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## Internal Control Framework for IFAD Investments

### Note to Executive Board representatives

#### Focal points:

#### Technical questions:

Michel Mordasini  
Vice-President  
Tel.: +39 06 5459 2518  
e-mail: m.mordasini@ifad.org

Domenico Nardelli  
Director and Treasurer  
Treasury Services Division  
Tel.: +39 06 5459 2251  
e-mail: d.nardelli@ifad.org

Patrick McNellis  
Risk and Compliance Consultant  
Financial Operations Department  
Tel.: 39 06 5459 2433  
e-mail: p.mcnellis@ifad.org

#### Dispatch of documentation:

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

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For: Information

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## Abbreviations and acronyms

AVP/FOD	Associate Vice-President Financial Operations Department
ACD	Accounting and Controller's Division
CM	Cash Management Team
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CVaR	conditional value at risk
ERM	Enterprise Risk Management
FALCO	Investment, Finance and Asset Liability Management Advisory Committee
FISCO	Investment and Finance Advisory Committee
FMD	Financial Management Services Division
FOD	Financial Operations Department
ICF	Internal Control Framework
IFI	international financial institution
IM	Investment Management Team
IPS	Investment Policy Statement
RCF	Risk and Compliance Function
TRE	Treasury Services Division

## Preamble

1. The Internal Control Framework (ICF) for IFAD Investments was first presented to the 104<sup>th</sup> Executive Board in December 2011 in conjunction with IFAD's Investment Policy Statement (IPS). While the IPS provides an overall framework for the management of IFAD investments, the ICF provides additional information pertaining to the internal control structures in place.
2. The first annual review of the IPS was presented for approval at the 107<sup>th</sup> session of the Executive Board in December 2012. Prior to that session, at its 125<sup>th</sup> meeting in November 2012, the Audit Committee requested that the annually revised ICF accompany the annually updated IPS for completeness.

# Internal Control Framework for IFAD Investments

## I. Overview of internal control best practices

1. One of the most complete and extensive internal control framework models is the widely used Internal Control – Integrated Framework (the Framework) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Internal Control Framework (ICF) for IFAD Investments is not independently audited or certified so as to be compliant with the COSO Framework. It therefore refers to the Framework for guidance on the content of this document.
2. Under the Framework, internal control is broadly defined as “a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.”
3. The Framework sets out five components and 17 principles associated with the components. The components are defined as follows:
  - (i) Control environment: organizational values and culture; policies; organizational structure. The control environment is the foundation for all other components of internal control;
  - (ii) Risk assessment: identification and measurement of threats, and responses to them;
  - (iii) Control activities: the policies and procedures that help ensure management directives are carried out;
  - (iv) Information and communication: reliability, timeliness, clarity, usefulness; and
  - (v) Monitoring activities: processes used to assess the quality of internal control performance over time.
4. An effective system of internal control reduces, to an acceptable level, the risk of not achieving an objective relating to operations, reporting and compliance. It requires that: (i) each of the five components of internal control and relevant principles is present and functioning; and (ii) the five components are operating together in an integrated manner. Internal controls, therefore, form an integral part of any organization's financial and business policies and procedures.
5. This paper sets out activities related to the ICF for IFAD Investment. Section II focuses on aspects of the control environment, specific organizational structure, and roles and responsibilities of the various key players. Section III describes the risk assessment, control, information and communication, and monitoring activities related to IFAD investments.
6. Annex III links the 17 principles introduced in the update to the COSO Framework to various investment-related policies and procedures as well as to relevant sections of the ICF itself.

## II. Organizational structure, roles and responsibilities

### A. Actors and their roles

7. According to the Framework, everyone in an organization has responsibility for internal control to some extent. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, each major entity in corporate governance has a particular role to play. This translates, in the case of IFAD, to:
  - (i) The Governing Council, which is the supreme plenary organ of the Fund. It is composed of representatives of the Member States. All powers of the Fund are vested in the Governing Council. Subject to the limitations stated in the Fund's charter, it may delegate powers to the Executive Board.
  - (ii) The Executive Board, and the Audit Committee, which is appointed by the Board, supervise internal control and risk management. Assisted by the Audit Committee, the Board is informed and updated on any changes to the operating principles of internal control including the main features of the risk management process, a summary of risks, control objectives and common control points for financial reporting.
  - (iii) The internal and external auditors of the organization also measure the effectiveness of internal control. They assess whether the controls are properly designed, implemented and working effectively while making recommendations on how to improve internal control.
  - (iv) Management is responsible for designing, approving and implementing the internal control and risk management process together with the group management team, subsidiary management teams and finance managers.
  - (v) The Enterprise Risk Management (ERM) Committee<sup>1</sup> is responsible for supporting and overseeing the risk management activities of the Fund. It is a critical element for the management of operational risk as it affects the investment activities of the Fund.
8. IFAD's Management and staff are committed to IFAD's Code of Conduct,<sup>2</sup> which was established to regulate their conduct and align it with the interests of IFAD.

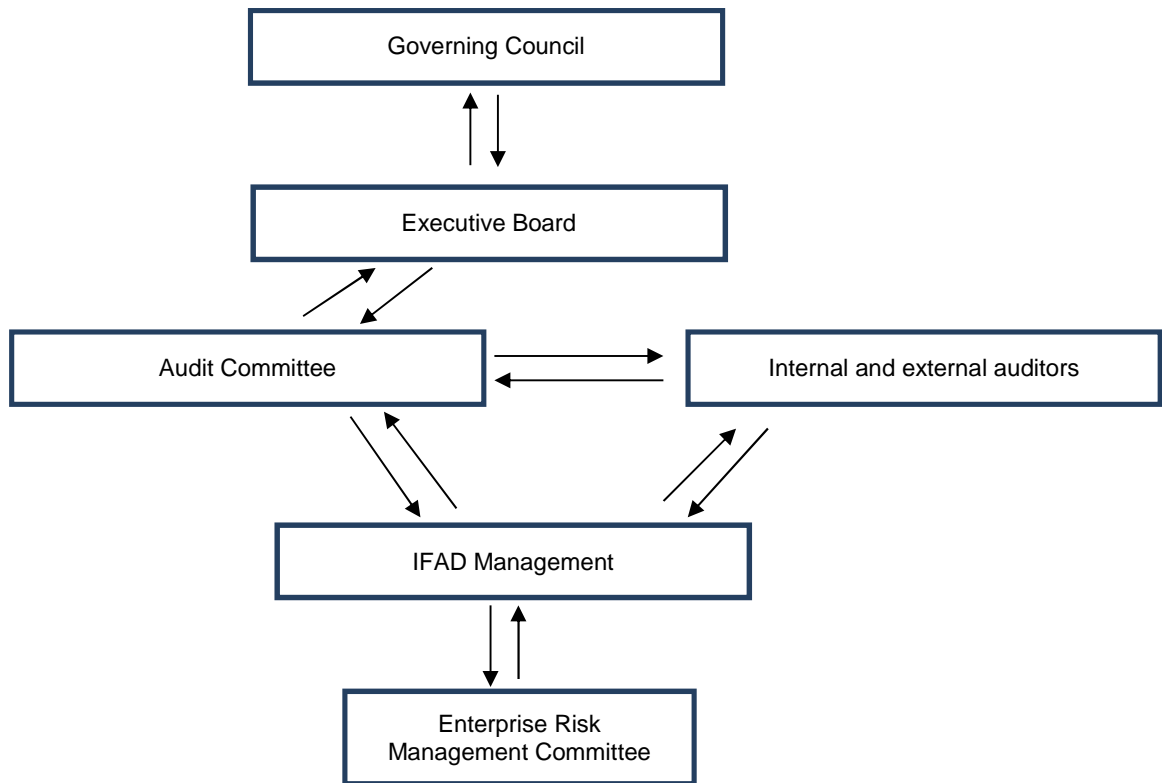
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<sup>1</sup> PB 2008/06.

