BOARD OF AUDITORS

Annual Report to the Board of Governors

for the period ended 31 December 2013

1. Introduction

The Board of Auditors of the European Stability Mechanism (the "ESM") is established pursuant to Article 30 of the Treaty establishing the ESM and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.

The Board of Auditors carries out independent audits, inspects the ESM accounts, audits regularity, compliance, performance, risk management, and monitors as well as reviews the ESM's internal and external audit processes and their results.

This report is addressed to the Board of Governors in accordance with Article 24 (6) of the ESM By-Laws and provides details on the audit work of the Board of Auditors, its audit findings in relation to the financial statements of the ESM and its conclusions and recommendations for the period from 1 January to 31 December 2013. This report will be made available also to the national parliaments and supreme audit institutions of the ESM Members, to the European Court of Auditors and the European Parliament.

The members of the Board of Auditors were appointed by the Board of Governors on 8 October 2012 as follows:

- Mr Harald Noack, nominated by the European Court of Auditors
- Mr Marc Gengler, nominated by the Supreme Audit Institution of the Grand Ouchy of Luxembourg
- Mr Ulrich Graf, nominated by the Supreme Audit Institution of the Federal Republic of Germany
- Ms Katarína Kaszasová, upon the proposal of the Chairman of the Board of Governors
- Mr Jules Muis, upon the proposal of the Chairman of the Board of Governors

The Board of Auditors elected Mr Harald Noack as Chairperson and Ms Katarína Kaszasová as Vice-chairperson of the Board of Auditors. The members of the Board of Auditors were appointed for a non-renewable term of three years, except for Ms Kaszasová and Mr Graf whose names were drawn by lot and who were appointed for a non-renewable term of four years to ensure continuity of the work of the Board of Auditors. Mr Harald Noack stepped down as Chairperson and member of the Board of Auditors on 20 November 2013 due to the end of his mandate as a Member of the European Court of Auditors. Since that day, meetings of the Board of Auditors were chaired by Ms Kaszasová who was later on 21 March 2014, elected as Chairperson. On 19 December 2013, Mr Igors Ludboržs was appointed by the Board of Governors as the fifth member of the Board of Auditors upon nomination by the European Court of Auditors.

At the time of their appointment and during the performance of their duties, the members of the Board of Auditors took care to avoid all conflicts of interest and have refrained from any action incompatible with their duties. The members of the Board of Auditors acted independently and have not sought or taken instructions from the ESM governing bodies, the ESM Members or any other public or private body.

2. Activities of the Board of Auditors

2.1. Meetings of the Board of Auditors

The Board of Auditors held 11 meetings in 2013. The purpose of these meetings was to be briefed by and to discuss with ESM management ESM developments and oversight questions, in particular relating to the ESM Board of Auditors core missions a) the assuring of the integrity and adequacy of the financial statements and the related controls frameworks; b) as well as the selective performance of efficiency and effectiveness reviews. Additionally, the Board of Auditors had two internal conference calls and met once with the ESM Board of Directors as well as with the Risk Committee of the Board of Directors.

During their meetings, the Board of Auditors received regular updates on the activities of the ESM and the ESM governing bodies, attended presentations by management on specific topics requested by the Board of Auditors and met with the internal auditor and the external auditor.

2.2 Scope

The Board of Auditors has:

- performed limited review procedures in accordance with Article 30 (3) of the ESM Treaty and Article 24 (4) of the ESM By-Laws focusing, among others, on the review of accounting and reporting systems, procurement policies, service level agreements and risk management governance and policies;
- reviewed whether and in how far recommendations arising from the 2012 Annual Report to the Board of Governors were considered and implemented;
- reviewed the ESM financial statements for the period ended 31 December 2013 as drawn up and adopted by the Board of Directors on 24 March 2014. The ESM's Financial Statements were prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006;
- noted that in accordance with the aforementioned financial statements, the balance sheet totals as at 31 December 2013 amount to EUR 760 billion and consist mainly of loans and advances to euro area Member states (EUR 46 billion), subscribed capital called but not paid (EUR 16 billion) and subscribed ("authorized" according to Article 8 of the Treaty establishing the ESM) capital not yet called and unpaid (EUR 620 billion). The total own funds do amount to EUR 700 billion and liabilities are composed of mainly debts evidenced by certificates (EUR 60 billion). The net profit for the financial year amounts to EUR 254 million, mainly the result of interest receivable and similar income (EUR 353 million), interest payable and similar charges (EUR 111 million), net profit on financial operations (EUR 26 million) and general administrative costs (EUR 31 million);

