



European Investment Bank

AUDIT COMMITTEE

Annual Report to the Board of Governors

For the 2003 financial year

AUDIT COMMITTEE**ANNUAL REPORT TO THE BOARD OF GOVERNORS****For the 2003 financial year**Table of contents:

1. INTRODUCTION	3
2. DEVELOPMENTS IN THE BANK'S ACTIVITIES	3
2.1. Recent developments	3
2.2. Significant measures taken by the Bank.....	4
3. REVIEW OF AUDIT WORK PERFORMED IN THE BANK.....	7
3.1. External auditors	7
3.2. Internal Audit.....	7
3.3. European Anti-Fraud Office (OLAF)	8
3.4. European Court of Auditors	8
4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2003 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE	8
5. WORK PROGRAMME FOR 2004/2005	9
6. CONCLUSION.....	10

1. INTRODUCTION

The statutory role of the EIB's Audit Committee is to verify that the Bank's operations have been conducted and its books kept in a proper manner. The Rules of Procedure further state that, to this end, it must confirm to the best of its knowledge and judgment that the activities of the Bank are conducted in a proper manner, in particular with regard to risk management and monitoring, and that the Bank's operations have been carried out in compliance with the formalities and procedures laid down in the Statute and the Rules of Procedure. Moreover, the Committee must establish whether the financial statements, as well as any other financial information contained in the annual accounts drawn up by the Board of Directors give 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. It shall provide the same confirmation in respect of the consolidated version of the financial statements.

In respect of its role, the Audit Committee does not perform audit work, rather, the Committee considers that its core duties are to oversee, coordinate and supervise the work performed by internal and external auditors, to safeguard the independence and integrity of the audit functions, to follow-up on audit recommendations and to understand and monitor how Management is assessing the adequacy and effectiveness of internal control systems, risk management and internal administration.

This annual report from the Audit Committee to the Board of Governors provides a summary of the Committee's activities during the past year. It covers the financial year 2003 as far as the Audit Committee's opinion on the Bank's financial statements is concerned. For other aspects, it covers the period since the last Board of Governors' meeting. A separate summary report of the Audit Committee's activities in respect of the Investment Facility is annexed to this report.

2. DEVELOPMENTS IN THE BANK'S ACTIVITIES

2.1. Recent developments

The Audit Committee noted the following recent developments that could impact on its work in some respect:

- Statute and Rules of Procedure Changes: a two stage change process for the Statute is taking place, the first occurring on enlargement based on the Accession Treaty, the second will be in the context of the Inter-Governmental Conference. The Rules of Procedure have recently been revised in response to the former and become effective on 1 May 2004. The *Audit Committee* notes therein clarification to its responsibilities in that it shall 'confirm that to the best of its knowledge and judgment, the activities of the Bank are conducted in a proper manner, in particular with regard to risk management and monitoring'. In this respect, the *Audit Committee* will give consideration to the internationally recognised 'best banking' rules and principles of the Basle Committee on Banking Supervision (BIS – Bank for International Settlements).

The *Committee* also notes that the number of Audit Committee observers will increase and that the expertise of members and observers will need to be balanced to provide overall coverage of financial, audit or banking supervisory expertise in the private or public sector. The *Audit Committee* does not have any influence on the appointment of Committee members or observers and as such will rely on the selection procedures applied by the Board of Governors to ensure that new members and observers have appropriate independence, competence, integrity and expertise.

Investment Facility and Facility for Euro-Mediterranean Investment and Partnership (FEMIP): Within the framework of the Cotonou Agreement (which succeeds the Lomé Convention), the Bank manages Members States' resources under the Investment Facility as well as associated own-resources lending in the Africa Caribbean and Pacific (ACP) and Overseas Countries and Territories (OCT). Operations within the Investment Facility officially started on 1 April 2003. The Business Plan 2004-2007 and the revised "Credit Risk Policy Guidelines" have been presented to the Audit Committee. The financial regulations for the Investment Facility incorporate the discharge procedures as those defined for the Bank within the Statute. As a result, the *Audit Committee* acknowledges its responsibilities for monitoring the activities, and for signing its statements, related to the Facility.

FEMIP delivered the results defined in its first year Business Plan. As a result of the ECOFIN Council decision in December 2003, it is proposed to reinforce FEMIP within the Bank's framework with additional opportunities to increase private-sector support in the Mediterranean region through the introduction of a capital allocation for Structured Finance Facility type operations and through establishment of a Trust Fund managed by FEMIP. The *Audit Committee* will review the activities of FEMIP as part of its ongoing review of the Bank's activities.