<sup>2</sup> IFAD Human Resources Implementing Procedures Chapter 1: Duties, obligations and privileges 1.7.9(vi).

9. The governance structure and reporting lines are presented in chart 1.

Chart 1  
**Governance structure**

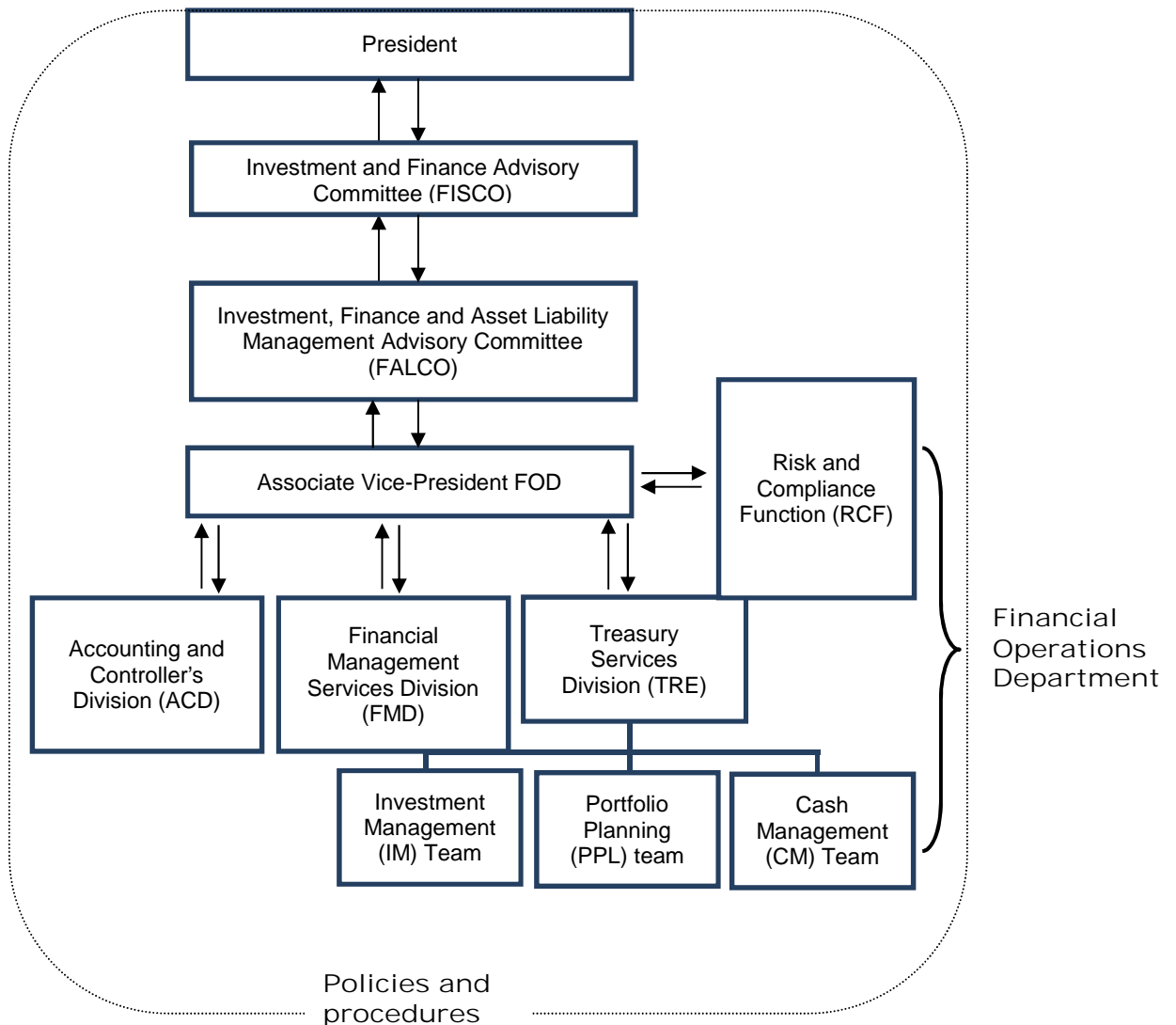


10. Part B of this section examines in detail the flow of financial information within IFAD, the internal actors involved in the process of investment decision-making, and the specific roles and responsibilities, as well as the flow of financial information as per chart 2.

**B. Investment-related roles and responsibilities in IFAD**

11. IFAD's internal flow of financial information in terms of investments is presented in chart 2.

Chart 2  
**IFAD's internal flow of financial information**



12. President. The President has oversight and decision-making responsibility for the investment of the assets based on the approved IPS. He or she may delegate authority for specific investment-related activities.
13. Investment committees. On 15 January 2007, the President issued a President's Bulletin<sup>3</sup> announcing the establishment of the following two new committees to replace and supersede the Investment Advisory Committee:

<sup>3</sup> PB/2007/01.

