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Report of the Chairperson on the 141st meeting of the Audit Committee

Note to Executive Board representatives

Focal points:

Technical questions:

Michel Mordasini
Vice-President and Interim Head
Financial Operations Department
Tel.: +39 06 5459 2518
e-mail: m.mordasini@ifad.org

Allegra Saitto
Officer-in-Charge
Accounting and Controller's Division
Tel.: +39 06 5459 2405
e-mail: a.saitto@ifad.org

Dispatch of documentation:

William Skinner
Chief
Governing Bodies Office
Tel.: +39 06 5459 2974
e-mail: gb_office@ifad.org

Executive Board — 118th Session
Rome, 21-22 September 2016

For: Review

Report of the Chairperson on the 141st meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 141st meeting of the Committee held on 7 September 2016. In opening the meeting, the Chairperson welcomed the new representatives for China and France, and the new interim General Counsel.

Adoption of the agenda

2. The agenda was adopted with changes in the order of presentation of some items. The Chairperson advised participants that, due to an apparent conflict of interest, he wished to recuse himself from deliberations on item 4. The Committee agreed that Ms Martina Metz of Germany would take the Chair for consideration of the item.
3. Before proceeding with the meeting, the Vice-President of IFAD made some opening remarks. The Committee was informed that Mr Mikio Kashiwagi, former Treasurer of the Asian Development Bank, would join IFAD from 1 October as interim Associate Vice-President, Chief Financial Officer and Chief Controller. The Audit Committee was also informed about:
 - Submission to the September session of the Executive Board of an information document on interest rates for ordinary and intermediary loans;
 - Some loans denominated in a single currency that would be submitted to the September session of the Executive Board for approval;
 - A corporate working group that had been set up to undertake a Management assessment of IFAD's lending policies, criteria and terms. Management was conducting a review of Debt Sustainability Framework (DSF) modalities and their impact on IFAD's financial sustainability. The outcome would be presented in the context of the Consultation on the Eleventh Replenishment of IFAD's Resources (IFAD11).

Minutes of the 140th meeting of the Audit Committee

4. The minutes were approved with no comments.

Progress report on the workplan for IFAD's Office of Audit and Oversight for 2016

5. The Committee was provided with a summary of the Office of Audit and Oversight (AUO) activities for the first six months of 2016. It was highlighted that field presence and decentralization remain the main audit priority. Management continues to place high importance on the implementation of audit recommendations. As at 30 June 2016, only 19 recommendations were overdue and none of these were of high priority. The implementation of reforms to the investigative and sanctions processes was ongoing and most actions were expected to be finalized by the end of the third quarter. Some of the agreed changes (such as revisions to the IFAD Procurement Guidelines) might need the approval of the governing bodies. In the area of investigations, the intake rate of allegations remained high, but the backlog of cases brought forward from 2015 had been reduced significantly through the conclusion of a high number of pending and new cases during the first six months of 2016. In early July, AUO hosted the annual meeting of the Rome-based agencies' internal oversight functions. It was also highlighted that AUO had requested and obtained additional financial resources to cover its human resource needs for the remainder of the year and that Management was actively considering an increase in the staffing of the investigation function as a more effective way of addressing the recurring need in this area.

Committee members commended the good work done in implementing the programme of work and requested some details on the status of the implementation of recommendation and investigations. Other Committee members expressed concern about the adequacy and the certainty of resources allocated to AUO. AUO provided the additional details requested, and clarified that Management was examining AUO resource requirements, and would keep the Committee updated.

6. The progress report was considered reviewed.

Selection of the external auditor of IFAD for the period 2017-2021

7. Management had facilitated the selection process for the IFAD external auditor for 2017-2012. The technical evaluation was undertaken on the three proposals resulting from the request for expression of interest. A commercial evaluation had subsequently been undertaken by a separate panel. Due to the highly technical nature of the services being solicited, and in line with prior selection exercises, the score weighting had been set at 70 per cent for the technical evaluation and 30 per cent for the commercial evaluation. Joint results had been submitted to the Contract Review Committee (CRC), which had reviewed the process and recommended to the Chief Procurement Officer that the contract be awarded to the firm Deloitte & Touche. The contract had been the most technically sound and had also quoted the lowest fee. The Audit Committee was represented by Ms Martina Metz during the technical evaluation, and by Mr Nicholas Strychacz (Executive Board representative for the United States during the CRC meeting).
8. The Audit Committee endorsed the submission of the proposal to the 119th session of the Executive Board in December 2016.
9. The representative for Germany commended the process for its transparency and efficiency.

