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Report of the Chairperson on the 138th meeting of the Audit Committee

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Executive Board — 116th Meeting
Rome, 16-17 December 2015

For: Review

Report of the Chairperson on the 138th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 138th meeting of the Committee held on 19 November 2015.

Adoption of the agenda

2. The agenda was adopted with the addition of an agenda item regarding the effect of the strengthening of the United States dollar on the 2015 financial accounts under the item other business.

Minutes of the 137th meeting of the Audit Committee

3. The minutes were approved with some editing changes agreed during the meeting. IFAD's 2016 results-based programme of work and regular and capital budgets, and the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2016 and indicative plan for 2017-2018
4. The Committee's discussion of this item is covered in a separate report (EB 2015/116/R.3).

Workplan for IFAD's Office of Audit and Oversight for 2016

5. The Director, Office of Audit and Oversight (AUO), presented the proposed AUO workplan for 2016, stating that the selection of audits for 2016 was based on an assessment of corporate risks and priorities. Field presence and decentralization were considered as an area of ongoing priority.
6. During 2015, a remote audit approach for IFAD country offices (ICOs) was introduced, which had allowed the expansion of audit coverage. This modality would also be applied in 2016.
7. The Committee was informed that in the investigations area, efforts would focus on addressing the investigative caseload that resulted from the high rate of deferrals to AUO during 2015.
8. The Director, AUO, further explained that the proposed AUO budget allocation for 2016 was slightly higher than in 2015.
9. Members agreed to the workplan and requested clarification on which areas AUO foresaw as high risk and on recent trends in corruption cases.
10. The Director, AUO, stated that the high-risk areas identified by AUO included the decentralization process and the fiduciary requirements of supplementary funds which were proving to be an additional burden on the Fund. To address these areas, AUO was planning to continue the increased audit coverage of country offices and to perform an audit on grants, as the majority of supplementary funds were deployed as grants. The Committee was informed that the trend in corruption cases was uneven; however, overall the number of cases referred to AUO had increased in 2015. AUO had taken various measures to address the cases depending on the circumstances, including referrals to national authorities.
11. The AUO workplan was deemed reviewed and would be submitted for confirmation to the Executive Board at its 116th session in December 2015.

Annual review of IFAD's Investment Policy Statement

12. Management presented the background and rationale for the Investment Policy Statement. The aim of the 2015 revision was to ensure a comprehensive range of tools to be used according to the major economic and financial scenarios; it was also intended to improve the efficiency of treasury operations.

13. The revision focused on eligible asset classes and financial instruments and included the risk budget. It introduced the following main changes:
 - (a) Develop market equities as an eligible asset class, though under a prudential portfolio limit of 10 per cent;
 - (b) Reintroduce securities lending to create a steady source of modest income to enhance returns; and
 - (c) Allow derivative instruments to enhance the asset and liability management tool.
14. Management also clarified that the current risk budget levels were sufficient to accommodate a limited exposure to equities and no changes to the current risk budget were necessary. Management informed the Committee that the introduction of such an asset class would be gradual and based on economic and financial market factors and on strategic and liquidity considerations.
15. The Committee requested clarification on: currency risks and costs associated with borrowing activities; in this regard the requirement to consider hedging costs in assessing the financial sustainability of any borrowing operation was recalled as required by the General Framework for Borrowing; comparisons with other international financial institutions (IFIs); the use of derivatives; the risk associated with securities lending given the legal uncertainty on entitlement on the lent securities in case of resolution of the counterparty; and the level of authority within the various IFIs to approve changes to investment policies. Some Committee members enquired about the possible targets set for investment returns, about the modality for introducing equities and how to handle counterparty risks.
16. Management provided detailed answers, clarifying that borrowing activities increased the risks associated with currency exposure. Those risks so far had been handled by ensuring that onlending operations were denominated in the same currency as the borrowed funds. It was clarified that currency swaps were used by other IFIs as hedging measures. Management noted that IFAD had not defined a target return but had associated the various mandates with external benchmarks. It was noted that counterparty risk would be handled by requesting collateral and by an accurate selection of counterparties based on credit rating and additional analysis. Management also clarified that the introduction of derivatives was subject to negotiation of a legal framework, which could be a lengthy exercise.
17. The Investment Policy Statement was deemed reviewed and would be submitted for approval to the Executive Board at its 116th session in December 2015, with the consideration that the equity investment portfolio should be gradually introduced, especially in the first year, and that therefore the overall equities cap of 10 per cent should also be gradually achieved.

Audit Committee work programme for 2016

18. The Chairperson introduced the work programme and opened the discussion by proposing certain changes to the workplan. These were discussed together with proposals from other members. In particular, while it was clarified that review does not necessarily amount to revising the ordinary terms, some members questioned the inclusion of the item on the ordinary lending terms for the September meeting on the ground that the review was premature and not required. The Chairperson objected that, on the contrary, the review is overdue, as not undertaken in 2014 and required on an annual basis by the Governing Council's Resolution of February 2013 (178/XXXVI), which adopted the "Policies and Criteria for IFAD Financing" as a whole; the Chairperson stressed that the latter delegate to, and require from, the Executive Board, to "decide, annually, the rates of interest to be applied to loans on ordinary terms. For that purpose, it shall review annually the rates of interest applicable to loans on ordinary terms and revise such rates, if necessary". The representative of the Legal Counselor's office confirmed this interpretation.

