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Investing in rural people

## Report of the Chairperson of the 130<sup>th</sup> meeting of the Audit Committee

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Executive Board — 111<sup>th</sup> Meeting  
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**For: Review**

## **Report of the Chairperson on the 130<sup>th</sup> meeting of the Audit Committee**

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 130<sup>th</sup> meeting of the Committee, held on 24 March 2014.

### **Adoption of the agenda**

2. The agenda was adopted with no amendments. One member proposed that the item on the general framework for borrowing by IFAD be discussed at the following meeting, as there had not been sufficient time to review the document due to late submission. The concern having been noted, the meeting was informed that the document could not have been made available earlier. In view of the fact that this was just the start of the process, it was decided that discussion would in fact commence at the present session.

### **General framework for a standardized approach for debt funding agreements**

3. The Chairperson introduced the item and invited Management to make a presentation.
4. Management outlined the background to the paper by stating that the Executive Board, during the discussion on the German Development Bank (KfW) loan at its December 2013 session, had requested IFAD to create a general framework for borrowing. Management clarified that while the general framework pertains to long-term financing from the Tenth Replenishment of IFAD's Resources (IFAD10) onwards, the KfW loan is embedded in the financial framework of the Ninth Replenishment of IFAD's Resources (IFAD9) and agreed programme of work. The two processes should be seen in parallel, with each process informing the other, but neither of them necessarily contingent on the other for finalization and approval.
5. Management stated that they would welcome suggestions to work with the Audit Committee or a subcommittee to develop the paper further.
6. The concept note presented was the outcome of discussions Management has had over the past months and should be considered as a stage in a process rather than a final document.
7. The key components of the framework were the following:
  - (a) Uses of borrowed funds;
  - (b) Cost recovery and financial sustainability;
  - (c) Investment policy; and
  - (d) Accounting and risk mitigation.
8. Management's aim at this point was to obtain confirmation from the Committee that these are in line with their expectations in terms of content, direction and overall coverage. The intention was not to cover all possible issues and questions at this point.
9. The chairperson thanked Management and reiterated that the document is a work in progress to lay the groundwork for a general framework, asking for comments from members on the process and on the concept note presented.
10. Members put forward many technical questions and asked for clarifications, underlining the need to deepen and address in more detail some specific issues, such as the rationale for borrowing as a source of funding over and above regular replenishment contributions. With regard to process, some members expressed the opinion that the KfW loan ought to be kept separate from the general framework,

which should be generic and not specific to any particular agreement, while two members expressed the view that the general framework should be finalized before presentation of the KfW loan to the Board. Further clarification was sought on whether certain aspects of the borrowing arrangements could attract voting rights, particularly taking into account concessionality; it was indicated that the general framework needed to define the significance of lending at "concessional" or "semi-commercial" terms by different categories of lenders; and the issue as to whether borrowing agreements would or would not place any restriction on the type of beneficiaries, project theme or country geographical area was discussed. There was a comment as to whether IFAD should be credit rated.

11. Members also indicated that matching IFAD's lending terms with the terms of the borrowing agreement, particularly in the case of concessional lending, might not be financially feasible. Members acknowledged that the concept paper was a good starting point for the framework as it addressed the key elements raised with the Executive Board, requested greater emphasis on financial sustainability, information on the outcome of discussions with the International Development Association (IDA) and asked Management to determine whether elements of the IDA borrowing framework could be adopted. It was also requested that the document clarify who would bear the cost of default.
12. Members sought further clarification on the ratio of maximum indebtedness to which the Fund ought to be exposed. Some members expressed support for debt instruments as vehicles for long-term innovative financing as opposed to covering immediate replenishment financing gaps. Management was requested to clarify whether the loans would be reviewed and approved by the Executive Board given that they would not be part of the Replenishment Consultation, and whether the loans would be managed under the performance-based allocation system (PBAS); also the nature and details of risk management measures and modalities to be applied.
13. Further clarification was requested on how the Fund found itself in a situation requiring borrowing; the Fund's commitment to honour its programmes beyond IFAD 10; other entities from which IFAD could raise such debt financing; and the possibility of a separate strategy paper setting forth the rationale for the initiative. One member expressed the opinion that voting rights should be restricted to regular replenishment contributions. Management was also requested to clarify whether borrowing from other entities on concessional terms would be subsidized by IFAD's resources and to confirm that borrowings would be segregated from regular resources for accounting purposes.
14. Management pointed out that development of the paper had been envisaged over a longer time horizon and that most of the thinking incorporated in the concept paper had been drawn from the experience with negotiating the KfW loan and consultation with other international financial institutions (IFIs), such as the World Bank. Management further stated that they were aware of the additional aspects not covered by the concept note and raised by the Audit Committee, and that the purpose was to start the discussion. Management therefore proposed that a subgroup be set up to carry the work forward. Management explained that the rationale behind the borrowing initiative was that there is plenty of potential for a programme of work larger than IFAD is currently covering from regular contributions and that the main driver is the intention to grow. The growth of regular replenishment contributions is not likely to meet growth in demand, to be clarified either in the framework document or another paper. In addressing concerns on financial sustainability, Management pointed out that a full financial analysis would be undertaken on all loans and submitted to the Executive Board for approval and that it did not envisage taking out a large number of loans in a short period of time. The Committee was informed that the proposal to have IFAD credit rated warranted consideration as it was quite expensive. In determining the extent

