced with the introduction of a stress scenario dedicated to contingent outflows for mark-to-market swaps.
- 4.11 To further strengthen its liquidity resilience, the Bank began implementing a collateral management system in 2015 which is expected to be completed in 2018. The system will allow the Bank to enlarge its liquidity sources, in line with Central Bank of Luxembourg (BCL) recommendations made in 2013 and with BBP applicable to the Bank. So far the project has delivered selected inventory and margining functionalities. Furthermore, the Eurosystem's real time gross settlement system TARGET2 replaced Deutsche Bank for the EIB's EUR payments in all parts of the back office. This removed the EIB's reliance on commercial bank intraday credit lines

and allowed the Bank to manage its own intraday liquidity via the posting of collateral at the Central Bank of Luxembourg.

- 4.12 In 2018 the Bank will start a full revision of its internal liquidity risk framework, in particular to take into account off-balance sheet aspects such as collateral management.

## 5 BEST BANKING PRACTICE

### Implementation and Verification Methodology

- 5.1 To consolidate the various BBP initiatives already undertaken by the Bank and in line with Audit Committee recommendations, the Management Committee initiated a project during 2016 to establish a holistic and forward looking oversight of Best Banking Practice which will further codify the BBP requirements applicable to EIB, and also to prepare a central point which documents the implementation thereof as well as more formally defining the respective roles of the governing bodies, the Audit Committee and the services of the Bank vis-à-vis this important subject.
- 5.2 The project, coordinated by the Secretariat General, will therefore lead to clarify the scope and substance of best banking practice applicable to the EIB; notably it is intended to codify the regulatory requirements in the form of: (i) BBP Guiding Principles; (ii) Internal Applicability Assessment Procedure; and (iii) BBP Book.
- 5.3 Following extensive consultation with the Audit Committee, the BBP Guiding Principles will be submitted to the Board of Directors for approval in the first half of 2018 and subsequently to the Board of Governors under written procedure. At the request of the Audit Committee the BBP Guiding Principles adopt a “comply or explain” approach. Unless the BBP Guiding Principles or the BBP Book expressly provide otherwise, the EIB will be expected to comply with all legislative acts and guidelines which are applicable to commercial banks; issued or adopted by EU institutions, bodies and agencies; and relevant to its activities.
- 5.4 The BBP Book is designed to centrally document and describe all the Rules not fully or partly applied by the EIB, including any adaptations to the Rules falling in the scope of BBP applicable to the Bank together with the rationale for any adaptations and - where appropriate – specifying mitigating measures in line with the EIB’s public policy nature and mission. These non-applications and adaptations to the Rules will be identified based on an Applicability Assessment Procedure according to which any new Rules or modification of existing Rules being considered to be included in the BBP Book will be assessed against certain criteria set out in the Guiding Principles. Subject to approval of the Guiding Principles by the Board of Governors, the Board of Directors will be requested to approve the BBP Book later in 2018.
- 5.5 BBP is a dynamic term – both as a concept and in substance. BBPs will change and evolve over time as legislation, banking industry standards and guidance and relevant related professional practices develop. For this reason, in order to ensure that the EIB applies the appropriate and most recent Rules, and that the BBP Book is appropriately up-to-date, the Applicability Assessment Procedure will set forth the responsibilities of the EIB Services concerned and the details of the key operational steps of the process that the EIB shall use not only to identify relevant Rules, and assess and make recommendations on their applicability/non-applicability to the EIB but to also consistently:



- (i) where appropriate, specify appropriate mitigating measures in case of adaptation or non-application of rules;
  - (ii) implement new/changes in the Rules falling in the scope of Best Banking Practice applicable to the EIB; and
  - (iii) ensure relevant reporting of implementation status to the governing bodies of the EIB.
- 5.6 Given that the regulatory requirements generally apply to financial institutions not only at an individual level, but as importantly at a group level, the EIF may also be subject to best practice as a consolidated entity of the EIB. Consequently, should it be considered that whilst the EIF does not need to comply with best banking practice at an individual level, it is recognised that the EIF still need to be equipped to support regulatory compliance at the EIB Group level (e.g. provide necessary information and data).
- 5.7 Until the BBP Guiding Principles, the BBP Book and related procedures are in place, the Bank's existing BBP framework will nevertheless still be maintained, including the annual self-assessment exercise conducted by each Directorate. Elements for further compliance by the Bank have been identified in 2017 and actions, reviews or investigations are underway to address them (see § 5.8 – 5.18 for further details).