- (i) The Investment and Finance Advisory Committee (FISCO) – the high-level committee. The rules of procedure and terms of reference of the FISCO are presented in annex I; and
  - (ii) The Investment, Finance and Asset Liability Management Advisory Committee (FALCO) – the operational committee. The rules of procedure and terms of reference of the FALCO are presented in annex II.
14. Associate Vice-President, Chief Financial Officer and Chief Controller (AVP/FOD). As head of the Financial Operations Department (FOD), the AVP/FOD is responsible for IFAD's financial resource management. Through the Accounting and Controller's Division (ACD), the Financial Management Services Division (FMD), the Treasury Services Division (TRE) and the Risk and Compliance Function (RCF), the AVP/FOD:
- (i) Manages and reports on IFAD's financial resources in a framework of cost efficiency, risk containment, transparency and accountability;
  - (ii) Invests and manages financial assets not immediately needed, in line with operational requirements;
  - (iii) Safeguards and maximizes the resources available for operations through prudent financial management and investment of financial resources, and through appropriate accounting, reporting and projection on IFAD's use of these resources; and
  - (iv) Works with internal and external partners in sharing knowledge, harmonizing financial management systems and procedures, and/or enabling their collaboration.
15. Accounting and Controller's Division (ACD). The ACD is responsible for the integrity, transparency and control of the management of IFAD's resources, including trust funds, supplementary funds and funds of hosted entities, and funds raised through innovative financing-related activities. The division provides leadership and interpretation on all major issues related to the formulation and implementation of accounting policies and procedures, such as adoption of the new International Financial Reporting Standards. The main specialized services provided by ACD are the following:
- (i) Maintaining adequate internal control systems to ensure that all IFAD's financial transactions are properly, completely and accurately recorded and reported, and are consistent with IFAD's Framework for the Delegation of Authority, and its policies and procedures;
  - (ii) Performing accurate and timely internal and external financial reporting work that reflects and captures all the Fund's transactions, reporting financial results and the financial position;
  - (iii) Originating governing body and other official documents on financial matters, e.g. financial statements and draw-down requirements;
  - (iv) Monitoring and strengthening financial management and fiduciary responsibilities for IFAD's fund flows, supplementary funds administration, audit and reporting;
  - (v) Ensuring financial and budgetary management of extra budgetary funds and hosted entities; and
  - (vi) Liaising with the external auditors and the Audit Committee.
16. Financial Management Services Division (FMD). FMD strengthens financial management practices in IFAD-funded operations, including financial reporting, audit, project liquidity management and fiduciary compliance. The division manages



IFAD's financial management workforce, including accredited consultants. The division is structured to:

- (i) Provide risk-based financial direction and oversight for the preparation and implementation of country strategic opportunities programmes, and the design, supervision and implementation support of IFAD projects, programmes and grant activities, ensuring that funds are used for the intended purpose through risk-based activities and diagnostics;
  - (ii) Provide corporate advisory and financial services on project, programme and grant financial management policies and procedures, including lending terms and conditions, debt issues and financial administration;
  - (iii) Ensure that financial management forms an integral part of the development process in all IFAD-financed and -managed operations, and engage IFAD's stakeholders in financial management knowledge-sharing and capacity-building;
  - (iv) Interact with international accounting and auditing bodies and donor partners to help countries strengthen their financial management capacity. Responsible for capacity-building of both external stakeholders – including governments, projects, project staff, auditors – and IFAD's workforce;
  - (v) Lead financial management systems and tools development, including the roll-out of the new IFAD Client Portal; and
  - (vi) Maintain strategic partnerships with other international financial institutions (IFIs) in the areas of financial management and administration, also to coordinate and harmonize FMD policy and operational practices where applicable.
17. Treasury Services Division (TRE). TRE has a key fiduciary role in managing IFAD's liquidity and the cash flows of both replenishment-based and borrowed resources. This includes strategic portfolio and liquidity planning and long-term financial projections of cash flows and resources. The specialized services provided by TRE include:
- (i) Formulating and implementing financial policies and procedures, including the investment policy;
  - (ii) Managing cash flow processes of disbursements and receipts through operational bank accounts;
  - (iii) Managing cash flow operations and short-term liquidity;
  - (iv) Managing investments internally/externally for IFAD and non-IFAD funds;
  - (v) Leading harmonization of TRE operations across the United Nations system;
  - (vi) Developing partnerships with other IFIs on financial matters in the area of treasury; and
  - (vii) Developing and managing business relationships with financial service providers.
18. TRE relies on three operating teams to deliver these services:
- A. The Cash Management Team (CM), manages IFAD's operational cash and liquidity requirements for all funding sources. Responsibilities include:
    - (i) Ensuring availability of funds for IFAD and non-IFAD operations through prudent liquidity management;
    - (ii) Managing and reporting on all cash flow operations and short-term liquidity of operational portfolios;

- (iii) Ensuring accurate processing for all transactions in operational bank accounts in compliance with relevant regulations and industry standards;
  - (iv) Reconciling operational accounts and treasury accounting of all transactions;
  - (v) Conducting back-office and investment settlement activities for internally managed portfolios;
  - (vi) Overseeing cash management and various back-office activities to maintain alignment of functions with the corporate strategic direction and ensure seamless operations;
  - (vii) Developing, managing and maintaining relationships with central and commercial banks for cash flow operations for headquarters and IFAD Country Offices accounts;
  - (viii) Undertaking joint management with the Investment Management team of relationships with custodian;
  - (ix) Managing Treasury's activities in support of IFAD's decentralization, including negotiating and executing banking arrangements; and
  - (x) Managing various electronic fund transfer systems and cash management systems.
- B. The Investment Management Team (IM) monitors and manages IFAD's internally managed portfolios. Responsibilities include:
- (i) Directly managing the global liquidity portfolio, the held-to-maturity portfolio (global strategic portfolio), the asset and liability matching portfolio, and internally managing non-IFAD funds and recommending applicable investment strategies;
  - (ii) Developing and managing relationships with counterparties for trading and short-term investments;
  - (iii) Analysing and monitoring investments of external fund managers;
  - (iv) Monitoring issuers, counterparties, securities and financial markets in general;
  - (v) Performing ongoing credit analysis for various issuers, particularly those on the lower end of investment grade ratings;
  - (vi) Following up with external portfolio managers on compliance matters flagged by the RCF; and
  - (vii) Managing the relationships with the external portfolio managers and undertaking joint management with the CM of relations with the custodian.
- C. The Portfolio Planning Team coordinates strategic portfolio and liquidity planning and oversees externally managed portfolios. Responsibilities include:
- (i) Periodically reviewing IFAD's investment policy and investment guidelines to ensure alignment and compliance with IFAD's investment strategies in light of changing financial and market conditions;
  - (ii) Recommending rebalancing between asset classes and liquidation strategies to meet IFAD's disbursement requirements;
  - (iii) Projecting the short-term (1 to 3 years) cash flow portfolio;

- (iv) Analysing and recommending the minimum liquidity requirement;
  - (v) Analysing and reporting on the investment portfolio for both IFAD and non-IFAD entities;
  - (vi) Making long-term financial/resource projections. In this regard, the team is responsible for managing and enhancing IFAD's financial model;
  - (vii) Preparing governing body and other official documents in relation to the investment portfolio for IFAD and non-IFAD entities;
  - (viii) Determining the resources available for commitment based on a sustainable cash flow approach;
  - (ix) Analysing the investment performance versus the applicable benchmarks including the construction and calculation of benchmarks for internally managed portfolios; and
  - (x) Managing and administering the pre-trade compliance system and delivering internal portfolio reports.
- D. The RCF reports directly to the AVP/FOD. This direct reporting line ensures segregation of duties of investment risk management from the investment function performed in TRE.
- (i) Actively monitoring, analysing and periodically reporting on IFAD's investment risk budget;
  - (ii) Liaising with TRE and providing credit input on existing and proposed investments;
  - (iii) Contributing to setting and managing the Fund's risk budget on an ongoing basis by monitoring, analysing and reporting on financial risk exposure and by identifying potential new risk factors in IFAD's investments;
  - (iv) Performing stress tests and scenarios and proposing mitigation strategies;
  - (v) Overseeing the global custodian compliance monitoring system to ensure correct alignment with all investment guidelines;
  - (vi) Providing advice on potential risks to IFAD's financial soundness based on extended knowledge of best practices of IFIs and on, inter alia, capital adequacy ratios and liquidity ratios;
  - (vii) Monitoring adherence to the established capital adequacy ratios;
  - (viii) Providing periodic investment risk reports to the AVP/FOD and Senior Management; and
  - (ix) Supplying input for technical and operational support provided by FOD front office to the AVP/FOD as requested.