- **Securitisation:** a detailed study in 2003 established that a pan European multi-seller funded securitisation scheme with the aim of financing SME and local infrastructure might reinforce the Bank's role as a policy driven bank, and would conform with its statutory tasks. The scheme may open in 2004. If so, a division of roles between the Bank and the European Investment Fund (EIF) regarding Asset Backed Security (ABS)-SME transactions will be agreed in advance in recognition of the criticality of success. The *Audit Committee* will focus attention on the associated risk exposure and on the accounting treatment and disclosure of securitisation activities.
- **Accession and associated audit requirements:** The contribution of the new Member States will be based on their share in the Bank's capital, reserves and provisions, comprising the balance of the profit and loss account established as at 30 April 2004. Therefore, the Bank will need to establish its unconsolidated financial statements at this date. The *Audit Committee* concurs with the Bank's intention for a review audit to be performed by the external auditors, based on inquiries of the Bank's personnel and analytical review procedures applied to financial information. The scope of the review will not result in an audit opinion being expressed on the interim financial statements.
- **External Audit Re-tender:** The existing contract for external audit services is with Ernst & Young, Luxembourg. The contract commenced 1 January 1997 and will expire when final signoff of the financial statements for the year ending 31 December 2004 takes place. The *Audit Committee* has statutory responsibility for the appointment of external auditors and will work with Bank management to ensure that the tendering procedure currently underway can be finalised to the satisfaction of the Committee and the Bank.
- **Use of Hedging instruments.** The Bank has experienced unexpected outturns in respect of a small number of hedging operations. The overall financial impact is limited, (the financial impact of the main such operation is referred to in section 4 of this report). The *Audit Committee* has received assurance that the Bank has responded appropriately to such instances by discontinuing the use of certain types of instruments and, where necessary, by involving Internal Audit to investigate the circumstances of situations. The *Audit Committee* has also received assurance that the agreed action plans arising from the associated Internal Audit reviews were implemented before the end of 2003.
- **Loan Portfolio Quality:** In 2003 the credit quality of the European corporate sector showed signs of stabilisation together with improvement in the creditworthiness of certain industry sectors (notably telecoms and energy). The banking sector is also showing signs of recovery. The Bank believes that the emerging trends in the large financial and corporate sectors should further support its traditionally high overall loan quality portfolio. Nevertheless, the Bank has improved its credit risk portfolio models and is improving identification of concentration and correlation risks. The *Audit Committee* will continue to seek assurance on the effectiveness of the Bank's risk management and monitoring in general.

2.2. Significant measures taken by the Bank

From the Audit Committee's perspective, significant measures have been taken by the Bank to respond to the changing environment and manage the risks arising from trends in its activities:

- **Creation of Risk Management Directorate:** In last year's report, the *Audit Committee* identified areas for improvement in the corporate governance aspects of risk management within the Bank. Following this, in November 2003, the Bank implemented a reorganisation of its risk management functions, and brought Credit, Asset and Liability Management (ALM), Market and Operational risks under a unified responsibility within the new and independent Risk Management (RM) Directorate. This measure has also triggered the production of a detailed

action plan, including the creation of a new “market risk policy manual” and the introduction of a new reporting framework for the ALM and financial risks functions (both foreseen for mid 2004).

- Risk Management Report: For the last two years, the Financial Report of the Bank has included a Risk Management statement defining the guiding principles adopted in this area. A further statement is made in the Financial Report relating to the 2003 accounts. In 2004, the Bank also presents its annual report on Risk Management to the Board of Governors. The *Audit Committee* has reviewed the statement and the report on risk management. The *Committee* notes that the report describes the key changes to risk management policies and methodologies thereby building on the descriptions of these areas provided in previous reports. The changes described in the report, together with the statement on risk management to be published in the Financial Report, are consistent with the *Committee*’s understanding of risk management policies and methodologies.
- A new Management Control function has been created consisting of a Management Control structure and a Management Control Committee. The Management Control structure encompasses the Accounting and Financial Statements Department, the Planning and Budget Control Division and a new Organisation Unit headed by the Deputy Secretary General. Within the Management Control Committee, the Bank now has a permanent committee which unites Central Services, General Secretariat, Human Resources, Information Technology as well as the Economic and Financial Studies division which will be responsible for enhancing the Bank’s change management within the Corporate Operational Plan objectives. The Financial Controller continues to have direct access to the President and Management Committee. Together with the Secretary General, the Financial Controller also signs the representation letter to the external auditors.
- Credit Risk Policy Guidelines: A number of changes have been made as summarised below:
 - Late in 2002, in order to better control the growth in single signature and single risk (SSSR) bank loans, the use of specific sub-limits for such exposures was approved. Over 2003, several such sub-limits were introduced for a number of banks. The Bank has codified a set of broad criteria that guide the establishment of such limits.
 - The risk-pricing policy progressed with the introduction of Additional Risk Pricing (ARP) for SSSR corporate loans and “project finance” and “justified exceptions” loans.
 - A new framework governing Structured Finance Facility (SFF) operations was defined. The EUR 250 m transfer from the Special Supplementary Reserve to the SFF Reserve has also supported the future development of SFF activities.
 - In order to allow the Bank more flexibility in its corporate lending, a re-orientation of the so-called “Justified Exceptions” rules has been introduced. The aim is to rely less on the borrowers’ external ratings assigned by the rating agencies and to give more weight to the internal Loan Grading, as independently assigned by the Bank’s Risk Management Directorate.

