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Report of the Chairperson of the 133rd meeting of the Audit Committee

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For: Review

Report of the Chairperson on the 133rd meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 133rd meeting of the Committee held on 4 September 2014. Mr Adolfo Di Carluccio, the newly appointed representative of the Italian Republic, assumed the role of Chairperson of the Audit Committee, thanking the outgoing Chairperson, Ms Raffaella Di Maro.

Adoption of the agenda

2. The agenda was adopted with no changes.

Minutes of the 132nd meeting of the Audit Committee

3. The minutes were approved with no comments.

High-level preview of IFAD's 2015 results-based programme of work and regular and capital budgets, and the preview of the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2015 and indicative plan for 2016-2017

4. Management presented the preview document, indicating that a more detailed version would be provided incorporating feedback from the Audit Committee and from the September Executive Board session. The budget proposal incorporates recurrent costs of the **action plan of the corporate-level evaluation of IFAD's institutional efficiency and efficiency of IFAD-funded operations** (CLEE) and of the Loans and Grants System (LGS) replacement project. The Committee was reminded of the absorption of all inflationary increases in the budget in the previous two years, which effectively represented a real decrease.
5. The Committee's attention was drawn to the document's key areas: the programme of loans and grants (PoLG), the strategic workforce plan and gender issues. The PoLG has been projected at US\$1.056 billion, which incorporates the assumption of a positive outcome of the negotiations with KfW Development Bank. The strategic workforce plan's budget impact is related to the addressing of operational staffing needs, including at IFAD country offices (ICOs).
6. The key cost drivers were the remaining balances of the CLEE-driven recurrent costs for 2015 and LGS-related costs, and price-related increases, mainly inflation. All estimates provided will be reviewed when finalizing the budget proposal.
7. The Committee was informed that the 2015 regular budget had been proposed at US\$152.25 million, compared with US\$149.64 million in the previous year, an increase of US\$2.61 million or 1.7 per cent. This increase covers CLEE action plan costs and factors in an inflationary price increase of 0.8 per cent. The capital budget is currently estimated at US\$4 million to cover mainly information technology (IT) and security facilities.
8. The Independent Office of Evaluation of IFAD (IOE) presented its work programme and budget for 2015 and indicative plan for 2016-2017. Underlying assumptions for inflation and staffing levels are those used in the IFAD budget. The preview presented had taken into account in-house consultations, feedback from the Evaluation Committee and IOE's selectivity framework. IOE presented a budget of US\$6.1 million, of which 60 per cent represents staff costs and 40 per cent non-staff – a nominal increase of 1.9 per cent from 2014, the first increase in six years. The Audit Committee was informed that the Evaluation Committee had found the IOE budget and work programme balanced and acceptable.
9. Several members welcomed the budget preview document. Comments from members included requests for clarification on: the level of the PoLG to be funded from the KfW loan; whether the 0.9 per cent real increase would cover the real increase related to the CLEE action plan; what is being absorbed versus additional

- costs in the regular budget; whether the continued pressure to maintain a relatively flat budget every year in spite of inflation translates into a real decrease and raises the question of whether IFAD has adequate funding to deliver its programme of work efficiently; the possibility of reporting on savings or efficiencies arising from the CLEE; whether the estimated budget increase for 2016 is inflation- or staff-cost-related; the basis of the inflation level factored into the budget for both IFAD and IOE; and the composition of the corporate cost centre. Appreciation was expressed for the continued gender analysis in the regular budget.
10. Other comments included clarification of the nature of the accelerated budget cycle and Management's comments on the cofinancing levels being planned. Members sought further clarification on: the basis of the exchange rate used, which entailed an overvaluation of the euro by about 7 per cent, as compared to the most recent quotation vis-à-vis the United States dollar, and the inflation rate; reconciliation between the administrative budget and capital budget figures, also in consideration of the US\$1 million amortization of a single project in 2015 which accounted for a substantial share of the expected increase in the administrative budget; the relationship between funding levels and operational needs; and the apparent reduction in the percentage allocation for cluster 2, dealing with policy dialogue and resource mobilization. Management advised that the final proposal would provide a breakdown of cluster information by department.
 11. In responding to comments from Committee members, Management stated that a blended inflation rate based on an Italian inflation of 1.5 per cent and an overall world inflation of 2.7 per cent was used to arrive at the 2.1 per cent estimate. The Committee was also informed that the 0.8 per cent non-staff price increase was derived by applying the assumed 2.1 per cent inflation only on the non-staff portion of the budget. On the exchange rate, Management stated that they took the rate of the previous year for comparative purposes, which is considered prudent at this preview stage – also noting that the actual average exchange rate for the year at the time the budget preview document was prepared was close to the assumed rate.
 12. The Chairperson invited Management to use realistic and updated values for both inflation and foreign exchange rates in the final budget, making reference to projections by major international organizations and the most recent available market quotations, respectively; and also to clarify the assumptions behind both, including the currency composition of IFAD administrative expenditures in the final budget document in December. In addition, the Chairperson invited Management to provide reconciled numbers on administrative and capital budget in the final budget document in December, possibly including a breakdown by years of expected current and capital expenditures within the ongoing projects.
 13. Management further stated that certain past decisions and cost drivers will impact the level of the 2015 budget, such as LGS, other IT commitments and a marginal increase in staff directly linked to ICOs. Management stated that it endeavours to ensure that operations are fully funded, even with minimal price increases, and reiterated the commitment to further improving the gender budgeting methodology. The accelerated budget cycle had been introduced based on comments of the Audit Committee and Executive Board during last year's budget deliberations. Management also confirmed the inclusion of loans in the PoLG to be approved from the KfW loan, should the Framework Agreement be approved by the Executive Board at its September session. Management informed the Committee that the CLEE action plan is a multi-period initiative and that some savings have been achieved to offset inflationary and other cost increases, and that the drive for efficiencies will continue in the medium term. Clarification was further provided on cofinancing policy and Management's commitment to seeking new sources of cofinancing, notwithstanding individual client countries' cofinancing capacities. The Committee was informed that costs of the corporate cost centre included items such as audit fees, depreciation and maternity coverage.