### C. Investment policies and procedures

19. The overall framework for IFAD's investment processes and controls is set by the following policies and procedures:
- (i) Financial Regulations of IFAD;
  - (ii) IFAD Policy on ERM;<sup>4</sup>
  - (iii) IFAD's Investment Policy Statement;

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<sup>4</sup> EB 2008/94/R.4.

- (iv) IFAD's Liquidity Policy;<sup>5</sup>
  - (v) IFAD's investment guidelines;
  - (vi) ICF for IFAD Investments;
  - (vii) Investment management and master custody agreements;
  - (viii) Treasury Manual;
  - (ix) Rules of procedure and terms of reference of IFAD's Investment Committees (FISCO and FALCO) referred to in annex I and II.
20. Financial Regulations of IFAD. The Financial Regulations of IFAD govern the financial administration of the Fund and are interpreted in accordance with the Agreement Establishing IFAD.
21. IFAD Policy on ERM. The ERM policy establishes a formal, systematic and integrated approach to identifying, managing and monitoring risks in IFAD and defines key roles and responsibilities for all stakeholders in ERM activities. Certain activities performed under IFAD's ERM relevant to the Fund's investments include:
- (a) Annual certification of compliance with the code of conduct and declaration of non-IFAD income, goods, services or assets. Consistent with IFAD's Code of Conduct,<sup>6</sup> all staff members are required to submit an annual certification form declaring: (i) compliance with the Code of Conduct; (ii) conflicts of interest; and (iii) all sources of non-IFAD income, goods, services or assets.
  - (b) Management assertion and external audit attestation<sup>7</sup> of internal controls over financial reporting. Since 2011, IFAD has issued an annual Management assertion on the effectiveness of internal controls over financial reporting, while the first independent attestation from external auditors was received for the financial year 2012.
  - (c) Financial disclosure statement for selected staff members. Since 2012 selected staff members, based on their role and responsibilities, are also required to submit a detailed financial disclosure statement.<sup>8</sup>
22. IFAD's Investment Policy Statement. The IPS is approved and reviewed annually by the Executive Board and provides the overarching principles regulating IFAD's key investment responsibilities, investment universe and acceptable risk parameters.
23. Specifically the IPS aims to:
- (i) Define the governance over IFAD's investments;
  - (ii) Set out IFAD's investment objectives for risk and return, including eligible asset classes;
  - (iii) Define key components of investment guidelines;
  - (iv) Determine the risk budget for IFAD's overall investment portfolio; and
  - (v) Establish formalized criteria to measure, monitor and evaluate performance and risk.

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<sup>5</sup> EB 2006/89/R.40.

<sup>6</sup> IFAD's Human Resource Implementing Procedures Chapter 1: Duties, obligations and privileges 1.7.9(vi).

<sup>7</sup> EB 2010/99/R.30.

<sup>8</sup> IFAD Information Circular IC/ETH/01/2012 paragraph 3(b).

24. IFAD's Liquidity Policy.<sup>9</sup> This policy provides a "means of monitoring and ensuring that the Fund has adequate liquidity available at all times".
25. IFAD investment guidelines. For each individual portfolio, IFAD's investment guidelines define the principles by which a fund is managed and monitored. The guidelines determine, among others, the individual portfolio's benchmark, the eligible universe or asset classes, currencies, the credit rating floor, the maximum and minimum portfolio duration, and any prohibited jurisdictions. The RCF, through daily oversight and monitoring, ensures strict compliance with investment guidelines through the compliance monitoring system provided by IFAD's custodian bank.
26. Investment management and master custody agreements. The agreements with external parties ensure that the relationship falls within a verified and constantly updated legal framework.
27. Treasury Manual. This manual provides a detailed description of the specialized services provided by TRE, and defines how the Division's workload is divided among its various functions.
28. The manual is divided into two main sections: (i) the executive manual, providing a broad overview of the organization and its major processes; and (ii) the operational manuals (cash management and investment management), which constitute a working document that provides the user with specific details, descriptions and examples of processes and procedures. Table 1 gives an overview of the Treasury Manual.

Table 1  
**Overview of the Treasury Manual**

	<i>Executive manual</i>	<i>Operational manuals</i>
What is it?	An overview document that provides a concise description of TRE's functions and procedures in a summary format.	A detailed description of the functions, tasks and processes that make up the responsibilities of TRE staff.
How is it used?	Contains embedded navigation links that take the user directly to relevant sections within the operating manual for additional information.	Contains specific listings of duties, activities, detailed process flows, and other "how-to" material. Can be used as a step-by-step instruction guide for most procedures.
Who are the prospective users?	Intended for use as a quick reference for those interested in how TRE operates and what its major functional responsibilities are.	Intended for use as a detailed reference for those tasked with carrying out TRE's day-to-day functions.

29. To maintain flexibility, accessibility and adaptability, the Treasury Manual is published on IFAD's local area network in portable document format (PDF). The electronic file is controlled by the TRE front office. In view of the constant revision of processes and the restricted nature of parts of the Treasury Manual, no hard copies are distributed.
30. Confidentiality. Due to the confidential nature of the information presented, parts of the Treasury Manual are restricted and can be viewed by authorized users only. Approved users may not divulge its contents to third parties without specific written permission by authorized senior staff. The public sections of the manual, i.e. the IFAD Treasury Executive Manual, are available to be viewed by all staff on the TRE intranet site.
31. Investment Committees. IFAD has two investment committees (FISCO and FALCO) as stipulated in annexes I and II.

<sup>9</sup> EB 2006/89/R.40.