The *Audit Committee* is encouraged by the Bank’s Risk Management activities. The *Committee* believes that management needs to focus on coordinating the new risk management and management control functions, both within the Bank and within the EIB Group as appropriate, to ensure that optimal benefits from the new functions can be delivered. Furthermore, as reported last year, the *Committee* recognises that the Bank, due to its very specific nature, does not have the possibility of diversifying its risks to the same extent as other banks. However, this should not detract from the need for a suitable balance to be sought between the Bank’s risk and development objectives.

- The new Corporate Operational Plan (COP) 2004-2006 was approved in the presence of observers of new Member States in accordance with the Accession Treaty. The COP has been established at a time of profound change, notably due to Enlargement, the ECOFIN Growth Initiative and accommodation of lending objectives in Partner Countries. These changes create challenges in lending priorities for the years to come. In 2001, the Bank introduced the corporate Strategy Map and Balanced Scorecard, identifying specific indicators and objectives for each directorate of the Bank. These have been revised and reflected in the new COP. Furthermore, the associated budget provides adequate resources for priority activities defined in the COP, while maintaining the total budget within strict limits compatible with the Bank’s economic environment.

- 2003 borrowing from 2004: The 2004 borrowing programme within the COP 2004-2006 has a global borrowing authorisation of EUR 50bn. At 31 October 2003, the 2003 borrowing programme was virtually completed, with 41bn raised. An advance of EUR 5bn from the 2004 borrowing programme was approved in December 2003 by the Board of Directors, being justified by the favourable conditions then prevailing on the capital markets for different types of operation.
- Project and Operations Monitoring covers the follow-up of projects during implementation and of counterparties (promoters, borrowers and guarantors) after loan signature and up to full loan repayment. It also includes the related administration of lending operations. A working party has revised the procedures to address known weaknesses in monitoring, particularly in respect of responsibilities, scope and frequency of review. The procedures will result in full coverage of all projects on a three-year rolling cycle. A number of the new procedures require additional IT and staff resources and an implementation schedule is being agreed by the Management Committee. In the meantime, the *Audit Committee* notes continued audit and Evaluation Department reporting of monitoring issues and strongly supports the Bank's activities to further develop appropriate monitoring as a priority.
- Activity Reporting: The Bank produces a vast amount of management information, including monthly reports on Balanced Scorecard activities and Operational Risk, quarterly reports on Asset and Liability Management and Credit Risk and annual reports such as the Analysis of the EIB's Loan Book. This information is essential in the management of associated functions. The full texts are also more widely distributed. Although executive summaries have recently been introduced onto all key management reports to identify the main issues for attention, the volume of information is high and often complex. The *Audit Committee* supports management's initiative to increase the use of exception reporting and to improve interpretation of results in the reports.
- Allegations and Investigations: with respect to alleged wrongdoing by third parties related to projects in which the Bank participates in the financing, Internal Audit now assumes first responsibility for co-ordinating the investigations into the nature and substance of all allegations received. The *Audit Committee* is briefed on the allegations and investigations undertaken and notes the coordination effort by Internal Audit on these matters. The *Audit Committee* encourages management to maintain sufficient resources for such work.
- Non-Governmental Organisations (NGOs): The Bank recognises that NGOs, as public interest groups, can have a valuable input into the evolution of policy at both a national and international level. The Corporate Promotion Division in the Press Office and Communications Department, Secretariat General is responsible for coordinating the Bank's replies to NGO queries (in close cooperation with operational, technical and legal colleagues from other Bank services and relevant Vice-Presidents). In 2003, the coordination practice was reinforced by internal guidelines for addressing requests for public access to information and documents held by the Bank. Many of such requests come from NGOs. The guidelines are publicly accessible in the Bank's "Information Policy Statement" and "Rules on Public Access to Documents".
- ISIS Project: the Bank continues its information systems programme which commenced in 2000 with the upgrade of its IT infrastructure (completed in 2002) followed by implementation of a series of new IT applications which will continue until 2005. The resulting architecture will be based mainly on standard infrastructure and packages rather than on in-house built applications as in the past. The *Audit Committee* notes that the new systems are intended to meet the following stated business objectives: facilitating decision making through appropriate tools and effective knowledge and information management at all levels; improving risk management tools including projections and simulations; promoting a flexible and dynamic organisation and processes allowing rapid adaptation to internal and external changes; and increasing the visibility of the Bank's cost structure and the breakdown of expenditure. The *Audit Committee* will closely observe ISIS project progress and seek suitable assurance of the application system migration controls in the coming years and on the user response to the new systems, including adoption of changed working practices.
- Bank Accounts: in 2003, the Bank reviewed its list of previously and currently held bank accounts and reported to the Audit Committee that no anomalies had been identified. The rules relating to the opening of bank accounts have been revised and an Internal Control Framework has recently been developed to formalise the accountability and control for bank accounts.