of indebtedness, Management indicated that financial modelling would be undertaken to assess the point at which borrowing ought to be discontinued, based on potentially different borrowing terms. In response to the question of whether IFAD would use the PBAS to allocate the funds, the Committee was informed that this might not be the case as the terms and conditions of the loans would govern the allocation approach. The concept note stated that the framework would not change any aspect of IFAD's existing instruments.

15. Management noted that as Members were expressing some divergent views IFAD would list the points raised and address them in subsequent discussions.
16. Further comments from Executive Board representatives present in an observer capacity included requests for clarification on the use of IFAD's resources to provide support for non-concessional borrowers and IFAD's strategy on handling default risk, including an overview of default experience over time in order to assess the extent of risk. Clarification was further sought on the competencies and capacities for administering the loans and the new operating model and on the restriction of lending to a specific target group.
17. Management clarified that IFAD would bear the default risk. The Committee was informed that the level of default is currently negligible and that historical experience can be shared over time. The Committee was also assured that in terms of financial sustainability, the amounts of repayments to the lender are very low relative to the loan amounts and the level of interest and repayments is matched to the interest and loan repayment inflows. The Committee was also assured that IFAD does have capacity in place to manage this kind of operation and that an analysis has already been done across the organization. Management further clarified that the framework was looking at a longer term horizon of up to 2020 – 2025 while the KfW related to the IFAD9 existing financial framework.
18. An update on the KfW loan negotiations would be presented at the informal Board seminar to be held on 27 March 2014.
19. The Chairperson wrapped up the item by noting that she would be providing an oral update to the Executive Board at its April session on the Committee's deliberations on this item, and requested that a list of the questions raised be included as an attachment to the report (see the annex). Following a discussion on meeting modalities, the Committee decided to hold monthly informal audit committee sessions to review and discuss the general framework and progress thereon, based on a similar experience in the Evaluation Committee.

#### **Minutes of the 129<sup>th</sup> meeting of the Audit Committee**

20. The minutes were approved with no amendments.

#### **Standard financial reports presented to the Executive Board**

21. The Chairperson introduced the item and invited Management to present updates on the status of the Ninth Replenishment of IFAD's resources, report on the 2013 investment portfolio and status of arrears in principal interest and service charge and repayments, as well as principal repayments and net service charge foregone as a result of Debt Sustainability Framework (DSF) grants.
22. Management presented the updates highlighting developments since the report was finalized in January. A pledge had been received from Russian Federation and instruments of contribution from Finland, Morocco and New Zealand and further payments had been received from Botswana, Cabo Verde, Finland, Haiti, Israel, Kiribati, Morocco, New Zealand, Norway, Switzerland and United Arab Emirates. Total pledges stood at US\$1.423 billion, representing 95 per cent of the overall target for donor contributions. Instruments of contributions amounting to 98 per cent of the pledges have been received to date.