High-level preview of IFAD's 2017 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 2017 and indicative plan for 2018-2019

10. The budget proposal incorporated recurrent costs of the main elements of the programme of work, and regular and capital budgets of IFAD. The document also presented the preview of the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2017 and indicative plan for 2018-2019.
11. Management presented the preview document, noting 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 finalization.
12. It was noted that this budget proposal had been prepared using the 2016 exchange rate assumptions. The final budget would be prepared in accordance with the agreed exchange rate methodology in order to determine the various cost components of the budget. The standard staff costs would be adjusted accordingly.
13. Management highlighted that: the IFAD programme of loans and grants (PoLG) projected for 2017 was US\$1.50 billion, and the 2017 regular budget had been proposed at US\$150.78 million compared to an approved budget of US\$146.71 million in 2016. This represented a 2.8 per cent nominal increase, comprised of a real increase of 1.7 per cent and a price increase of 1.1 per cent. The 2017 total capital budget for necessary IT and regular annual capital expenditures is not expected to exceed US\$2.5 million. The budget includes an estimate of US\$1.14 million for a special expenditure budget for the IFAD11 exercise.
14. Management also provided details on the main cost drivers of the 2017 proposal.

15. The Independent Office of Evaluation of IFAD (IOE) introduced its programme of work and budget for 2017, highlighting that the focus would be on a corporate-level evaluation on IFAD's financial architecture (i.e. the adequacy and sustainability of the financial instruments used by IFAD to fund its PoLGs) with the purpose of identifying possible innovative sources of financing beyond replenishment sources. IOE would also undertake five new country strategy and programme evaluations. In addition, the geographic coverage of its evaluations would be expanded to further strengthen learning and accountability. The proposed IOE budget for 2017 was US\$5.76 million, a nominal 1.6 per cent increase against the 2016 approved budget of US\$5.67 million. The 1.6 per cent nominal increase comprised a 0.3 per cent real increase, attributable to higher staff costs due to recruitment for a fixed-term position at the P-4 level, and a 1.3 per cent price increase.
 16. It was noted that the proposed IOE budget for 2017 was 0.39 per cent of IFAD's expected PoLG for next year, well below the IOE budget cap of 0.9 per cent adopted by the Executive Board.
 17. Committee members requested further information on the allocation to sub-Saharan countries, level of cofinancing, allocations to thematic issues and status of borrowing initiatives. With regard to the latter, the increased amount of estimated borrowing in the three-year period, starting from 2016, was noted and some members called for the early involvement of the Committee on borrowing initiatives. A member also noted the higher decentralization-related costs, as opposed to the costs cited in the update provided to the Board last April. Some members invited Management to be more cost-conscious, with specific reference to decentralization.
 18. Management provided details requested.
 19. The budget preview document was considered reviewed.
- Proposal to access the KfW borrowing facility for IFAD10
20. Management presented a proposal for IFAD to use the remaining funds of EUR 100 million under the current KfW Framework Agreement to deliver the target PoLG for IFAD10. The Audit Committee was reminded that in 2014 the Executive Board had granted approval for IFAD to enter into a Framework Agreement with KfW Development Bank to borrow up to EUR 400 million. Over the IFAD9 period, IFAD borrowed a total of EUR 300 million. Therefore, EUR 100 million was still available. Consistent with prior practice, the borrowed funds would be on-lent only to IFAD's ordinary terms borrowers. It was noted that borrowing the additional EUR 100 million was financially sustainable and respected all conditions set forth in IFAD's Sovereign Borrowing Framework (SBF), despite the fact that the KfW Framework Agreement had been signed prior to the adoption of the SBF.
 21. Committee members requested details of terms offered by other sovereign institutions and a comparison with terms obtained by other multilateral banks for borrowing activities.
 22. Management clarified that the borrowing terms were linked to the country rating and that since Germany was one of the top-rated countries, KfW was one of the best options available for IFAD. Management also noted that it would be misleading to perform a comparison with other multilateral institutions as they raised funds in capital markets while this option was not available to IFAD at the moment.
 23. The document was considered reviewed.
- Review of the Sovereign Borrowing Framework
24. Management introduced the agenda item, highlighting some challenges that the SBF posed in conversations with potential lenders. These challenges mainly related to: (a) size of loans; (b) currency of denomination; (c) thematic restrictions; and (d) clauses against substitution risk.