3. REVIEW OF AUDIT WORK PERFORMED IN THE BANK

The Audit Committee held eight meetings in the year under review. During those meetings, the Audit Committee regularly reviewed the work of the external and internal auditors. The Committee also maintained contacts with the European Court of Auditors.

3.1. External auditors

The Audit Committee reviewed the scope of the external auditors' work and concurred with the emphasis placed by the auditors on IT systems, derivative valuations and the accounting treatment of complex borrowing instruments. The Committee examined the various reports produced by Ernst & Young and, during private meetings, discussed any other matters of importance with the external auditors.

The Audit Committee also performed the checks it deemed necessary to ensure the independence of the External Auditors and noted the change in key audit personnel for the 2003 audit and a proposed change of lead partner for the 2004 audit, which is in line with recommended good practice.¹

3.2. Internal Audit

The Audit Committee meets with the Head of Internal Audit at each Audit Committee meeting and private sessions are held when required.

The Audit Committee was consulted on the drafting of the Internal Audit (including Internal Control Framework (ICF)) work programme for 2004-2005. In order to ensure full coverage, the programme includes an analysis of audit activity in the last three years and a risk matrix. The programme is considered to be ambitious yet sufficiently focused on some of the key domains.

The Audit Committee also took note of the Internal Audit reports produced, focusing on those covering financial and operational risks and administrative aspects. Those considered more relevant were reviewed and discussed in detail. The Committee also monitored the implementation of internal and external audit recommendations and noted that agreed action plans exist for all recommendations that remained outstanding as of end-December 2003. Overall, the Audit Committee is satisfied with the Bank's actions in response to internal and external audit recommendations.

The Audit Committee also reviewed the results of the latest Internal Control Framework exercises introduced with the assistance of Internal Audit for Credit Risk (2003), Borrowing activities (2004) and Bank Accounts (2004) held by the Bank. As previously reported, the Committee considers the concept of the ICF exercises to be very useful for the Bank in providing some assurance as to the efficiency and effectiveness of the internal controls for the Bank's main operational areas. The Committee is keen to see the main processes of the Bank entirely covered through ICFs and will continue to closely monitor further implementation of ICFs in the remaining important areas of the Bank. The Committee will also seek assurance that ICFs are updated on a timely basis according to changes in business activities and particularly in response to the significant number of new application systems implementations planned for 2004 and 2005.

Internal Audit also has responsibility for co-ordinating investigations into cases of alleged wrongdoing as noted under paragraph 2.2.

The *Audit Committee* will seek regular assurance that the Internal Audit work programme is being executed and that audit resources are maintained at a level necessary to do so.

¹ Audit partner rotation after seven years is recommended by the European Commission: Recommendation on Statutory Auditor's Independence in the EU, International Federation of Accountants (IFAC) – Code of Ethics, the Code of Ethics issued by the Luxembourg Institut des Réviseurs d'Enterprises and within the Sarbanes-Oxley Act of 2002.

3.3. European Anti-Fraud Office (OLAF)

In July 2003, the Court of Justice of the European Communities ruled on the action lodged by the European Commission on 12 January 2000 challenging the position taken by the Bank in relation to the European Anti-Fraud Office (OLAF), the EU's specialised body in combating fraud and corruption.

The ruling now provides the Bank with a legal framework for continuing its full cooperation with OLAF, an external and independent body. The framework allows OLAF to conduct investigations within the Bank for the purpose of fighting fraud, corruption and any other illegal activity affecting the financial interests of the European Community. Accordingly, the Bank has taken steps to adapt its internal rules and procedures to this new legal framework in order to ensure optimal cooperation with OLAF in the fight against fraud and corruption. This is done in coordination with the Commission and OLAF.

Cooperation with OLAF in external investigations conducted on projects financed by the Bank is ongoing.

The *Audit Committee* supports the initiative introduced whereby OLAF is notified of all Bank-initiated investigations into cases of alleged wrongdoing, and periodically of the status thereof, at the same time at which the Committee is informed of such cases. The *Audit Committee* is also apprised of joint Bank-OLAF investigations.