23. The Committee was informed of the recent payments by the Democratic People's Republic of Korea in the amount of EUR 358,000. The country's total arrears amount to US\$8.9 million.
24. On the investment portfolio performance for 2013, the committee was informed that the overall performance of negative 1.11 per cent had resulted in a loss of US\$24 million. The first two months of 2014 indicate positive performance of 88 basis points, which translates into investment income of US\$18.2 million, outperforming the benchmark by 14 basis points.
25. The estimated drawdown for 2014 is estimated at 35 per cent of the Ninth Replenishment contributions reflecting the second instalment due from unqualified contributions.
26. Comments from Members included requests for clarification on Management's perception of investment performance in 2014 thus far and whether the changes made are yielding the expected results.
27. Management expressed satisfaction with the portfolio performance for the beginning of the year, but indicated that while improved performance is foreseen for this year, a smaller negative 2014 return is nevertheless probable throughout the market normalization period. Positive returns are expected from 2015 onwards.
28. Members also asked for clarification on whether there is a deadline for replenishment pledges by Member States; the relationship between the amount of the projected IFAD9 financing gap and the US\$24 million loss in the investment portfolio for 2013; the Executive Board's responsibility to maintain long-term viability considering the impact of foregone DSF reflows and the projected amount of DSF principal repayments foregone for the period 2019-2021, whether all countries receiving DSF grants are 100 per cent DSF-eligible, and the impact of the drawdown on liquidity and the investment portfolio in 2014.
29. Management clarified that the projected investment return at the time of the IFAD9 Consultation (June 2011) for the IFAD9 period and beyond was 3 per cent. The projections were subsequently revised downward in light of the less favourable financial environment. The projected impact of the lower projections on the programme of loans and grants achievable for IFAD9 is US\$138 million. The loss incurred in 2013 is US\$24 million. The Committee was informed that the list of DSF-eligible countries is contained in a document submitted to the Board periodically on projects to be approved in the following months; however a list can be provided upon request. The Committee was informed that the decrease in the IFAD portfolio balance was expected and in line with disbursement commitments. Management monitors the portfolio level and ensures that commitments are at a level such that the portfolio remains above the minimum liquidity requirement.
30. The Interim General Counsel confirmed that there is no set deadline by which pledges have to be made, although Members are encouraged to make them within six months of the date of the replenishment resolution.
31. In response to a question as to whether Management should consider changing the investment portfolio in the light of poor performance in 2013, the Committee was informed that the investment policy approved by the Board stipulates the classes of assets they invest. The investment strategy was revised in 2013 and tailored to the market normalization period to minimize negative impact, and this has proved successful in containing losses. In addition, as IFAD's portfolio is invested with a long-term view, performance should be considered in a matching time period as shorter term returns could be misrepresentative. Management also confirmed that the contributions report included both regular and complementary contributions.
32. The meeting was adjourned.

## **LIST OF QUESTIONS ASKED ON THE GENERAL FRAMEWORK FOR A STANDARDIZED APPROACH FOR DEBT FUNDING AGREEMENTS**

1. Clarification on the relationship between the general framework and individual loans such as the KfW loan.
2. Whether the framework should be in place before conclusion of the KfW loan.
3. Rationale for the borrowing initiative as a source of funding over and above regular replenishment contributions.
4. Whether borrowing arrangements attract voting rights, particularly taking into account concessionality.
5. As the scope of the framework encompasses all borrowing from Member States and other public entities, clarification was sought as to what constituted public entities lending at concessional terms or semi-commercial terms.
6. Whether the borrowing agreement would place any restriction on the type of beneficiaries, project theme or country geographical area.
7. Should IFAD be credit rated to protect both itself and the lender?
8. Should the lending terms be matched to the terms of the borrowing agreement, especially in the case of concessional lending, as it might not be financially feasible?
9. What levels of borrowing will warrant financial sustainability while taking into account the level of need?
10. Requests were made for more emphasis on financial sustainability to be reflected in the document, including a request for information on the outcome of discussions with IDA and what elements of the IDA borrowing framework could be adopted.
11. Clarification was sought on who should bear the cost of default, and it was indicated that this should be clarified in the document.
12. Clarification on the ratio of maximum indebtedness to which the Fund can be exposed.
13. Clarification on whether the loans would be reviewed and approved by the Executive Board given that the funds would not be part of the replenishment, and whether the loans would be managed under the PBAS, including details of risk management measures and modalities to be applied.
14. Clarification was requested on how the Fund had found itself in a situation that required it to take on additional borrowing.
15. Consideration of a separate strategy paper outlining the rationale for the general framework.
16. Clarification was requested as to whether borrowing from other entities on concessional terms would be subsidized by IFAD's resources, as well as confirmation that borrowings would be segregated from regular resources for accounting purposes.
17. Clarification on the use of IFAD's resources to provide support for non-concessional borrowing terms and IFAD's strategy on handling default risk and an overview of default experience over time in order to assess the extent of risk.
18. Clarification on the competencies and capacities for administering the loans and the new operating model and on the restriction of lending to a specific target group.
19. Definition of concessionality.