25. This was the first review of the SBF and no changes were proposed at present. It was noted, however, that in order to best serve IFAD as a dynamic and transforming institution, the SBF needed to be a flexible tool attuned to IFAD's needs and reality.
26. Committee members requested details about lessons learned and timing of future reviews, and reiterated the importance of replenishment contributions. They suggested that proposals for any corrective measures be highlighted and that a more in-depth analysis, including of possible constraints, challenges and risks, be provided at the next SBF review.
27. Management clarified that technically no deals had been formalized under the SBF as the KfW Framework Agreement had been signed prior to the adoption of the SBF. Management assured the Committee that there would be regular interaction in the future on lessons learned as more experience was gained in the use of the SBF.
28. The document was considered reviewed.

Borrowing from financial markets

29. Management provided an oral update on the preparatory steps needed for borrowing from financial markets, highlighting that the need for IFAD to mobilize additional resources had been partially addressed by Management through the implementation of the SBF. Management had been encouraged by the Executive Board to undertake, during the IFAD10 period (2016-2018), a feasibility study and preparatory work to explore the potential and scope for borrowing from the financial markets.
30. In response to the Executive Board's enquiry, Management presented an oral update on the functional steps towards a feasibility study on market borrowing. These include establishing initial contact with the rating agencies to understand the rating methodology applied to IFAD; negotiating the International Swaps and Derivatives Association (ISDA) documentation with bank counterparties necessary for the execution of derivatives contracts for currency hedging; and preparing a road map to list all required steps and actions to allow IFAD to issue bonds in the capital markets.
31. The update was noted.

Review of the adequacy of the General Reserve

32. Management presented the agenda item noting that the General Reserve had been established by the Governing Council in 1980 to address four specific risks of over-commitment of IFAD's resources. Over the years, several transfers had been approved, bringing the General Reserve up to its current level of US\$95 million. To date, the General Reserve had never been used. It was noted that strategies and mechanisms adopted over the years to mitigate over-commitment risks had strengthened the financial framework in which IFAD operated, in line with its evolving business practice.
33. It was noted that since the introduction of the long-term sustainable cash flow approach as a mechanism to define IFAD's commitment capacity, the relevance of the General Reserve had decreased. Since IFAD9, risks of over-commitment of IFAD's resources were being mitigated by ensuring availability of sufficient liquidity to meet overall disbursement needs. Management also highlighted that by 2018 IFAD would have to implement a new accounting principle that would require more stringent impairment measures for financial assets. This would have an impact of an estimated US\$100 million as an additional impairment, with no cash flow consequences. In recognizing IFAD's sound financial framework, and in order to maintain a prudent approach in view of the scaling up of borrowing activities, the possible rating exercise and the likely impact of the implementation of the new accounting principle, Management recommended that the General Reserve be

maintained at the current level of US\$95 million, and that this assessment be reconsidered in 2017.

34. The document was considered reviewed and the recommendation was endorsed for the Board's approval at its 118th session.

IFAD's variable interest rate methodology: Introduction of interest rate floor

35. Management introduced the agenda item. In response to the unprecedented historical market situation in which the EURIBOR and Japanese yen LIBOR had presented negative values and in anticipation of any further decline of the LIBOR/EURIBOR components of IFAD's reference rate, a modification was proposed to the methodology for setting IFAD's variable interest rates¹ applicable to loans approved on ordinary terms. This modification would be effective as at 1 January 2017.
36. The modification would allow the introduction of a zero floor to the LIBOR/EURIBOR components of IFAD's reference rate and would apply to existing and newly approved loans on the above-mentioned terms.
37. The proposal was in line with evolving practices at other international financial institutions and would allow Management to mitigate interest rate risks associated with the borrowed funds.
38. As a follow-up to the Committee's request, and in response to a specific question on possible legal risks for the ongoing portfolio, Management clarified that the change in methodology would not require amendment of current loan agreements. Management also clarified that the financial viability of the KfW Framework Agreement was assured considering the overall impact of all terms contained in the Agreement.
39. The proposal was endorsed.
- Standard financial reports presented to the Executive Board
40. Management presented the report on IFAD's investment portfolio for the second quarter of 2016 for the Committee's review.
41. The Treasurer updated the Committee on the latest portfolio developments, highlighting the positive performance of 3.72 basis points as at 19 August. It was also noted that all risk parameters remained below the budget level defined in IFAD's Investment Policy Statement.
42. The report was deemed reviewed.
- Other business
43. No items were discussed under other business.

¹ As detailed in EB 2009/98/R.14 and EB 2011/102/R.11.