#### **Prudential Risk Management**

- 5.8 The Bank remains broadly compliant with the qualitative and quantitative elements of the CRD IV/CRR, current BCBS and European Banking Authority guidelines and practices. Since 2014, in order to address remaining areas for compliance, a specific BBP programme and target road map has been drawn up and continually updated and additional internal and external resources allocated to BBP. The prudential BBP programme is run under the supervision of a dedicated Steering Committee, comprising senior managers from the Bank's first and second lines of defence as well as from IT. Progress is reported regularly, both to the Management Committee and to the Audit Committee.
- 5.9 As of end 2017, 56 projects have been initiated since the beginning of the programme in 2014, 34 have been closed, 18 remain active, with 4 on hold. During 2017 the following major steps were completed in high priority projects; the Recovery Plan and the Capital Contingency Plan were approved by the Board of Directors, the annual ICAAP and the EIB Group Risk Disclosure Report ('Pillar 3 Report') were prepared, the LCR was implemented and the transversal Macroeconomic Stress Test was conducted at the Group level.
- 5.10 During 2018, the following high priority projects are scheduled to be completed: the Large Exposures Framework (full coverage of connections between clients), implementation of the NSFR and Revised Securitisation Framework and Credit Risk Control Unit (CRCU). Significant progress in implementation is expected in the 2018 with respect to projects on the enhanced Risk Appetite Framework (RAF 2.0), Interests Rate Risk in the Banking Book (IRRBB), Settlement Risk and the Risk Data Aggregation and Risk Reporting (BCBS 239) projects.
- 5.11 In view of the forthcoming changes to the prudential requirements as presented by the Commission in November 2016 (CRD V/ CRR II), an impact assessment of implications for the EIB has been conducted. Further analysis is ongoing as the legislative text is being finalised by the EU regulators.



- 5.12 In addition to the identification and review of BBP applicable to the Bank embedded into all phases of the audit, each year Internal Audit perform a specific review of aspects of the credit risk framework in order to comply as BBP with the relevant requirements of CRD IV/CRR. The 2017 review focussed on (i) the credit risk model review for treasury derivatives and remuneration; (ii) the ICAAP and ILAAP 2016 reviews; and (iii) the EIB Group Risk Disclosure Report.

#### **Corporate Governance**

- 5.13 The Bank applies the BBP applicable to it in the field of corporate governance and transparency to the extent possible, given the precedence of the Statute in respect of the organisation, composition and nomination to the governing bodies.
- 5.14 The Bank is in the process of revising its Codes of Conduct and Whistleblowing Policy, considering best practices and the EU Institutions and International Financial Institutions standards, whilst incorporating the principles of EU legislation, as appropriate. The revised Codes of Conduct will strive to adopt a positive tone in general and take into consideration the increased size of the Bank, its multicultural dimension and its specific role as not only a Bank but a policy driven institution. The revised Whistleblowing Policy aims to simplify the current document and make it more accessible to staff members and other stakeholders, encouraging them to adhere to a speak-up culture. The Bank expects to finalise the revision of the Staff Code of Conduct and Whistleblowing Policy in 2018.

#### **Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT)**

- 5.15 Following the Management Committee's approval of the EIB Group AML-CFT Framework in 2014, the Bank has developed the revised AML-CFT processes, workflows and IT upgrades, to ensure the implementation of the AML-CFT framework under the co-ordination of the AML-CFT Steering Committee. These processes and controls are outlined in the EIB AML-CFT Procedure, with specific responsibilities assigned to first and second line of defence functions. In line with the requirements of the 4th AML Directive, the EIB Group AML-CFT Framework is published on the EIB website.
- 5.16 In 2017, the respective Compliance teams of EIB and EIF have considerably strengthened their engagement on policies, processes and procedures, fostering the Group Compliance culture. This co-operation and increased interaction has been formalised by a Framework of Cooperation. In 2018, the Group Compliance function will continue discussions with the Compliance function of the EIF to ensure Group alignment, to the extent applicable, on AML-CFT procedures and processes.
- 5.17 A comprehensive revision of the Know Your Customer (KYC) records of the existing Relevant Counterparties (the "legacy" portfolio project) was launched in 2016, with progress closely monitored by the AML-CFT Steering Committee. This project was completed by the end of 2017 with adequate minimum standard KYC documentation obtained. Furthermore, as from the beginning of 2017, any active Relevant Counterparty falls under the periodic KYC review foreseen by the EIB AML-CFT Procedure.

**Remuneration policies and practices**

- 5.18 Articles 74 and 75 of the CRD IV request that “remuneration policies and practices are consistent with and promote sound and effective risk management” as well as the need for an “oversight of remuneration policies”. Furthermore article 450 of the CRR describes the disclosure requirements of the remuneration policy. Both CRD IV and CRR rules are complemented by wider European Banking Authority guidelines on sound remuneration policies (EBA/GL/2015/22), which came into force on 1 January 2017.