In conclusion, the Audit Committee adopted the work programme with the understanding that the inclusion of the agenda item "Review of lending terms" for the September meeting will be decided at its 139th meeting in March 2016 and with the following amendments:

- (a) The agenda item "Review of Sovereign Borrowing Framework" would be moved from the March meeting to the July meeting; and
- (b) The agenda item "Update on Sovereign Borrowing Framework" would be moved from the September meeting to the July meeting.

Project audit reports for fiscal year 2014

19. Management gave an overview and update on the situation of project audit reports and the related project financial management activities undertaken by IFAD in 2014. The proportion of unqualified audit opinions increased in 2014 to around 88 per cent from 80 per cent in 2013.
20. A slight increase was noted in the timely submission of audit reports from 58 per cent in 2013 to 60 per cent in 2014. Where significant control risks had been identified, the projects had been requested to prepare a time-bound action plan.
21. Management informed the Committee of the improvements planned and/or implemented between 2014 and 2015 as follows:
 - (a) Increased engagement in the international platforms dedicated to capacity-building of supreme audit institutions (SAIs) in developing countries;
 - (b) The implementation of the IFAD-supported grant to the International Organization of Supreme Audit Institutions (INTOSAI) was boosting the capacity-building of some SAIs in West and Central Africa and East and Southern Africa; and
 - (c) Development and/or update of a number of web-based tools to manage the project cycles for loans and grants.
22. The Committee acknowledged the progress made in the area of project audit and noted the status report.

Standard financial reports presented to the Executive Board

23. Management presented the following documents:
 - (a) Resources available for commitment (for review);
 - (b) Report on the status of contributions to the Tenth Replenishment of IFAD's Resources (for information); and
 - (c) Report on IFAD's investment portfolio for the third quarter of 2015 (for review).
24. Management confirmed that resources available for commitment for IFAD's programme of loans and grants were now defined under a sustainable cash flow approach.
25. Management provided an update on the status of the Tenth Replenishment of IFAD's Resources (IFAD10) informing the Committee that since the date that the report was issued, IFAD had received additional instruments of contribution corresponding to 46.6 per cent of overall pledges.
26. Management provided an update on the performance of the investment portfolio, reporting negative investment income of US\$4.8 million with a year-to-date performance for 2015 of negative 0.15 per cent. Management noted that all risk parameters remained below the budget level, as required by the Investment Policy.

27. The Committee requested clarification on the report on IFAD's investment portfolio, in particular on the performance against benchmarks and on the level of realized and unrealized losses.
28. Management clarified that during the third quarter of 2015, the performance was lower than the benchmark and that this is due to very difficult market conditions; however, losses are so far all unrealized, and expected to remain so, given the large availability of liquidity by IFAD to meet disbursement requirements.
29. It was agreed that, in presenting this agenda item, Management should describe more clearly the performance of the various mandates as well as the level of the realized and unrealized gains and losses.
30. The reports were reviewed with no further comments.

Other business

(a) Annual progress report on the KfW Development Bank facility

31. Management presented the first annual progress report on the financing arrangement with KfW Development Bank. It was highlighted that the loan represented a source of funding for the programme of loans and grants under IFAD9. Handling of the KfW funds had been smoothly integrated into IFAD's operational framework. All financial ratios were well within the threshold established by the KfW framework agreement and were also within the thresholds of the Sovereign Borrowing Framework. The implementation of this initiative had been a positive experience with lessons learned.
32. It was noted that the project and resource gap for IFAD9, which the KfW facility was to support, had been reduced over the last two years as a result of positive changes to underlying model assumptions. Therefore, only EUR 300 million of the EUR 400 million facility would actually be needed to support the programme of loans and grants for IFAD9. The remaining EUR 100 million was still accessible under the facility until 2018 and Management would consider this amount alongside other options available for sovereign borrowing under IFAD10. Any such arrangement would, however, be subject to prior Executive Board consultation and approval.
33. Committee members requested some clarifications about: the possibility of carrying forward undrawn funding from KfW to the IFAD10 period; the terms adopted for onlending; and the accounting methodology and costs associated with future cross-currency swaps. The commitment by Management to re-assess compliance with the financial stability conditions of the General Framework for Borrowing (GFB) on the occasion of any individual loan agreement and on the basis of the evolution of the relevant parameters, and to report to the Executive Board, was recalled.
34. Management clarified that the KfW funding facility was approved under the principle of self-sustainability and for accounting purposes a dedicated ledger had been opened to record all related activities. It was also clarified that KfW resources had been onlent to countries eligible for financing on ordinary terms only and in euro. In cases where the currencies of borrowed funds do not match those of the onlending, the costs of hedging would be considered. Management reassured that a more comprehensive assessment on compliance of the signed ILAs with the financial stability conditions of the GFB will be undertaken in the first quarter of 2016.
35. The document was deemed reviewed and would be submitted for approval to the Executive Board at its 116th session in December 2015.

(b) Implication of US\$ appreciation on the financial accounts

36. Under this item, Management informed the Audit Committee of the effect that the appreciation of the United States dollar against other currencies was having on

IFAD's financial statements. The Committee was informed that as of 30 September 2015, the Fund had recorded an unrealized foreign exchange translation loss on the translation of the special drawing rights loan assets of approximately US\$236 million. This would be recorded in the income statement. Management also clarified that the translation loss was an accounting entry only and would have no effect on the overall cash situation nor on the Fund's business.