Report of the Chairperson on the 137th meeting of the Audit Committee

Note to Executive Board representatives

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Executive Board — 115th Session
Rome, 15-16 September 2015

For: **Review**
Report of the Chairperson on the 137\textsuperscript{th} meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 137\textsuperscript{th} meeting of the Committee held on 3 September 2015.

   \textbf{Adoption of the agenda}

2. The agenda was adopted, noting that under other business Management would provide an oral update on the review of the lending terms.

   \textbf{Minutes of the 136\textsuperscript{th} meeting of the Audit Committee}

3. The minutes were approved with some revisions agreed during the course of the meeting.

   \textbf{High-level preview of IFAD’s 2016 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 2016 and indicative plan for 2017-2018}

4. Management presented the preview document, indicating that a more detailed version would be provided prior to the Executive Board session in December incorporating feedback from the Audit Committee and from the September Board session. It also highlighted that assumptions and costs would be reviewed as part of the normal budgeting exercise prior to the finalization of the budget.

5. The budget proposal incorporates recurrent costs of the main elements of the programme of work, and regular and capital budgets of IFAD. The document also presents the preview of the Independent Office of Evaluation of IFAD’s results-based work programme and budget for 2016 and indicative plan for 2017-2018 which was already reviewed by the Evaluation Committee at its eighty-eighth session on 26 June 2015.

6. Attention was drawn to the significant change in the euro to United States dollar (EUR/US$) exchange rate, the implications of which had to be carefully considered in preparing the 2016 preview. Compared to the exchange rate used of EUR 0.735/US$1 for 2015, the exchange rate for 2016 was EUR 0.85/US$1, based on the foreign exchange methodology agreed in July. As a result, the 2016 budget proposal was lower than the 2015 approved budget. This change was effected as per the new methodology agreed with the Audit Committee at the previous session on 2 July 2015.

7. The Committee's attention was drawn to the document's key areas: the programme of loans and grants (PoLG), with a target of US$3.0 billion for the period of the Tenth Replenishment of IFAD’s Resources (IFAD10) and projected at US$0.9 billion for the year 2016; the annual strategic workforce planning exercise; and the fact that 2016 would be the first year of the new rolling medium-term plan, which aimed to align IFAD’s corporate and operational objectives with the strategic thrust of IFAD10 to further improve IFAD’s development effectiveness and its role as a knowledge institution, the decentralization strategy and contain costs related to IFAD country offices, and price increases primarily related to the within-grade salary increment (WIGSI).

8. As in previous years, an attempt would be made to absorb much of the inflationary increases anticipated in 2016 within the regular budget through cost reductions arising from efficiency measures, streamlining of processes and cost control. However, once the standard staff costs were adjusted for the new exchange rate it would no longer be possible to absorb the annual salary increment associated with WIGSIs.
9. The Committee was informed that the 2016 regular budget had been proposed at US$147.46 million compared to an approved budget of US$151.59 million in 2015, or a 2.7 per cent nominal decrease, using a current exchange rate estimate of EUR 0.85 Euro/US$1. In preparing the final budget proposal, the exchange rate would be adjusted based on the agreed methodology, estimates of cost drivers would be revisited and all costs would be reviewed. The capital budget was currently estimated at US$3 million and would pertain mainly to information technology and security facilities.

10. The Independent Office of Evaluation of IFAD (IOE) presented its work programme and budget for 2016. The Committee was informed that the preview included feedback provided by the Evaluation Committee, that it had been formulated in consultation with IFAD Management and that it reflected suggestions from the Fund's governing bodies. IOE presented a budget of US$5.65 million, with a 7 per cent nominal decrease against the 2015 approved budget of US$6.07 million. The decrease was attributable to reduced staff costs as a result of the weakening euro against the United States dollar; the decrease was partly offset by a very minimal real increase of 0.6 per cent in non-staff costs due to increased activity and application of more robust methodologies for project performance evaluations and evaluation synthesis reports. The proposed 2016 IOE budget was 0.56 per cent of IFAD's expected PoLG for next year, well within the budget cap of 0.9 per cent adopted by the Executive Board.