- monitored and reviewed external audit processes performed by PricewaterhouseCoopers, Société coopérative, Luxembourg (further referred to as "PwC");
- met regularly with the ESM Managing Director, members of the Management Board including the Secretary General, Head of Corporate Governance & Internal Policies, Head of Finance and Control, Operational Risk Officer, Internal Auditor and other members of ESM management and discussed as well as reviewed relevant issues and developments; and
- received on its request various written representations from the ESM management Board members and members of the ESM management concerning issues of oversight interest.

3. Follow up of 2012 Board of Auditors Annual Report to the Board of Governors

The Board of Auditors invited the Board of Governors to consider findings and recommendations mentioned in its 2012 Annual Report and to undertake appropriate initiatives.

Based on a follow-up audit and its ongoing work, the Board of Auditors points out the following:

- The Board of Auditors observed during the year 2013, and in the subsequent months up to the signing of its 2013 Annual Report, progress being made in the direction of the development and implementation of a standard practice controls framework. It commends the ESM management for its efforts, and notes that in the first full year stage of ESM operations design of a control framework inevitably precedes its implementation.

  In that context the Board of Auditors reiterates its strong recommendation that the ESM adopts the EU regulatory framework as its own.

- The Board of Auditors notes that, at this early stage, the ESM's controls framework is work in progress; that ESM's "three lines of defense" concept in building such framework is still progressing in design, and with some delay in implementation.

- The Board of Auditors focused in particular in this development phase on the adequacy and acceptability of the ESM's financial controls and its Financial Reporting frame of reference.

  The Board of Auditors welcomes in this regard the ESM management's commitment, based on the Board of Auditors' 2012 recommendation, to reassess in 2014, after two years of experience, the ESM's chosen accounting frame of reference (the EU accounting and Banking Directives), as "fit for purpose".

  In addition the Board of Auditors takes note of the progress made to introduce an ESM accounting manual.

- The Board of Auditors takes note of the progress made in the area of procurement. Nevertheless the Board of Auditors points out that the ESM procurement policies are not aligned with EU public procurement policies.

The follow-up of the 2012 findings and recommendations related to the internal and external audits are presented and commented in separate sections of this report.

4. Findings

4.1. Financial statements

In accordance with the ESM By-Laws, Article 23 (2) (d) the Board of Auditors reported, in its separate Report on Financial Statements, the following:

"Having examined the first full year of the ESM, the Board of Auditors observes, as detailed in its Annual Report for the year ended 31 December 2013, that the institution has made progress in design and in implementation of internal, operational and managerial controls. The ESM controls framework is still evolving and, against the background of rapidly changing operational and external demands, continues to face challenges in reaching standard practice. The Board of Auditors notes that, to the best of its judgement no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the period ended 31 December 2013."

Based on knowledge obtained from exchanges of view with the ESM management and the external auditors as well as based on publicly available information, the Board of Auditors is not aware of any significant subsequent events to be recognized in the ESM financial statements for the period ended 31 Oecember 2013.

4.2 External audit

In accordance with the ESM treaty, Article 29 *"Accounts of the ESM shall be audited by independent external auditors approved by the Board of Governors and responsible for certifying the annual financial statements".*

The ESM financial statements for the year ended 31 Oecember 2013 were audited by PricewaterhouseCoopers, Société cooperative, Luxembourg (further referred as "PwC").