Progress report on the workplan for IFAD's Office of Audit and Oversight for 2014

14. In the internal audit area, the Committee was informed that five assignments from the plan had been completed and most of the others were in progress. Two additional final reports had been issued since the report had been prepared. A slight adjustment of the plans may be needed based on risk assessment owing to the higher-than-expected workload. A positive trend continues on the status of implementation of recommendations, with only 25 non-high-priority currently outstanding. In the area of investigations, a significant number of new complaints had been received, but notwithstanding this, the number of active cases has been reduced to 15, with the support of external experts.
15. The Committee was further informed that the office intensified anticorruption awareness activities. Additional resources were required to meet the Office of Audit and Oversight's (AUO) mandate and, as in previous years, Management promptly allocated the funds. AUO intends to request additional resources during this year, as well as a slight increase for 2015. The Director, AUO, also informed the Committee about the external review of the investigations and sanctions process planned for this year, which aims to assess the adequacy of the organizational and procedural framework, with particular attention to comparative practices of other United Nations agencies and international financial institutions (IFIs).
16. Members requested clarification on: (i) the nature of the long-outstanding recommendations and whether there is an established target for the rate of implementation; (ii) the amount of additional funding requested from Management and whether the funding issue was normal or systematic; and (iii) the procedure and policy regarding debarment of consultants.
17. The Director, AUO, clarified that the target is to not have any recommendations outstanding. This entails recommendations being implemented by the date agreed with Management. However, it is normal that some actions may not be implemented within the time frame initially planned, since AUO tries to link recommendations to ongoing or planned institutional projects or initiatives, and completion of implementation will be linked to completion of the related project. If the underlying risk is significant, AUO will recommend short-term actions to mitigate the risk while a long-term solution is in progress. It was emphasized that implementation of recommendations has been steadily improving and this is a reflection of Management's commitment to addressing issues, especially those with high priority.
18. On the funding issue, the Committee was informed that AUO had submitted an initial request for a non-staff budget of US\$300,000. It was further clarified that having financial rather than staff resources provided flexibility, especially for investigations where the volume and nature of the caseload cannot be predicted. The Committee was also informed of the results of the July sanctions committee, the situation regarding debarment, and the ways in which IFAD can benefit from accessing public debarment lists of other IFIs.

Update on preparation of a General Framework for Borrowing by IFAD

19. Management presented the update, drawing the Committee's attention to discussions at the 110th session of the Executive Board in December 2013. At that session, Management presented a document on the proposed framework for a debt-funding agreement with KfW and was requested by the Board to develop a parallel general borrowing framework to guide IFAD in its future financial partnerships based on debt-funding.
20. The Committee was reminded of the concept paper on a general framework that was presented by Management at the 130th session of the Committee in March, highlighting the main items that triggered the debate at the Board session: the rationale for IFAD to enter into borrowing, the legal framework, the type of lenders with whom IFAD should engage, the use of borrowed funds, the impact on IFAD's

long-term financial sustainability, cost recovery, risk management, auditing, accounting and due diligence procedures.