### III. Risk assessment, control, information and communication, and monitoring activities

#### A. IFAD's investment portfolio structure

32. IFAD's investment portfolio is allocated into several individual portfolios within the fixed-income universe. Cash and held-to-maturity investments are managed internally while marked-to-market investments are managed through several external managers.
- (i) Operational cash. Cash is allocated within several banks in line with eligibility criteria currently in place.
  - (ii) Global strategic (held-to-maturity) portfolio. Funds are invested in government, corporate and supranational bonds all having a maximum maturity of five years. The customized benchmark is calculated internally (for the short-term instruments and legacy bonds) and externally by Barclays (for newly purchased bonds) and combined internally.
  - (iii) Global government bond portfolio. Funds are invested in a multi-currency individual portfolio of government bonds. The credit rating floor is BBB- (i.e. investment grade); the duration is approximately one year; and the benchmark is the global treasuries IFAD-customized one-year index by Barclays.
  - (iv) Global credit portfolio. Funds are invested in a blend of government agency mortgage-backed securities and asset-backed securities and corporate bonds. The credit rating floor is BBB- (i.e. investment grade), with the exception of mortgage-backed and asset-backed securities that must be rated AAA by at least two of three agencies; the duration is approximately four and a half years; the benchmark is the global aggregate IFAD-customized index by Barclays.
  - (v) Global inflation-indexed bond portfolio. Funds are invested in a multi-currency asset class of inflation-indexed bonds. The credit floor is BBB- (i.e. investment grade); the duration is approximately five years; the benchmark is the World Global Inflation-Linked Customized 1-10-year bond index by Barclays.
  - (vi) Emerging market bond portfolio. Funds are invested in investment grade government fixed-income securities in convertible currencies. The credit rating floor is BBB- (i.e. investment grade); the duration is approximately seven years; and the benchmark is the emerging market debt investment grade IFAD-customized index by Barclays.
  - (vii) Asset liability portfolio. Funds are invested in a blend of fixed-income asset classes, including government-related securities, corporate, supranational and covered bonds. The credit floor is BBB- (i.e. investment grade) apart from covered bonds that must be rated AAA.
  - (viii) Global liquidity portfolio. Funds are invested in highly liquid, highly rated fixed income securities. The credit floor is AA+, the portfolio does not have a benchmark and the duration is kept to a minimum. The performance target is equal to zero or better.

#### B. Potential portfolios

33. Global developed market equities portfolio. Funds will be invested in equities issued by corporations registered in IFAD Member States and included in the Morgan Stanley Developed Market Index.
34. Renminbi portfolio. Funds are to be invested in government and supranational-related securities denominated in CNY (onshore renminbi) and CNH (offshore renminbi). Exact portfolio characteristics are currently being discussed.

## C. Risk identification

35. IFAD's investments are exposed to a variety of financial risks. Marked-to-market investments are affected by market risks (specifically interest rate, currency and liquidity risks), as well as credit, counterparty and operational risks. A detailed definition of these risks and a summary of the key measures used to measure such risks in IFAD's investment portfolio are given below.

### Market risks

36. Interest rate risk is defined as the potential risk that the value of a fixed rate security will decline as a result of an upward movement in the absolute level of interest rates, based on the spread between the two rates, and the overall shape of the yield curve. Interest rate risk is monitored on the overall portfolio and on the individual portfolios and managers, based on measures obtained with the enhanced risk management system (see section III, D). The measures include duration, standard deviation, ex ante tracking error (active risk), value at risk and conditional value at risk (CVaR). The allowable limits for tracking error and the CVaR are stated in the IPS. In addition, stress tests and scenario analyses on the portfolio may be performed upon request or whenever considered necessary due to prevailing market conditions.
37. The data provided by the custodian may be complemented with internal analyses on single securities using tools provided by Bloomberg or other sources.
38. Currency risk arises from the change in price of one currency against another. IFAD faces currency risk on a balance sheet level, as the majority of IFAD's commitments, i.e. the undisbursed loans and grants, are denominated in special drawing rights (SDR). Therefore, to the extent possible, IFAD maintains a portion of its assets (the investment portfolio, the promissory notes and the contribution receivables) in the currencies and ratios of the SDR. Similarly, the General Reserve and commitments for grants denominated in United States dollars are matched by assets denominated in United States dollars. This is the so-called "SDR currency alignment procedure".
39. Liquidity risk is defined as the risk stemming from the lack of marketability of an investment that cannot be readily sold in the secondary markets to generate the necessary liquidity to meet contractual obligations. At any point in time, IFAD must be able to meet its disbursement obligations for loans and grants.
40. The liquidity risk is addressed through the minimum liquidity requirement.<sup>10</sup> This amount must be available at any point in time to ensure IFAD's ability to meet its disbursement obligation promptly and without additional costs.

### Credit risk

41. Credit risk is defined as the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation.
42. Credit risk is managed through the establishment of a minimum rating floor in the investment guidelines. The eligibility of individual securities and issuers is determined on the basis of ratings by major credit rating agencies. Credit analyses by security and issuer are performed on an ongoing basis by TRE in conjunction with the RCF for all internally managed investments. In addition, such analyses, on a selective basis, are carried out on externally managed assets, and on commercial and central banks, through the use of financial information systems, credit analysis providers and other related sources.

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<sup>10</sup> EB 2006/89/R.40 and EB 2013/110/R.15.

#### Counterparty risk/trading counterparties

43. Counterparty risk is defined as the risk to each party of a contract that the counterparty will fail to perform its contractual obligations.
44. Counterparty risk is managed for all investments through the establishment of a minimum rating for eligible counterparties, including banks for operational cash and for short-term investments and trading counterparties.
45. Counterparty risk is also managed by capping exposure to each issuer/bank. Counterparty risk analyses are performed internally for the purpose of trading and short-term investments with banks; in the case of commercial and central banks, financial information systems, credit analysis providers and other sources are used.

#### Country risk

46. Country risk is a collection of risks associated with investing in a country. These risks include political risk, exchange rate risk, economic risk, sovereign risk and transfer risk, which is the risk of capital being locked up or frozen by government action.
47. Country risk is managed for all investments through the establishment of maximum country exposure concentrations within the guidelines of every individual portfolio. Country exposures are monitored on a daily basis through the internal compliance system.

#### Industry (or sector) risk (for equities portfolio)

48. This is the risk related to investing in a specific industry or sector. This risk is addressed in the context of the definition of the equities portfolio strategy by ensuring industry and sector diversification and by setting concentration limits in the investment guidelines.

#### Operational risk

49. Operational risk is defined by the Basel Committee on Banking Supervision as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." Operational risk is the risk which is not inherent in financial, systematic or market-wide risk. This includes business continuity, legal risk and reputational risk. A typical example of operational risk is the lack of clear segregation between the front and back office.
50. The operational risk is addressed by defining a sound framework of responsibility and accountability within IFAD's financial structure, by establishing back-up procedures and by performing legal reviews of all official policies. The operational risks were mapped and analysed during 2012 and the Operational Risk Management - Treasury, Investment and Cash Management Operations report was finalized.
51. On a broader organizational level, IFAD's Policy on Preventing Fraud and Corruption in its Activities and Operations<sup>11</sup> aims to: "(i) affirm and communicate the Fund's resolve to prevent and combat fraud and corruption in its activities and operations; (ii) describe the ongoing efforts of the Fund in this area; and (iii) outline actions that the Fund will be taking in implementing this policy".
52. In addition, IFAD's Human Resources Implementing Procedures specify that "Screening will be conducted with professional rigour ... and selection processes ensuring that candidates are assessed on the basis of the highest standards of competence, integrity, and appropriate experience to carry out IFAD's objectives and avoid potential conflicts of interest".<sup>12</sup>

<sup>11</sup> EB 2005/85/R.5 and subsequently revised EB 2005/86/INF.8.

<sup>12</sup> IFAD's Human Resources Implementing Procedures, chapter 2: Staff recruitment and appointment 2.3.1 (iii).