11. In opening the floor for comments by Committee members, the Chairperson stressed that the proposed 2.1 per cent increase in real terms would be presented together with a reduced annual programme of loans and grants in 2016 (equivalent to US$900 million) even if there were some uncertainties about the definitive size of the PoLG envelope, which would warrant gradualism, particularly in increasing staff. Several Committee members welcomed the budget preview document and requested: clarification on the level of PoLG during the IFAD10 period, including its expected volume in 2016 as opposed to the three year PoLG of US$3.0 billion, the borrowing target for the same reference period and the allocation of resources to sub-Saharan countries; and additional details on decentralization costs and plan, including how long Management expects decentralization to remain a significant cost driver for the budget in future. Committee members also enquired on the adequacy of the capital budget estimate and, in particular, additional costs for new country offices now and in future years. A confirmation of the exchange rate methodology used was requested by one member. Some members suggested separate documents and approval processes for the IFAD budget and IOE budget.

12. Management clarified that the budget of US$147.46 million represents a 2.7 per cent nominal decrease, while in real terms it represents a 2.1 per cent increase. Management also reassured the Committee that the PoLG for the IFAD10 period would be at least US$3.0 billion, and noted that following the confirmed final IFAD10 target of US$1.353 billion, Management would soon be assessing the borrowing target for 2016-2018. It was also explained that expected proposed budget levels continued to remain aligned to this target PoLG. On the adequacy of the capital budget, Management reassured members that it was set at a level to ensure optimum alignment with the capacity for implementing the high-impact and prioritized initiatives.

13. In addition to the distinction between the gross and net budgets, Management further explained some of the historical structural elements in the budget addressed in the proposal, the integration in the administrative budget of the remaining core function positions that have been funded so far from other supplementary sources. Additional details were provided in relation to the decentralization strategy and costs associated with the opening of planned new country offices.
14. In outlining the key cost drivers, Management illustrated the prominent role of decentralization, indicating the high priority given to this in IFAD's medium-term plan. On the exchange rate used for the preview budget and expected to be used for final budget preparation, Management confirmed consistency with the methodology agreed at the Committee meeting on 2 July and further informed the Committee that based on recent movements, the final rate was in line with expectations.

15. On the subject of separate IFAD and IOE budget documents, Management suggested that decisions made at prior governing bodies sessions be provided to guide future conversations on this subject.

16. The budget preview document was considered reviewed.

Progress report on the workplan for the IFAD's Office of Audit and Oversight for 2015

17. In the internal audit area, the Committee was provided with a summary of the activities for the first six months of 2015. The Office of Audit and Oversight (AUO) had set an ambitious target for the 2015 workplan, aiming to audit up to eight country offices. It was noted that the work for four of these audits was almost complete and the benefits of this wider coverage were clear in terms of the ability to benchmark/compare practices among offices and in terms of audit efficiency. The average time taken by Management to implement recommendations appeared to have increased slightly in 2015, but this may have been attributable to timing. Some recommendations had been closed soon after the 30 June deadline; therefore the year-end statistics would provide a more realistic picture.

18. It was highlighted that IFAD’s investigation and sanctions processes were reviewed by an external team of experts. The general conclusion of the report was positive but several recommendations were made by the reviewers to ensure that IFAD’s practices remained aligned with best practices in the United Nations system and international financial institutions (IFIs). Working closely with Management, AUO had formulated an action plan covering all recommendations issued. AUO was in the process of implementing the plan with the help of external experts and expected to have a revised framework in place by the end of the year.

19. In the area of investigations, there had been an increase in the number of incoming cases during the first half of 2015. The nature, sources and subject matter of the new cases were varied and not indicative of any trend, other than an increased awareness among staff of their responsibilities in relation to reporting misconduct and irregular activities since most new complaints were forwarded to AUO by staff members. As in previous years, AUO had requested and obtained additional financial resources that would allow it to complete its work through the use of external support.

20. Several Committee members expressed their appreciation for the progress report and requested clarification as to whether budget resources allocated to AUO were adequate, also in relation to one of the recommendations (no. XVII) of the external review of the investigation and sanctions processes and, more broadly, about the implementation of such recommendations. Additional details were also requested on implementation of high-priority overdue recommendations by Management, and recruitment for the vacant investigation position. In responding to these requests for clarifications, Management stated that reporting on the implementation of the recommendations would be included in the context of the annual report.