3.4. European Court of Auditors

The *Audit Committee* continued its relations with the Court of Auditors as in previous years and under the new tripartite agreement (between the Bank, Commission and Court of Auditors) signed in October 2003.

The *Audit Committee* did not undertake any joint on-the-spot audits with the Court in 2003, however, the *Committee* noted the report on a Bank related audit carried out by the Court in 2003.

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2003 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE

The *Audit Committee* examined the Bank's consolidated and non-consolidated financial statements, including those of the Investment Facility for 2003 by reviewing the reports drawn up by Ernst & Young and by requesting further details on certain items in the financial statements, where necessary. The non-consolidated accounts have been prepared in accordance with the general principles of the European Directive applicable while the consolidated financial statements have been prepared in accordance with the IFRS (International Financial Reporting Standards previously known as International Accounting Standards (IAS)) and the general principles of the European Directive applicable (the IFRS prevailing in the case of contrary provisions).

The *Audit Committee* noted the following matters:

- Accounting treatment of main hedging issue: The main hedging issue related to the use of a Deferred Rate Setting (DRS) instrument. In the unconsolidated statutory accounts, the issue was treated as a consequence of funding cost (accounting entries have been made to reflect accrued interest). In the consolidated accounts, the IFRS accounting framework requires assessment of each transaction closure. In this case, the fair value difference between cash received from entering the subsequent Interest Rate Setting instrument and unwinding the DRS was minor (EUR 2m) and has been reflected as a realised loss on consolidation.
- The Fund for General Banking Risks has been reduced by EUR 55m to reflect the improved credit ratings for activities in Accession countries.
- Specific provisions: The specific loan provision of the Eurotunnel exposure at 2002 has been maintained.
- Venture capital operations: Value adjustments amounting to EUR 108.7m have been recorded in the unconsolidated financial statements and EUR 119.7m in the consolidated financial statements.
- The transfer of EUR 750m from the Special Supplementary Reserves as follows: EUR 250m to Funds allocated to the structured finance facility and EUR 500m to Funds allocated to the venture capital operations (subsequently mandated to the European Investment Fund).

- Accounting treatment for the staff pension and health insurance scheme: An actuarial valuation of the schemes was not available at the year-end, meaning that in the consolidated financial statements, the schemes have not been valued in accordance with IFRS (IAS 19). This will be applied in 2004.
- Fair value of Venture Capital Fund operations: the Group did not apply the revised version of IAS 39 as published on 17 December 2003. Adoption of the revised IAS 39 will be mandatory in 2005.

The *Audit Committee* submits a separate report to the Board of Governor's regarding the financial statements of the Investment Facility, as annexed to this report.

In the light of the reviews it has carried out and the information it has received (including a favourable opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Bank), the *Audit Committee* concludes that the Bank's consolidated and non-consolidated and the Investment Facility's financial statements (comprising the balance sheet, the statement of Special Section, the profit and loss account, the statement of own funds and appropriation of profit, the statement of subscriptions to the capital of the Bank, the cash-flow statement and the notes to the financial statements) have been drawn up correctly and that they give a true and fair view of the Bank's results and financial status according to the principles applicable to the Bank.

The *Audit Committee* is of the opinion that it has been able to carry out its work under normal conditions and that it has not been prevented from performing any task which it would consider relevant for its statutory mission. On this basis, the *Audit Committee* signed its annual statements.

5. WORK PROGRAMME FOR 2004/2005

The Manual of the Audit Committee is being revised to clarify roles and objectives stated within the revised Statute and Rules of Procedure (effective 1 May 2004). The operational activities of the Audit Committee in 2004/2005 will depend on the developments envisaged in the Bank's operations and on the new challenges the Bank will face, as it is recognised that Bank activities, structures and controls are changing and progressing significantly.

The *Audit Committee* will continue to receive presentations on new activities or products which normally include an analysis of related risks and risk mitigation controls. However, in response to a few Bank-identified slippages in control procedures during the last year, the *Committee* commits to seeking suitable assurance of progress made to resolve such control issues and will continue to seek frequent representations regarding controls in place.

The *Audit Committee* has formally reviewed its own performance during 2003 and will continue to do so as recommended by best practice². The key findings from the performance assessment in 2003 that the *Audit Committee* intends to incorporate into the current year work plan (and which have not been identified above) are summarised below. The *Audit Committee* will:

- identify processes to ensure that an appropriate level of review of the effectiveness of the system for monitoring compliance with laws, regulations and published internal procedures and the results of managements investigation and follow up of any fraudulent acts or non-compliance can be facilitated.
- pay regular attention to ensuring that all members, including future new members, understand and can demonstrate knowledge of the background of the Bank and the ability to interpret changes related to the Bank's activities.
- specifically ask management to provide assurance on consistency of financial statements with any non-financial statement disclosures, analyst reports and filing reports or relevant public releases and press announcements.