## D. Risk measurement and management

### Risk budgeting and risk tolerance

53. The aforementioned points are addressed through a risk-budgeting framework which represents the overall risk appetite and tolerance of the organization. This translates into risk metrics as defined in the IPS, investment guidelines, liquidity policy as well as other policies and internal procedures.
54. Specifically, risk budgeting is the procedure of allocating risk within and between funds. It entails setting predetermined limits for the investment portfolio – on an aggregate level and at the level of individual managers – monitoring these measures and adjusting the portfolio whenever they exceed the tolerance level. In more detail, risk budgeting is the process of:
- (i) Measuring and decomposing the aggregate risk of a portfolio into its constituents on a quantitative basis;
  - (ii) Setting risk limits (risk budgets) for the overall investment portfolio and individual portfolios, ex ante through the definition of ranges of selected risk metrics in line with the organization's risk appetite and tolerance level;
  - (iii) Allocating risks across the assets in compliance with risk budgets;
  - (iv) Monitoring the use or misuse of risk budgets on an ongoing basis;
  - (v) Analysing the results (ex post); and
  - (vi) Changing investments when necessary to align the portfolio with the desired risk level.
55. IFAD's IPS sets the risk budget for IFAD's overall investment portfolio. The risk budget for individual portfolios is approved by the President of IFAD. Further limits are set in IFAD's investment guidelines, minimum liquidity requirement, investment policies, and in other internal procedures. Table 2 details the risk measures selected for the risk management framework and their tolerance level as defined in these IFAD policies and guidelines. The table, together with chart 3, also presents the internal procedures established under the risk management framework to monitor and manage the risks within the new risk-budgeting framework.

### IPS risk-budgeting levels

56. The risk measures and their tolerance level presented in IFAD's IPS have been established as a result of several analyses conducted with the help of two external risk management providers, and since 2012 through the BarraOne risk management tool which allows IFAD to perform what-if analysis on the portfolio and managers' risk levels. Specifically:
- (i) The established levels of one-year CVaR for each individual portfolio have been set by analysing both the actual portfolio and the corresponding benchmark CVaR representing IFAD's desired investment universe. The final risk-budgeting levels have been derived by adding a security buffer to account for market volatility;
  - (ii) The established levels of one-year CVaR for the overall portfolio have been set based on the CVaR of IFAD's current individual portfolios and stress testing under extreme market conditions; and
  - (iii) The established levels of ex ante tracking errors for each individual portfolio (N.B. not applicable to held-to-maturity investments) have been set based on IFAD's investment guidelines for existing individual portfolios and on accepted industry-wide tracking error levels as discussed with IFAD's external portfolio managers.

Table 2  
**IFAD's Investment risks, established limits and control framework**

<i>Risk type</i>	<i>Risk measure and source</i>	<i>Established limit</i>	<i>Monitoring frequency/tool</i>	<i>Reporting frequency</i>	<i>Alert level/Action taken</i>
Interest rate risk	Manager's duration (determined in IFAD's investment guidelines)	Duration must be no lower than zero (i.e. divesting into cash, lower limit) and no higher than two years above the benchmark duration (upper limit)	Daily through compliance system	Monthly in the risk report to the Treasurer and the AVP/FOD  Quarterly in the Report on IFAD's investment portfolio to the Executive Board	Should the duration upper or lower limit be breached, the issue will be reported by the RCF to the IM, the Treasurer and the AVP/FOD. The IM will immediately liaise with the investment manager to: <ul style="list-style-type: none"> <li>• Verify the reason for the duration position/strategy.</li> <li>• Agree on a reasonable time frame for the manager to restore duration within allowable limits.</li> <li>• Upon execution of required trades, request written confirmation by the manager of the new duration level.</li> </ul> The RCF will then re-evaluate the duration level and report to the Treasurer and the AVP/FOD.
	1-year forward-looking ex ante tracking error (stated in IFAD's IPS)	<ul style="list-style-type: none"> <li>• Global liquidity portfolio: maximum 1.5 per cent</li> <li>• Global government bond portfolio: maximum 1.5 per cent</li> <li>• Inflation-indexed bond portfolio: maximum 2.5 per cent</li> <li>• Global credit portfolio: maximum 3.0 per cent</li> <li>• Emerging market bond portfolio: maximum 4.0 per cent</li> <li>• Global developed market equities portfolio: will be determined upon implementation and selection of benchmark</li> <li>• Renminbi portfolio: maximum 1.5 per cent.</li> </ul>	Weekly through risk management system	At least monthly in the risk report to the Treasurer and the AVP/FOD. More frequently if the variance is close to the established limit.  Quarterly in the Report on IFAD's investment portfolio to the Executive Board	Should the tracking error on any manager exceed its threshold by more than five per cent, or should the change from prior month exceed five per cent, the issue will be reported by the RCF to the IM team, the Treasurer and the AVP/FOD. The IM team will immediately liaise with the investment manager to: <ul style="list-style-type: none"> <li>• Verify the reasons underlying the discrepancy in tracking error.</li> <li>• If deemed necessary for risk mitigation, agree on a reasonable time frame for the manager to restore tracking error within allowable limits.</li> <li>• Upon execution of required trades, request written confirmation by the manager of the new tracking error.</li> </ul> The RCF will verify the tracking error level and report to the Treasurer and the AVP/FOD.

\* It should be noted that a high tracking error does not necessarily indicate a higher risk, but only a higher degree of difference when compared with the benchmark. For example, should a benchmark contain sub-prime mortgage-backed securities, a portfolio indexed against this benchmark and not containing such securities may show a high tracking error but a lower risk level in absolute terms.