21. The progress report was considered reviewed.

Progress report on the review of IFAD's investment strategy

22. Management presented a progress report on the review of IFAD’s investment strategy to be presented to the Board in December. In this context and considering the complexity of the current financial market, Management presented a brief
summary of the investment strategy review, which would feed into the investment policy statement. It was noted that the review was carried out with the support of an external adviser who had completed an asset allocation study for IFAD. The main themes included the impact on the portfolio of the liquidity constraint that would affect IFAD over the coming years, and the strategic positioning of IFAD across asset classes, looking also at the possibility of introducing equities. The review was also important as it addressed the strategic implications of borrowing funds. The adoption of a more proactive stance towards green investments was also considered. Committee members welcomed the details provided. Clarifications were requested with regard to the consultant supporting the Fund in this exercise, if comparative data with other IFIs had been considered, and on the precise scope of the review. In relation to equities, members requested more detailed information on risk parameters prior to the Board session in December.

23. Management clarified in this effort IFAD has been supported by a major fund manager/adviser, who had provided background material and investment scenarios. The conclusions had been elaborated by Management. It was also noted that comparative information from other multilateral development banks had been considered. Management explained the main differences between IFAD and other IFIs in relation to investment style and investment portfolio structure. It was clarified that investment strategy reviews were not meant to be reviewed by the Audit Committee; however Management found that it was beneficial to share the main conclusions with the Committee to ensure that it played a constructive and active role on this topic. Further information, including a more detailed presentation, would be shared at the next Committee meeting.

24. The document was considered reviewed.

**Review of the adequacy of the General Reserve**

25. Management presented the agenda item, noting that the General Reserve had been established by the Governing Council in 1980 to address the potential risk of over-commitment of IFAD resources in four areas, namely: exchange rate fluctuations; potential delinquency in the receipt of loan service payments; potential delinquencies in the recovery of amounts due to the Fund from the investment of its liquid assets; and the possible diminution in assets caused by fluctuations in the market value of investments. Over the years, several transfers had been approved, bringing the General Reserve up to its current level of US$95 million. It was noted that the document outlined the strategies and mechanisms adopted over the years to mitigate these risks, including some recent measures implemented to help further reduce the risks related to over-commitment. Consequently, it was highlighted that the level of the General Reserve and the risks of over-commitment should be reviewed in light of the resource definition based on sustainable cash flows and considering all factors that could affect IFAD’s liquidity. It was noted how financial risks were being addressed effectively and, in light of this initial assessment, it was proposed that the current level of the General Reserve be maintained until a formal assessment was conducted in 2016.

26. While understanding the various factors which will imply a postponement of the review, Committee members requested clarification on the new timeline proposed for this exercise.

27. Management reassured Committee members that postponement of the review of the General Reserve did not imply a violation of provisions set by Governing Council or by statutory documents. Financial regulations required a periodic review of the General Reserve without specifying a precise timetable; the three-year cycle was set out in the Audit Committee’s Terms of Reference. Any departure from this reference period fell therefore within the competence of the Executive Board. Management also clarified that due to the complex requirements of International Financial Reporting Standard (IFRS) 9 – on which discussions were ongoing with
the external auditors – the review of the General Reserve would be presented in 2016, most likely during the second half of the year.

28. The document was considered reviewed and the proposal of postponement was endorsed.

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

29. Management presented an oral update on issues pertaining to the hosting of the Global Mechanism noting that: the Global Mechanism had relocated from IFAD in Rome to the UNCCD Secretariat in Bonn and vacated their offices at IFAD in April 2014. In February 2015, the International Labour Organization Administrative Tribunal (ILOAT) had confirmed IFAD’s decision not to renew the contracts of the complainants and interveners. In relation to the one outstanding complaint filed by the former Managing Director, the Tribunal had decided that IFAD was the appropriate venue to consider the complaint, through internal dispute resolution mechanisms. In June 2015, following a negotiated settlement, IFAD paid the former Managing Director of the Global Mechanism and settled the issue. Subsequently the entire remaining amount in the escrow account amounting to US$3.38 million was transferred back to the UNCCD. This was noted as a very positive outcome, given that the initial estimate of potential liabilities was US$4.5 million and the Fund was able to deal with all the liabilities and return approximately US$3.8 million to the UNCCD. The Committee was informed this matter could now be considered as closed.

30. The Committee requested details about the amount paid to the former Managing Director and, with the clarification provided by Management, the update was deemed noted.