PwC was appointed as "réviseur d'entreprises agree" (statutory auditor) by the ESM Board of Governors on 8 October 2012. The engagement letter was signed by the ESM representatives on 4 February 2013. Based on this engagement letter, PwC was requested to carry out a statutory audit of the financial statements of the ESM as of and for the year ending 31 Oecember 2013 in accordance with International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier" (further referred as "CSSF"), the Luxembourg legislation, the professional standards adopted by CSSF and the professional standards issued by the "Institute des Réviseurs d'Entreprises".

PwC issued an unqualified Auditor's report on 3 April 2014 stating that *"In our opinion, the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2013, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directives."*

In accordance with the ESM By-Laws, Article 24, (4) *"It (Board of Auditors) shall monitor and review the ESM's internal and external audit processes and their results".*

The Board of Auditors has met the PwC representatives several times; reviewed documentation prepared by PwC and discussed the auditor's strategy and planning, interim results and the closing of the audit. The Board of Auditors noted that due to improvements in the design and implementation of ESM internal controls, the substantive tests were combined with tests of controls. The PwC team also included an international expert responsible for compliance assessment of the ESM accounts with the EU Accounting Oirective.

The Board of Auditors brings to Board of Governors' attention the following:

- Despite the Board of Auditors recommendation in 2012 to conduct a procurement process for the selection of the external auditor of the ESM financial statements prepared for the year ended 31 December 2013, the ESM has continued to engage PwC through a contract signed on 4 February 2013.

  The Board of Auditors therefore reiterates its earlier recommendation; but takes note of the proposal made by the ESM to conduct a competitive procurement process in mid-2014. The Board of Auditors also welcomes the ESM invitation to observe this process to ensure full transparency and quality of the process.

- PwC presented a selection of the audit evidence to the Board of Auditors during a meeting in the PwC premises. Nevertheless, full access to the external audit files was not granted for the year ended 31 December 2013 due to legal obstacles.

  Therefore the Board of Auditors must reiterate its 2012 finding and recommendation about access to the audit documentation, as required by ESM's statutory provisions. The Board of Auditors welcomes the effort to be made between the ESM and the external auditors to assure statutory compliance in respect of the statutory audit of the 2014 ESM financial statements and onward.

- Although the PwC audit report issued on 24 March 2014 was prepared in accordance with International Standards on Auditing, the Board of Auditors would like to reiterate its former recommendation to expand the external auditor's mandate to include a long form report, e.g. covering risk management as well.

  The Board of Auditors takes note of the ESM's "special topic report", aimed at audits over and beyond the narrow financial audit requirements. Nevertheless this initiative cannot be treated as a substitute for a long form report.

- The service providers refused the Board of Auditors as well as the ESM direct (audit) access; despite an attempt by the ESM to secure such access in the Service Level Agreement.

  The Board of Auditors reiterates its former recommendation to have unlimited audit access regarding services provided by third parties.

- PwC noted in its management letter that the ESM needs to:
  - document the main controls put in place;
  - implement additional controls in accounting entries and deliverables produced in order to avoid accounting errors and therefore to put in place also an automatic link between ESM and the service provider accounting system;
  - continue the efforts performed in the monitoring of the list of authorized signatures and give more details in the procedure with regard to the opening and closing of bank accounts.

  The ESM management committed to follow up those recommendations.

4.3 Internal audit

The ESM Treaty, Article 28 stipulates: *"An internal audit function shall be established according to international standards". Additionally, Article 24 (4) of the ESM By-Laws requires: "It (the Board of Auditors) shall review the ESM's internal and external audit processes and results".*

After a temporary internal audit outsourcing arrangement with an external firm of auditors in early 2013, the ESM's internal audit function was launched as of 1 July 2013. The ESM's internal audit carried out a number of audits, on matters such as governance and risk framework of the investments of paid-in capital, ESM funding activities, lending, Human Resources Administration and compensation and benefits. A proper

response mechanism has been set up to assure internal audit recommendations follow-up.