<i>Risk type</i>	<i>Risk measure and source</i>	<i>Established limit</i>	<i>Monitoring frequency/tool</i>	<i>Reporting frequency</i>	<i>Alert level/Action taken</i>
Interest rate risk (continued)	1-year conditional value-at-risk at 95 per cent confidence level (stated in IFAD's IPS)	<ul style="list-style-type: none"> <li>• Global liquidity portfolio: 2 per cent</li> <li>• Global government bond portfolio: 2.0 per cent</li> <li>• Inflation-indexed bond portfolio: 9.0 per cent</li> <li>• Global credit portfolio: 7.0 per cent</li> <li>• Emerging market bond portfolio: 15.0 per cent</li> <li>• Global developed market equities portfolio: 27 per cent</li> <li>• Renminbi portfolio: maximum 2 per cent</li> <li>• Asset liability portfolio: 8.0 per cent</li> <li>• Overall portfolio: maximum 6% with and without equities</li> </ul>	Monthly through risk management system	<p>At least monthly in the risk report to the Treasurer and the AVP/FOD. More frequently if alert level for measure is reached.</p> <p>Quarterly in the Report on IFAD's investment portfolio to the Executive Board</p>	<p>Should the CVaR on the overall portfolio or on any single manager exceed its threshold by more than five per cent, or should the changes from prior month exceed five per cent, the issue will be reported by the RCF Unit to the IM, the Treasurer and the AVP/FOD. The following actions will be taken:</p> <ul style="list-style-type: none"> <li>• The RCF will perform a break-down analysis to identify the sources of increased CVaR.</li> <li>• Depending on the result of the break-down analysis, the RCF will recommend to the AVP/FOD and to the Treasurer corrective measures on the overall portfolio or for a single manager. These measures may include, but are not limited to, increasing the cash exposure, decreasing duration and divesting from a certain sector.</li> <li>• The measures will be discussed within TRE and RCF an action plan will be presented to the AVP/FOD and to the Treasurer.</li> <li>• Upon approval, the recommendations will be implemented with the concerned counterparty.</li> </ul>
Currency risk	Percentage deviation from SDR currency ratios	While the aim of the framework is to minimize any variance (i.e. zero variance), any deviation of more than 10 per cent per SDR currency is considered above the absolute limit.	Monthly through internal analysis	<p>At least monthly to the Treasurer and the AVP/FOD. More frequently if the variance is close to the established limit.</p> <p>Quarterly in the Report on IFAD's investment portfolio to the Executive Board</p>	<p>Should the percentage deviation in any single currency exceed 10 per cent, the following actions will be taken:</p> <ul style="list-style-type: none"> <li>• The RCF will recommend a realignment strategy by one of the following tools: foreign exchange transactions on internally managed cash or change in currency composition of one or more of the externally managed individual portfolios.</li> <li>• An execution time frame for the realignment will be communicated by the RCF to the Treasurer and the AVP/FOD and to the concerned teams (the IM and/or the CM)</li> <li>• The concerned party will be instructed to execute the trades.</li> <li>• Upon execution, a new analysis will be performed to verify the realignment of the assets.</li> </ul> <p>Should the percentage deviation in any single currency exceed 5 per cent, the following</p>

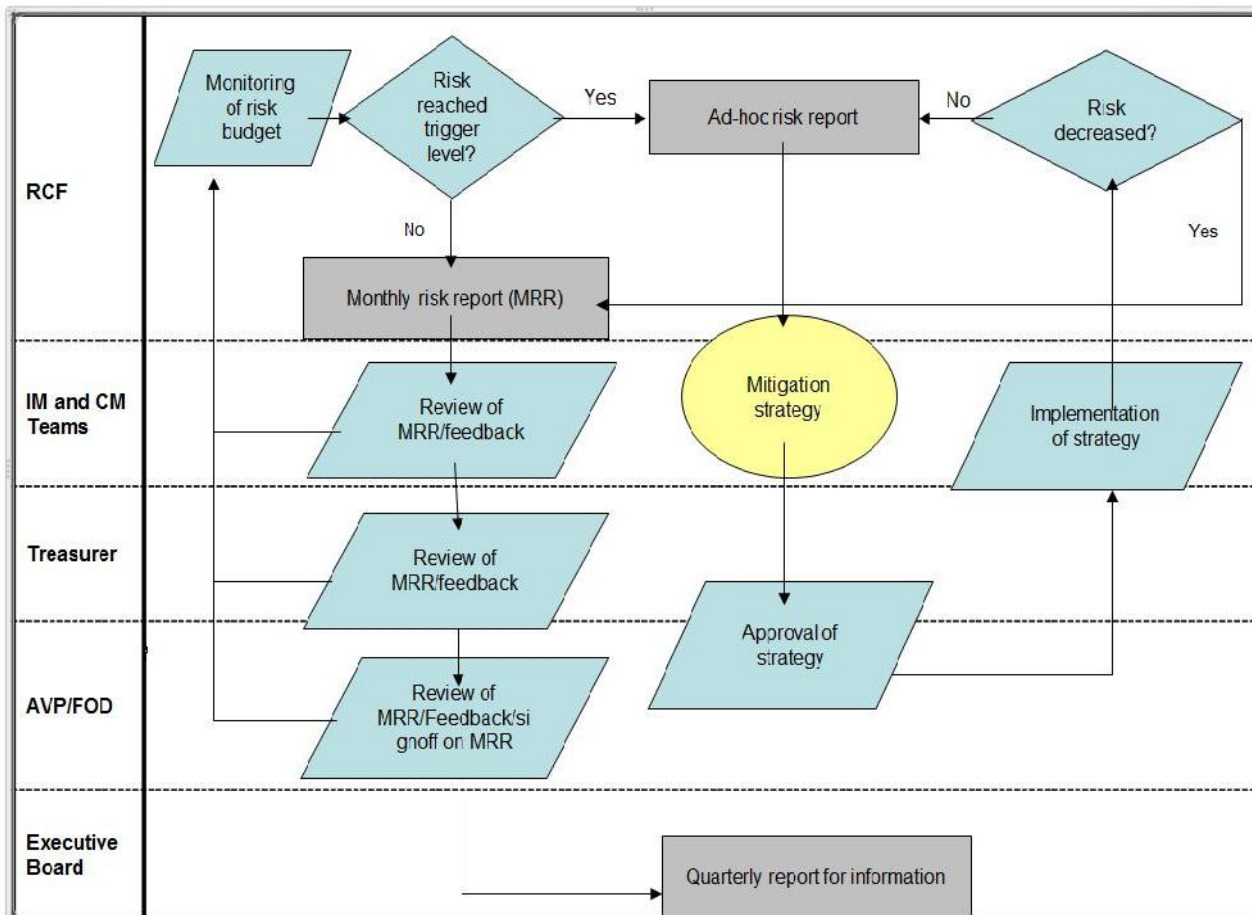
<i>Risk type</i>	<i>Risk measure and source</i>	<i>Established limit</i>	<i>Monitoring frequency/tool</i>	<i>Reporting frequency</i>	<i>Alert level/Action taken</i>
					<p>actions will be taken:</p> <ul style="list-style-type: none"> <li>The RCF may recommend a non-binding realignment strategy via the internally managed cash (if available and feasible for TRE to implement) and will be communicated to the Treasurer and the AVP FOD.</li> </ul>
Liquidity risk	Percentage of gross disbursement (determined in IFAD's minimum liquidity requirement)	Minimum liquidity requirement (composed of IFAD's investment portfolio) set at 60 per cent of the total of annual gross disbursements (cash outflows) and potential additional requirements due to liquidity shocks	Quarterly through internal analysis	Quarterly in the Report on IFAD's investment portfolio to the Executive Board	Should IFAD's investment portfolio decrease to reach the level of 70per cent of gross disbursements, the issue will be reported by the RCF to the AVP FOD and the Treasurer and immediately communicated to the Programme Operations Department in order to revise the plan for future disbursements.
Credit risk	Credit rating (determined in IFAD's investment guidelines) and fundamental analysis carried out in-house	Minimum credit floor in investment guidelines for managed portfolios is BBB- (i.e. investment grade)	Daily through compliance monitoring system	<p>At least monthly in the risk report to the Treasurer and the AVP/FOD</p> <p>On a quarterly basis a credit rating analysis by portfolio will be presented in the Report on IFAD's investment portfolio to the Executive Board.</p>	<p>Should a security be downgraded below IFAD's minimum credit floor, the issue will be reported by the RCF to the IM, the Treasurer and the AVP/FOD. As per the investment guidelines, the manager will dispose of the concerned security within 30 days of the date of the downgrading by the credit rating agency.</p> <p>Credit risk is reported and analysed by the RCF. TRE also analyses the credit risk for internally managed investments, and, on a selective basis, for externally managed assets. Credit risk analyses for commercial and central banks are performed by using financial information systems, credit analysis providers and other market sources.</p>
Counterparty risk	Credit rating for counterparties (determined in IFAD's investment guidelines)	Minimum credit rating for eligible counterparties.	Monthly through internal analyses	Ad hoc basis, but if there is a credit event (e.g. downgrade) then a report will be written.	<p>Should counterparty be downgraded below IFAD's minimum credit floor, the issue will be reported by the RCF to the Treasurer, the AVP/FOD and the IM and CM. Immediate action will, as appropriate, be taken with the investment manager.</p> <p>TRE performs analysis of counterparties for all investment activities, including trading, derivatives and banks eligible for investments. Monitoring is also performed on commercial and central banks' credit ratings and financial soundness.</p>