**Oral update on progress in the development of the Loans and Grants System**

31. Management provided an oral update on progress in the development of the Loans and Grants System (LGS). The Phase 1.5 project – whose purpose was implementing functionality to refine and enhance the usability of the original LGS solution – was proceeding on time and within budget. The entire underlying system and associated data warehouse development work were now finalized and currently being tested. The deployment of these customizations should take place by the end of September. Regarding the LGS Phase 2 project, a number of client-focused web-based functionalities were planned for delivery through a web-based portal application. A project manager for the pre-implementation phase had been appointed in May. This six-month pre-implementation phase would deliver a project proposal document detailing the expected project scope and costs, including implementation, recurrent expenditures and depreciation, and providing recommendations on how to phase the project implementation timetable and subject areas. The detailed options and recommendations would be presented to IFAD Management in November 2015. Project activities carried out to date included: a client survey to 18 borrower countries to understand client priorities; identification and prioritization of the business requirements for the portal; and approval by the project steering committee of a phased approach to implementation, with the initial phase to be delivered nine to 12 months after the start of the project. The initial phase of the solution would deliver reporting capabilities and the ability to submit withdrawal applications electronically through the portal for an initial set of countries. A request for procurement to select a vendor to deliver the portal solution had been sent out through IFAD’s e-procurement system a couple of weeks previously. It was foreseen that project implementation would commence in early 2016 once the procurement process was completed and Management’s approval of the recommendations had been received.
32. The update was noted.

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

33. The Committee noted Management's report on IFAD's investment portfolio for the second quarter of 2015 and the Report on the status of contributions to the Tenth Replenishment of IFAD's Resources.

34. The Committee was informed that during the second quarter of 2015, IFAD's investment portfolio performed negatively with a net rate of return of negative 0.76 per cent, translating into an investment loss of US$12.1 million. On a year-to-date basis, the investment portfolio performance was positive 0.14 per cent. During the period, the value of the investment portfolio in United States dollar terms decreased by US$48.5 million, from US$1,706 million at 31 March 2015 to US$1,666 million at 30 June 2015. The main factors for this decrease were negative net flows and negative investment income offset by positive foreign exchange movements. The duration of the portfolio had increased compared to the first quarter of 2015, and now stood at 3.7 years as opposed to 2.9 of the benchmark. This was due mainly to the investment of the KfW Development Bank resources, which had been held in cash until the end of March 2015 through the asset liability portfolio. All risk parameters remained below the budget levels as stated in IFAD's Investment Policy Statement. In terms of credit risk, the bulk – 61 per cent precisely – of IFAD's portfolio remained invested in AA- or better-rated assets. The next annual review of IFAD's Investment Policy Statement would be submitted for approval at the Executive Board session in December 2015.

35. Management also provided an update on the Status of the Tenth Replenishment of IFAD's Resources, highlighting that as of 16 August, IFAD10 pledges had reached US$1.15 billion, equating to 79.85 per cent of the target of US$1.44 billion set by the Member States. Pledges for core contributions amounted to US$1.07 billion, making it the highest level of core contributions ever achieved at this point in any IFAD replenishment cycle. It was highlighted that at the same point in IFAD9 and IFAD8, pledges for core contributions had amounted respectively to US$1.04 billion and US$0.97 billion. Furthermore, it was highlighted that pledges to IFAD10 in terms of both core and unrestricted complementary contributions surpassed by 10 per cent the equivalent pledges made by Members during the same period for IFAD8 and IFAD9.

36. It was further noted that despite the difficult global financial and economic situation, IFAD had received renewed and strong support from its Members, including borrowing countries: 76 countries had pledged by 16 August in IFAD10, in comparison with 64 countries in IFAD9 and 59 countries in IFAD8.

37. As per the resolution of the Governing Council, the final target for IFAD10 had now been revised to account for the actual pledges as at 16 August 2015 and amounted to US$1.353 billion. The slight shortfall versus the initial target was caused mainly by two factors: the impact of currency exchange rate fluctuations on pledges received so far showed that depreciation of several national currencies vis-à-vis the United States dollar had resulted in a US$57.6 million reduction in IFAD10 contributions measured in United States dollar terms, representing about three quarters of the gap between the original target and the revised target, and the Debt Sustainability Framework (DSF) compensation payments becoming effective as of IFAD10. As a result, Member State contributions to IFAD10 had been adjusted by US$2.984 million to account for DSF compensation; specifically, in IFAD10, the total DSF share to be received from Member States was estimated to be US$3.4 million. It was also noted that DSF compensation payments would be substantially higher in future replenishments; in IFAD11 they were expected to be US$39.5 million and in IFAD12 US$97.9 million. It was clarified that the DSF compensation payments were not included in the replenishment target but attracted voting rights.
38. To account for this reality, Management would seek the support of IFAD Membership to ensure higher pledges for contributions in future replenishments. It was also clarified that while the replenishment target had been adjusted to reflect the actual pledges by 16 August 2015, the targeted IFAD10 programme of loans and grants was being maintained at a level of at least US$3 billion. The approved Sovereign Borrowing Framework provided the capacity to seek additional resources to meet the targeted programme of loans and grants through sovereign borrowing. In the coming weeks a proposal regarding the sovereign borrowing target will be submitted to the Executive Management Committee for its consideration and decision. Moreover, in the coming weeks, Management was to further actively engage with Members, on one hand to secure more pledges of core and unrestricted complementary contributions and, on the other, to receive the instruments of contribution and payment of their announced pledges. Effectiveness of IFAD10 would be reached when at least 50 per cent of the pledged amounts had been received by way of payments or instruments of contribution. Since 16 August 2015, one more Member State had indicated its intention to pledge, and instruments of contribution had increased to 34.9 per cent of pledges.