21. The Committee was further reminded of the informal committee meetings that were convened after that meeting, which aimed to address the issues raised, and of the consensus reached at the informal meetings to prepare the borrowing framework in two parts: part 1, dealing with borrowing from sovereign states and state-supported institutions and, subsequently, part 2, dealing with market-based borrowing.
22. Management reported on the progress reached as of the fifth informal meeting, which included agreement on the rationale for borrowing by IFAD; the scope of the framework and the fact that it will be considered to be an evolving document; inclusion of a reference to the establishment of an indicative ceiling for borrowing; governance over borrowing proposals and the use of borrowed funds; inclusion of a section on risk management; and how to handle any requests for voting rights by members contributing through lending.
23. The Committee was informed that the main outstanding issue – relating to the possible use of IFAD's funds to support borrowing, if necessary – is still to be agreed on and will thus require further discussion. It was further informed that, at the next informal meeting in October, Management would present a draft of part 1 of the document, including all points agreed on, and would seek further guidance from the Committee on any missing items and on the timing of submission to the Executive Board.
24. Following Management's update, comments from members included recognition of the progress made to date and the need to resolve the one major outstanding issue concerning the use of IFAD's funds to support borrowing. Members requested that specific information and examples be provided to facilitate discussion on this issue. Clarification was sought on whether the update that has been provided would also be provided to the Executive Board. There was a discussion on the issue relating to use of IFAD resources to support borrowing, and how and at what time this should be presented to the Board for consultation.
25. The Committee concluded that this issue should be discussed further at the next informal meeting and that this information should be conveyed to the Executive Board, including in the Chairperson's report.

Framework Agreement with KfW Development Bank for the granting of individual loans to IFAD

26. Following Executive Board authorization in December 2013 to negotiate with KfW, Management presented progress made to date and the status. The Committee was reminded of an informal seminar held in March to inform members of the terms of the KfW loan and its impact on IFAD. Management reported that negotiations were completed in July on all major issues, and stated that the agreement is beneficial to IFAD from the financial and programmatic points of view.
27. Management highlighted the following points:
 - (a) The KfW loan will provide up to €400 million to meet the PoLG target of US\$3 billion for the period of the Ninth Replenishment of IFAD's Resources (IFAD9).
 - (b) The Framework Agreement will define all terms except the amount of individual loans and their interest rate. These will be specified in individual loan agreements (ILAs), which will be in the minimum amount of €50 million each.
 - (c) The KfW loan will be used to finance the projected pipeline of loans on ordinary terms for approval in December 2014 and during 2015.
 - (d) The loan will be self-sustainable, not requiring an external grant or use of IFAD's own resources.
 - (e) The loan, in the euro currency, will have a maturity period of 20 years and a grace period of 5 years.

- (f) The interest rate will be based on the Euribor six-month rate, plus a spread that will be determined at the time of the signing of each ILA and that KfW has indicated, and that IFAD has embedded in its presented projections.
 - (g) KfW will not be involved in the governance or approval of IFAD projects financed under these loans.
28. Comments from members included appreciation for the work done by Management and the outcome reported. Members sought clarification on: the financial sustainability condition and whether that could be clarified in a technical addendum; the timing of each ILA and alignment to resource requirements; the fact that KfW net liquidity is not projected to fall below zero; and the format of reporting on each ILA, and whether it would involve the Audit Committee in consideration of Management's request for delegation of authority and the variability of some important financial parameters of the operation (i.e. KfW actual spread for each ILA). Management was also requested to provide assurance as to the controls in place for what appears to be a manually intensive process in order to reduce the risk of error. Clarification was also sought on: why the actual Framework Agreement was not included with the document presented to the Committee; the use of the extra US\$148 million; and the reason for omitting the amount of the cost compensation fee, while the commitment fee was included. Further comments included questions about: the currency for onlending and whether that should be the borrower's choice; the basis of the liquidity calculation and how financially sustainable it is; and whether projects would issue withdrawal applications before IFAD requests the corresponding funds from KfW. Clarification was also sought on whether payment of the commitment fee will be linked to disbursement to borrowing countries.
29. In responding to these comments, Management began by explaining the difficulty of producing a detailed addendum and getting it translated in time for the September session of the Executive Board. It was agreed that a summary addendum would be tabled at the latest on the day of the meeting. Management further noted that it may not be easy to spell out all conditions of the Framework Agreement in the addendum. On the issue of fees, Management stated that information concerning the cost compensation fee cannot be publicly disclosed, as that may jeopardize IFAD's position in negotiating future borrowing agreements, and that KfW may also not wish to have that information made public. In all modelling used in the analysis, administrative costs have not been included, given that the incremental costs are perceived to be minimal. Management further clarified that the forecast cash flows show a positive net value after the life of the loan, when all repayments have been made. The Committee was also assured that IFAD's internal control systems will be applicable to the KfW funds just as with other IFAD resources, and thus the loan does not pose any new specific risks due to being manually intensive. Management clarified that the forecast gap was based on estimates, and the actual gap may be slightly different. On the currency of the loans funded out of the KfW loan, the Committee was informed that although the funds may be disbursed in any currency, the loan will be denominated in euro to match the currency of IFAD's liability to KfW. Management explained that the liquidity graph addresses the availability of cash to meet IFAD's obligations to repay KfW and that it is sustainable, as it shows that liquidity is projected to be above zero throughout the life of the loan.
30. The Committee was informed that funds from KfW will be drawn down based on the Board's approval of projects, not on withdrawal applications from borrowers. On the issue concerning the disclosure of the Framework Agreement, Management explained that such agreements are not made public, as each borrower is assessed on its financial strength and the terms tend to reflect that. The actual Framework Agreement is a very lengthy document, but all key terms of the agreement have been highlighted in the Executive Board document. The Committee was further informed that IFAD could draw down the funds under the Framework Agreement up to December 2018, although the intention is to commit the bulk of the funds within the IFAD9 period.