The *Committee* will continue to monitor and consider developments pertaining to 'best banking practice' in the context of the Bank, and to provide external viewpoints on risk management and relevant corporate governance issues.

² "...a well-functioning Audit Committee will be concerned about and spend significant amount of time in defining the scope of its oversight responsibilities and how it discharges its duties." - Report of the Blue Ribbon Committee

6. CONCLUSION

Overall, the *Audit Committee* is of the opinion that the Bank is conducting its affairs in accordance with the Statute and Rules of Procedures. The *Committee* recognises the significant measures taken by the Management Committee and the staff of the Bank to maintain, formalise and where necessary improve corporate governance, risk and control awareness and responsiveness.

The Audit Committee can also assure Governors, that overall it has met its own responsibilities during 2003. The *Committee* believes that it has appropriate standing within the Bank, that appropriate relations with management and Bank staff exist and operate well, and that there are no detractions from the *Committee's* statutory mission and need to be independent.

The *Committee* is confident that the Bank provides relevant and timely information in order to allow *Committee* representatives to undertake their duties. However, the Bank's business and industry sector is changing more rapidly than ever and the *Audit Committee* acknowledges the need to tailor and communicate its expectations of both management and auditors to ensure duties can be fulfilled in the future.

In 2003, the *Committee* has successfully integrated a new Committee representative. In 2004, the *Committee* will be enlarged in line with the revised Rules of Procedure effective 1 May 2004. Attention must be focused on getting all representatives to a good level of understanding of the Bank's business and the *Audit Committee's* roles and responsibilities as quickly and effectively as possible. The *Audit Committee* welcomes the Bank's support on this matter.

Date , 5 May 2004

C. NACKSTAD, Chairman

M. HARALABIDIS, Member

M. COLAS, Member

Having participated in the work of the Audit Committee as Observer, I concur with the above report.

A. DIAZ ZURRO, Observer



European Investment Bank

AUDIT COMMITTEE

**ANNUAL REPORT TO THE BOARD OF
GOVERNORS**

INVESTMENT FACILITY

For the 2003 financial year

AUDIT COMMITTEE**ANNUAL REPORT TO THE BOARD OF GOVERNORS****INVESTMENT FACILITY****For the 2003 financial year**Table of contents:

1. INTRODUCTION	3
2. DEVELOPMENTS IN THE INVESTMENT FACILITY'S ACTIVITIES	3
2.1. Investment Facility launch	3
2.2. Operations	3
3. REVIEW OF AUDIT WORK PERFORMED IN THE BANK	4
3.1. External auditors	4
3.2. Internal Audit	4
3.3. European Anti-Fraud Office (OLAF)	4
3.4. European Court of Auditors	4
4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2003 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE	4
5. CONCLUSION	5

1. INTRODUCTION

The statutory role of the European Investment Bank's (the Bank's) Audit Committee is to verify that the Bank's operations have been conducted and its books kept in accordance with the applicable rules. The Rules of Procedure further state that, to this end, it must ensure that the activities of the Bank are conducted in a proper manner, in particular with regard to risk management and monitoring, and that the Bank's operations have been carried out in compliance with the formalities and procedures laid down in the Statute and the Rules of Procedure. Moreover, the Committee must establish whether the financial statements, as well as any other financial information contained in the annual accounts drawn up by the Board of Directors give 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. It shall provide the same confirmation in respect of the consolidated version of the financial statements. Within the framework of the Cotonou Agreement, the financial regulations for the Investment Facility incorporated the audit and discharge procedures as defined for the Bank within the Statute. As a result, the *Audit Committee* acknowledges its responsibilities for signing a statement to the Board of Governors in respect of the Facility.

In respect of its role, the Audit Committee does not perform audit work, rather the Committee considers that its core duties are to oversee, coordinate and supervise the work performed by internal and external auditors, to safeguard the independence and integrity of the audit functions, to follow-up on audit recommendations and to understand and monitor how Management is assessing the adequacy and effectiveness of internal control systems, risk management and internal administration.

This report from the Audit Committee to the Board of Governors provides a summary of the Committee's activities and covers the first period of operational activity of the Investment Facility as far as the Audit Committee's opinion on the Investment Facility's financial statements is concerned.

2. DEVELOPMENTS IN THE INVESTMENT FACILITY'S ACTIVITIES

2.1. Investment Facility launch

Within the framework of the Cotonou Agreement (which succeeds the Lomé Convention), the Bank manages Member States' resources under the Investment Facility, (which are represented in a separate set of financial statements), in addition to associated own-resources lending in the Africa Caribbean and Pacific (ACP) and Overseas Countries and Territories (OCT). The Investment Facility was established within the Bank as a special business unit with additional staffing and operations officially started on 1 April 2003.