The results of the audits are reflective of the development stage of the ESM and show progress in the design of controls systems in the areas indicated above. The results of the audits also flag some lagging in implementation.

The Board of Auditors has established a close working relationship with the internal auditors, monitored management response and proposed resolution of the matters raised.

The Board of Auditors emphasizes that in ESM's control framework the internal audit forms a third line of defense, yet at this stage is composed of one professional only.

4.4 Risk Management audit

The Board of Auditors carried out an audit of the risk management. The audit covered different aspects of risk management; the aim was to obtain an overview of the design of the ESM risk management system as well as the policies and guidelines.

The engagement excluded a review of the strategic risk management. It is the Board of Auditors` understanding that this function, which entails lending decision preparation as well as monitoring the compliance with the conditionality attached to the financial assistance facilities, has been delegated to members of the 'Troika'. Their views are subject of review and political decision by ESM's shareholders as represented in the Board of Governors. Hence, the audit has been limited to the operational responsibilities of the ESM.

The audit was carried out in accordance with Article 30(3) of the ESM Treaty. In line with Article 24(5) of the ESM By-Laws, the Board of Auditors appointed subject matter experts to support the audit work. The main findings are as follows:

- The ESM-Treaty obliges the ESM to implement appropriate risk management. The ESM follows a "Three Lines of Defense" concept, whereby the second line represents the independent risk management function. The ESM´s risk management is based on an embedded organization: Beside the central Risk Department, specific tasks have been distributed to experts "embedded" within other operational units. Some of these experts have responsibilities which comprise both first and second line of defense activities.

  The Board of Auditors recommended a clearer distinction between first line and second line of defence. ESM staff should either be assigned to an operational function or a designated risk management function.

  The ESM management has replied that it will reorganize the risk management organization due to the increased profile of the ESM in 2014. In future there will be no combined first and second line teams or embedded risk managers.

- The ESM has a transitional investment portfolio which by 31 December 2013 amounted to EUR 9 billion. With this portfolio ESM issues papers effectively on behalf of EFSF. The Board of Auditors notes that the transitional portfolio does not feature in ESM's general investment strategy.

  The ESM management emphasized that the transitional investment portfolio was designed to address transitional aspects of the emergence of ESM and will definitely be closed by December 2014.

- The ESM, being is a high profile organization, faces a high reputational risk. The Board of Auditors signaled room for improvement in respect of reputational risk management and recommended that reputational risk be clearly defined and covered by a specific policy.

The ESM management will adopt a coordinated reporting of reputational risk incidents. It also considers an update to the High Level Principles to ensure that a clear and distinct definition of reputational risk appears therein.

- At the time of the audit various risk management positions were vacant. Also a number of risk management elements and risk policies did not exist, were not finalized or were not fully implemented.

  The ESM management informed the Board of Auditors that the recruitment is either underway or has already been completed. The risk management elements and risk policies are implemented or underway.

- The ESM management has outsourced several key functions. Certain outsourcing contracts and service level agreements lack internal audit clauses.

  The ESM management informed the Board of Auditors that a standard right-to-audit clause for ESM has been developed. The ESM has been in the process of gradually introducing the clause in contracts with key suppliers of outsourced services. One key supplier did not accept a right-to-audit clause in the service level agreement.

  The Board of Auditors stresses that this clause has to be integrated in all contracts and service level agreements. The right-to-audit clause has to be a prerequisite for all future outsourcing arrangements.

5. In closing

The ESM, for the period under review, was in its first year of full operation. The Board of Auditors notes that the progress was made in the design and implementation of the internal control environment. The Board of Auditors recommends the Board of Governors to consider the potential risks associated with the ESM's evolving internal controls framework, notably its attempts to establish itself as a "lean organisation", in the context of its operational challenges and public expectations.

The Board of Governors is invited to consider the findings and recommendations mentioned in this Annual Report and to undertake appropriate initiatives.

Luxembourg, 12 June 2014

Board of Auditors