31. The document was reviewed.

Update on progress in the implementation of the Loans and Grants System

32. Management presented an update on development of the LGS and an addendum, tabled at the request of the Chairperson, providing additional information on depreciation costs.
33. The Committee was informed that the system had gone live on 1 November 2013 with no major disruptions or issues. Some work on reporting was ongoing and was expected to be completed soon. Additional work in phase 1.5 was also expected, pending approval by the project steering committees.
34. Members requested information on the timing of the beginning of phase 2, the envisioned timetable and status of its realization.
35. The Committee was informed that Management is internally assessing the scope and potential costs of phase 2 before further work is carried out. The two main areas envisaged under this phase include electronic disbursements and the borrower's portal. The Committee was further informed that the initial plan envisioning phase 2 to be completed by end 2015 will be delayed, mainly due to the ongoing scope review prior to contracting work for subsequent phases, the significant learning curve for staff on the project, and reporting activities still under way.

Standard financial report presented to the Executive Board

36. The Committee noted Management's report on IFAD's investment portfolio for the second quarter of 2014.
37. The Committee was informed that the value of IFAD's investment portfolio decreased by US\$71.6 million in dollar terms, from US\$2.03 billion at 31 March to US\$1.959 as at 30 June. The main factors causing this were:
- Net flows represented by outflows for disbursements;
 - Grants and administrative expenses;
 - Inflows from loan reflows and encashment of Member States' contributions.
38. The net flows were slightly offset by the positive investment income and foreign exchange movements. The investment portfolio generated a net return of 1.28 per cent, translating into a net investment income of US\$25.1 million. On a year-to-date basis as at 30 June 2014, the net rate of return for IFAD's investment portfolio was 2.28 per cent, translating into a net investment income amount of US\$44.9 million.
39. The Committee was informed that all four externally managed asset classes performed positively and outperformed their relative benchmarks. Although all portfolios were performing well, there were expectations of less-favourable returns in the future when global economic growth and accompanying increases in interest rates materialize. All risk parameters continued to remain below the prescribed budget levels as stated in IFAD's Investment Policy Statement.
40. Members expressed their satisfaction with portfolio performance. The Chairperson highlighted the restricted nature of the IFAD investment portfolio, which focuses on fixed-income asset classes. This policy places constraints on asset composition, while providing a sense of comfort to members and stakeholders; and exposes the portfolio to interest rate risk, precluding important opportunities for diversification and hedging, at a time when such a risk is increasing substantially in global financial markets.

Oral update on the developments with respect to the financial implications of hosting the Global Mechanism of the United Nations Convention to Combat Desertification (UNCCD)

41. Management presented a brief update informing the Committee that there had been no significant developments on the issue. The Committee was reminded of the move of the Global Mechanism to the UNCCD Secretariat in Bonn, with a liaison

office at the Food and Agriculture Organization of the United Nations (FAO). Almost all Global Mechanism staff have been offered contracts either with UNCCD or with IFAD. The Global Mechanism has also vacated its offices at IFAD. The funds held in the escrow account have been retained, pending decisions on the cases before the International Labour Organization Administrative Tribunal (ILOAT), with the exception of a payment of US\$640,000 that was recently made for FAO invoices confirmed as having been settled. The Committee was informed that IFAD and the UNCCD Secretariat have been actively collaborating with a view to reaching a mutually acceptable solution to closing the account and releasing the funds back to the Secretariat.

42. The update was noted.