2.2. Operations

The procedures related to the loan activities are similar to those previously audited for activities under the Lomé agreement. The financial accounting and control aspects of the Investment Facility are very similar to the procedures for other such activities within the Bank, although separate accounts are used to reflect the Member State ownership status of the funds. The systems supporting the procedures and controls are also common to the Bank and the Investment Facility.

In 2003, two transfers of funds were received from the Member States. The Investment Facility undertook two types of operations (loans and equity participation) and the systems, procedures and controls supporting each type of operation are identical. At the year-end, there were nine active (i.e. signed) projects. For the nine projects active at the year-end, disbursements totalling 4 m EUR were made on four operations, (all equity investments). No loan guarantees were approved in 2003 and foreign exchange risk was not hedged as, at yet, the Bank's mandate only covers investment operations. Also, no repayments on loans were received and no interest was accrued or received before the year-end.

The Audit Committee has received a presentation of the Investment Facility Business Plan 2004-2007 and of the revised "Credit Risk Policy Guidelines".

3. REVIEW OF AUDIT WORK PERFORMED IN THE BANK

3.1. External auditors

The Audit Committee reviewed the scope of the external auditors' work. The Committee examined the various reports produced by Ernst & Young and discussed any other matters of importance with the external auditors and relevant competent members of the Bank's services.

The Audit Committee also performed the checks it deemed necessary to ensure the independence of the External Auditors.

3.2. Internal Audit

A number of the Investment Facility's activities share common systems and controls with those of the Bank. Although no specific Internal Audit reviews of the Investment Facility were undertaken in 2003, the Audit Committee took note of the Internal Audit reports produced for the Bank's systems and controls, focusing on those covering financial and operational risks and administrative aspects. Those considered more relevant were reviewed and discussed in detail. The Committee also monitored the implementation of internal and external audit recommendations and noted that agreed action plans exist for all recommendations that remained outstanding as of end-December 2003. Overall, the Audit Committee is satisfied with the Bank's actions in response to internal and external audit recommendations.

The Audit Committee was consulted on the drafting of the Internal Audit (including Internal Control Framework (ICF)) work programme for 2004-2005. The programme provides for an audit of the Investment Facility including review of the translation of policies into adequate rules and procedures, service level agreements and issues relating to the set-up of the Facility. Several loans will also be tested.

3.3. European Anti-Fraud Office (OLAF)

In July 2003, the Court of Justice of the European Communities ruled on the action lodged by the European Commission on 12 January 2000 challenging the position taken by the Bank in relation to the European Anti-Fraud Office (OLAF), the EU's specialised body in combating fraud and corruption.

The ruling now provides the Bank with a legal framework for continuing its full cooperation with OLAF, an external and independent body. The framework allows OLAF to conduct investigations within the Bank for the purpose of fighting fraud, corruption and any other illegal activity affecting the financial interests of the European Community. Accordingly, the Bank has taken steps to adapt its internal rules and procedures to this new legal framework in order to ensure optimal cooperation with OLAF in the fight against fraud and corruption. This is done in coordination with the Commission and OLAF.

Cooperation with OLAF in external investigations conducted on projects financed by the Bank is now ongoing. Operations under the Investment Facility may also be subject to investigations by OLAF.

3.4. European Court of Auditors

The Audit Committee continued its relations with the Court of Auditors as in previous years and under the new tripartite agreement (between the Bank, Commission and Court of Auditors) signed in October 2003. In 2003, no audits were undertaken by the Court on Investment Facility activities.

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2003 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE

The Audit Committee examined the Investment Facility's financial statements for 2003 by reviewing the reports drawn up by Ernst & Young and by requesting further details on the financial statements,

where necessary. The accounts have been prepared in accordance with the general principles of the European Directive applicable.

The Audit Committee noted the following matters:

- The Member States cover in full the expenses incurred by the Bank for the management of the Investment Facility. Accordingly, these financial statements exclude such expenses.
- Interest on bank deposits arising from the funds provided by the Member States which have been placed by the Facility within the Bank is not accounted for by the Facility, as it is payable directly to the European Commission (in accordance with the Cotonou Agreement).

In the light of the reviews it has carried out and the information it has received (including a favourable opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Investment Facility), the Audit Committee concludes that the Investment Facility's financial statements (comprising the balance sheet, the profit and loss account and the notes to the financial statements) have been drawn up correctly and that they give a true and fair view of the Investment Facility's results and financial status according to the principles applicable to the Bank and to the Investment Facility.