39. Some Committee members requested clarification on the increase in the portfolio duration, which was more pronounced if the reduction in cash was considered; on future investment performance outlook; and on annex III of the Report on the status of contributions to the Tenth Replenishment of IFAD’s Resources.

40. Management clarified that the second quarter performance was impacted by extreme volatility in all sectors of financial markets; however, recent data on portfolio performance seemed more positive. Management provided in-depth explanations regarding allocation of voting rights procedures and informed the Committee about the possibility of taking up this topic for further clarification in the Working Group on Governance.

41. The documents were considered reviewed.

Other business

42. Under other business Management provided an oral update on the review of lending terms, and summarized the last review of the lending terms that took place in 2012. As a result of this review, the terms had been amended and a new category of lending terms was introduced, that of blend terms. A decision was also made to stop offering the categories of intermediary terms and hardened terms. No other changes had been made to other terms and conditions. While there had been a preliminary indication to the Audit Committee that a new review might be conducted in 2015, Management noted that it would be more effective to conduct this exercise in 2016. The main reasons were that: in light of the loan from KfW Development Bank and the newly approved Sovereign Borrowing Framework, IFAD’s funding model was going through a transition phase. A driving element of IFAD’s lending terms should be, as for other IFIs, IFAD’s own cost of capital. Management considered that the cost of borrowing, which was representative of the average cost of capital, was not yet established and could be subject to adjustments in the coming months if future single borrowing arrangements with sovereign lenders had different conditions. Management suggested deferring a fuller review of the lending terms to a later stage, once other borrowing opportunities had been pursued and actual deals were in place.

43. Another element to take into consideration was that Management – as part of its commitment to enhance its differentiated approaches for countries in fragile situations, low-income countries or middle-income countries – was also considering new financial instruments, such as single currency lending or guarantee products. It would therefore be advisable to have such new developments considered in a review of the lending terms. It was also noted that IFAD benchmarks its products against those offered by other institutions, and offers variations around similar
products. This benchmarking would be a crucial dimension of the review, particularly with regard to the highly concessional and blend terms, which were closely aligned with the concessional lending of IFIs. Finally it was highlighted that the Sovereign Borrowing Framework had been approved on the assumption that there would not be a major review of current terms and conditions of IFAD lending in the near future. Management proposed that the review process commence with the establishment of an IFAD cross-departmental working group that would undertake a comprehensive and holistic review. This process would be launched in early 2016 and would focus on strategic, legal, operational and financial considerations. Following internal discussions, the conclusions and recommendations would be presented to the Audit Committee for direction in autumn 2016.

44. One Committee member expressed their understanding that the Sovereign Borrowing Framework would not imply a revision of lending terms, as it had been approved on the basis of the self-funding principle.

45. It was clarified that the review of the lending terms was a necessary process to be undertaken on a periodic basis and that it had already been scheduled on the 2015 Audit Committee workplan prior to the approval of the Sovereign Borrowing Framework. The postponement was agreed; however, the Chairperson, while supporting the postponement, remarked that the approved Sovereign Borrowing Framework did not include any commitment to refrain from reviewing pricing, either in the short or in the long term; neither did it include any language that could raise such expectations. The Chairperson added that such provision would encroach on the authority of the Governing Council on establishing and reviewing IFAD lending terms.

46. The update was noted, with the understanding that draft minutes would be circulated, as per standard practice, among Committee members.

47. No additional items were discussed under other business.