In 2017, the Bank performed a gap analysis of the current remuneration practices against prevailing BBP requirements, a detailed assessment of the finding of this analysis will be presented to the Audit Committee in April 2018.

**6 THE INVESTMENT FACILITY**

- 6.1 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, 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 own resources supported operations.
- 6.2 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.

## 7 LOOKING AHEAD

- 7.1 Europe remains in the midst of profound change. Many key elements impacting the EIB's role longer term and the delivery of its shorter term Operational Plan will be externally influenced and create a high level of uncertainty. For this reason, and in particular to align to the timeline of Article 50 negotiations, exceptionally a one year Operational Plan for 2018 was approved by the Board of Directors. Preliminary indications for the subsequent two years are included, however during 2018 progress on the Article 50 negotiations will be closely followed. Throughout 2017 the Management Committee has kept the Member States informed on the consequences for the Bank of the Article 50 negotiations and the associated potential mitigants - this dialogue will continue into 2018 and beyond.
- 7.2 The exceptional one year Operational Plan for 2018 sets out a cautious and flexible approach to the Bank's activities in light of the uncertain external environment. As the EU economy moves into growth, and the Bank celebrates its 60<sup>th</sup> anniversary, the time is viewed as opportune to take a critical look at the responsibilities and organisation of the EIB Group and ensure that necessary adaptations are made to make best use of overall EU Member States resources. In this context, the Management Committee will carefully consider the centralisation of Group level functions as recommended by the Audit Committee.
- 7.3 Looking ahead, EIB management proposes to reorganise its services supporting external lending activity in order to respond better to the priorities set by EU Member States, the EU's External policies and the New European Consensus on Development. The proposal is intended to improve the Group's internal governance, manage costs and optimise EIB's use of existing public resources such as guarantees.
- 7.4 In the rapidly evolving regulatory environment, ensuring compliance with existing and emerging BBPs which are applicable to the Bank has an impact on Bank-wide business processes and potentially on operational and policy target achievement which should not be under-estimated. Continuing to achieve and maintain compliance with the prudential and non-prudential BBP requirements poses a material challenge to the Bank in terms of dedicated human resources available as well as systems and data capabilities.
- 7.5 The upcoming regulatory changes are expected to have a negative, albeit not material, effect on the prudential ratios of the EIB reducing its risk bearing capacity and implementation will require significant effort and resources. The exact impact will be assessed once EU legislators have finalised the CRD V/CRR II proposals and final regulatory texts are available. Furthermore, in December 2017 the BCBS finalised the post-crisis Basel III reforms which introduce significant changes to the methodology used to calculate regulatory capital requirements. The implementation of the BCBS reforms is scheduled from the beginning of 2022 - according to the initial assessments, the EIB is not expected to be significantly affected.
- 7.6 IFRS 9 and IFRS 15 were endorsed by the EU in 2016 and require application for the first time from 1 January 2018 onwards. In this context, the necessary changes to IT applications, processes and models were implemented in 2017, ensuring full compliance with the new standard as from the beginning of 2018. As required by the new standards, the IFRS financial statements as of 31 December 2017 included a pre-transitional impact assessment, highlighting the expected impacts of the introduction of the new standards. The Bank expects to continue to refine the

IFRS 9 implementation as appropriate during 2018 and beyond, notably to align processes and procedures with emerging best practices and guidance to be issued by standards setters.

- 7.7 The European Audit Reform which entered into force in June 2016 imposed further restrictions on the provision of non-audit services by audit firms to audit clients. In order to facilitate the process for future external auditor rotation in light of these increased restrictions, the Compliance and Controls Committee will continue to monitor on a Group wide basis, the consultancy contracts awarded to potential external audit firms. The Committee are currently reviewing the possible options to ensure a robust process is in place to monitor and report on existing and future potential contracts awarded to professional services firms, and will make recommendations to the Management Committee.

## **8 CONCLUSION**

- 8.1 The Bank's 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 Management Committee is pleased to note the performance evaluation exercise that was initiated in 2017, and are supportive of initiatives to further improve the effectiveness of the Audit Committee.
- 8.2 The Management Committee is highly appreciative of the level of engagement and the valuable feedback provided by the Audit Committee during 2017. It is also pleased to note the increased co-operation between the Audit Committee and the Audit Board of the EIF, including the "Co-operation Paper" formalising the way in which the two bodies cooperate and transparently communicate.
- 8.3 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, are appropriately reviewed and that systems, policies and/or procedures have been established to manage those risks.



**CORPORATE**

# **Audit Committee Annual Reports**

for the year 2017



**European  
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