The Audit Committee is of the opinion that it has been able to carry out its work under normal conditions and that it has not been prevented from performing any task which it would consider relevant for its statutory mission. On this basis, the Audit Committee signed its annual statements.

5. CONCLUSION

Overall, the *Audit Committee* is of the opinion that the Investment Facility is conducting its affairs in accordance with the Statute and Rules of Procedures and within the framework of the Cotonou Agreement. The *Committee* recognises the significant measures taken by the Management Committee and the staff of the Investment Facility to formalise corporate governance, risk and control awareness and responsiveness.

The Audit Committee can also assure Governors, that overall it has met its own responsibilities during 2003. The Committee believes that it has appropriate

standing within the Investment Facility, that appropriate relations with management and Investment Facility staff exist and operate well, and that there are no detractors from the Committee's need to be independent.

The Committee is confident that the Investment Facility provides relevant and timely information in order to allow Committee representatives to undertake their duties. However, the Investment Facility's business is still in development and the Audit Committee acknowledges the need to tailor and communicate its expectations of both management and auditors to ensure duties can be fulfilled in the future.

Date , 5 May 2004

C. NACKSTAD, Chairman

M. HARALABIDIS, Member

M. COLAS, Member

Having participated in the work of the Audit Committee as Observer, I concur with the above report.

A. DIAZ ZURRO, Observer



**Response of the Management Committee
To the Annual Reports of the Audit Committee
For the Year 2003**

RESPONSE OF THE MANAGEMENT COMMITTEE TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE FOR THE YEAR 2003

Introduction

The Management Committee welcomes the Annual Reports of the Audit Committee.

This note :

- sets out the approach of the Management Committee to audit and control issues; and
- responds to certain comments and proposals in the Audit Committee Reports.

The Management Committee is fully committed to a strong and effective audit and control system for the EIB. To that end, it cooperates constructively with the Audit Committee and the external auditors appointed by it. Where the use of EU budget funds is concerned, it co-operates with the European Court of Auditors.

Within the Bank, the Management Committee ensures that the Internal Audit team produces independent reports covering all significant areas of the Bank's business. There is also an Internal Control Framework consistent with Basle guidelines, covering all of its important operational activities.

Developments in 2003 and Priorities for 2004

The most important development in the past year to strengthen the EIB's control mechanisms were :

- the reorganisation of Risk Management; and
- the introduction of a Management Control function.

The Risk Management Directorate now covers credit, market, and operational risk. Its responsibilities are completely independent of the operations that can give rise to such risks. A full assessment of the Bank's approach is given in the '2004 Report on Risk Management in the EIB' distributed separately to Governors.

Throughout the year the Bank has made successful efforts to improve the quality of the loan book. At the same time we have identified a need for a strengthening of the monitoring of operations and implementation of appropriate measures is under way.

A new set of market risk policy guidelines is being drafted and is expected to be adopted by mid-year. It will contain, inter alia, a list of permissible hedging instruments, as well as detailed criteria for their use under the independent supervision of the Risk Management Directorate.

The newly-reorganised Management Control Function, which is under the supervision of the Deputy Secretary General, combines the functions of the Financial Controller, the Bank's accounts department, and the control of the Bank's budget, thus giving greater coherence and effectiveness to these functions.

Priorities for 2004

In line with the observation in the Audit Committee Report, one of the priorities for 2004 will be to ensure that comprehensive systems are in place to ensure proper risk management operates at the level of the EIB Group. There are already developed risk management systems in both the EIB and the EIF. In 2004, these will be reviewed to ensure that they fully cover EIB Group risk.

The Audit Committee Report refers to the need to improve loan monitoring procedures. This is an issue being addressed by the Bank, and will be a priority for 2004. The Management Committee has already taken the decision in principle to consolidate financial monitoring of lending operations in one location, thereby clarifying responsibilities, promoting specialisation and making better use of resources. A feasibility study is in progress and a final recommendation will be presented in June 2004.

The Bank's pension fund has been shown to be in good financial health according to methods used until now. However, it will have to be valued according to IFRS rules (IAS 19) in the Consolidated Financial Statements from 2004 onwards. Actuarial work has already been commissioned and is underway. Results will be available during 2004.

New accounting rules (IAS 39) will equally apply to establish the fair value of venture capital operations in the Group's consolidated accounts. Work is underway, in co-operation with the EIF, to deal with this issue.

The Bank continues to fully cooperate with OLAF on all allegations of fraud. Within the Bank, the Internal Auditor takes the lead in this work.

The Audit Committee mentions a few control slippages that have occurred in the past year. Processes for identification and correction of such events through the Bank's procedures for reporting and dealing with operational risk have been put in place. The Internal Control Frameworks will be further developed to cover such areas fully.