<i>Risk type</i>	<i>Risk measure and source</i>	<i>Established limit</i>	<i>Monitoring frequency/tool</i>	<i>Reporting frequency</i>	<i>Alert level/Action taken</i>
Industry (or Sector) risk (for equities portfolio)	Maximum industry exposure and concentration limits (determined in IFAD's various investment guidelines)	Depending on investment portfolio guidelines	Daily through compliance monitoring system	Monthly in investment portfolio reports to FALCO and FISCO and quarterly to the Executive Board.	Should a country concentration be exceeded, the issue will be reported by the RCF to the Treasurer, the AVP/FOD and the IM and CM . Immediate action will be taken, as appropriate, with the investment manager.
Country risk	Maximum country risk exposure and concentration limits (determined in IFAD's investment guidelines)	Depending on investment portfolio guidelines	Daily through compliance monitoring system	Monthly in investment portfolio reports to FALCO and FISCO and quarterly to the Executive Board.	Should a country concentration be exceeded, the issue will be reported by the RCF to the Treasurer, the AVP/FOD and the IM and CM. Immediate action will be taken, as appropriate, with the investment manager.
Operational risk	Segregation of duties within TRE, back-up procedures, legal control (determined in the Treasury Manual and Operational Risk Management for Treasury, and Cash and Investment).  Segregation of duties of TRE and the RCF reported in this ICF document and various investment guidelines	Not applicable	Continuous	Annually, through the revision of the Treasury Manual and the Operational Risk report (from 2012).	Segregation of duties for core financial procedures within the FOD department exists between ACD, TRE and RCF. ACD has the authority to instruct movements of IFAD funds to external parties while TRE executes such instructions through operational bank accounts. RCF independently reports on the investment activities. The ACD and TRE divisions independently post accounting entries in the General Ledgers which are reconciled at least on a monthly basis. Within TRE, segregation of duties exists between the IM which recommends (for the Treasurer's approval) and executes trades, and the CM which performs trade settlement.  Additionally, with regard to the investment portfolio, the first level of sign-off is performed between the external portfolio managers and IFAD's Global Custodian, thereby ensuring accountability and segregation of duties.  Procedures are reported in the Treasury Manual. Whenever a new procedure is set up, back-up functions are established and documented to ensure a thorough business continuity plan.

- E. Control, information and communication, and monitoring activities
57. TRE reports externally certain risk measurement metrics and analyses to the Executive Board and the Audit Committee through the quarterly and annual investment portfolio report. Comprehensive monthly risk reports are also produced by the Unit and shared internally with the Treasurer and AVP/FOD, and if deemed relevant, with FALCO or FISCO.
  58. These comprehensive monthly risk reports inform, communicate and monitor activities that cover the following areas of risk monitoring:
    - (i) Currency risk;
    - (ii) Country risk;
    - (iii) Market and credit monitoring, and risk levels compared to predetermined risk budget levels;
    - (iv) Compliance monitoring versus investment guidelines and subsequent actions if any; and
    - (v) Portfolio and benchmark performances.
  59. Whenever a risk measure reaches the "alert level", as defined in table 2, the RCF will inform the IM, the Treasurer and the AVP/FOD. Appropriate risk-mitigating strategies will be recommended and actions will be taken, as described in table 2. Upon completion of the actions, the RCF will verify the risk level and report the new level to the concerned parties. The process is illustrated in chart 3.
  60. In addition to the risk measures established in IFAD's IPS for risk-budgeting purposes, a comprehensive set of risk measures is analysed through the risk management system. Whenever one of the risk measures, either on the overall portfolio or on a single manager, is deemed to be excessive or shows a significant change from the previous period, the RCF will bring the issue to the attention of the AVP/FOD, the Treasurer and the IM.
  61. The additional measures (whose definitions are given in annex IV) include:
    - (i) Annualized standard deviation or returns by manager, individual portfolio, benchmark and for the overall portfolio and benchmark;
    - (ii) CVaR with a one-year forward-looking horizon and a 95 per cent confidence level, by manager, by individual portfolio benchmark, and for the overall portfolio and the overall benchmark;
    - (iii) Historical overall monthly CVaR for the historical period of the past two years;
    - (iv) Overall risk decomposition, by risk type; and
    - (v) Risk-adjusted return indicators (Sharpe ratio, tracking error, information ratio, beta and alpha).
  62. ACD executes full data control and reconciliation of financial records against the custodian and/or third parties.
  63. The risks in IFAD's investments are currently monitored with a variety of tools:
    - (i) Enhanced risk management system. In order to be equipped for an effective risk-budgeting framework, IFAD strengthened its analytical resources. A new enhanced risk management system, BarraOne, was implemented in June 2012. This system has strengthened IFAD's ability to monitor the risks in the investment portfolio, and enable the TRE and the RCF Unit to perform ex ante analyses as well as stress tests on assets, on the individual portfolios and on individual managers;

- (ii) Compliance monitoring system. This web-based application supplied by the global custodian enables the RCF to verify on a daily basis the compliance of external portfolio managers with the respective investment guidelines. The majority of guidelines are currently coded in the system, and the application flags breaches or alert levels on a daily basis. Guidelines that cannot be coded in the system are monitored through internal analyses and manual procedures;
- (iii) Compliance checks on the internally managed portfolios are, for reasons of segregation of duty, performed by the global custodian who alerts the RCF Unit as soon as a breach occurs and produces a monthly report; and
- (iv) In addition to the above, the IM performs qualitative analyses on selected issuers and counterparties.

Chart 3  
Flow of control framework for investment risks



## Rules of procedure and terms of reference of the Investment and Finance Advisory Committee (FISCO) (High-level committee)<sup>13</sup>

### 1. Purpose

- 1.1 To assist and advise the President in determining the overall investment strategy and Investment Policy Statement (IPS) and deciding on other strategic financial matters.
- 1.2 To review, monitor, discuss and make recommendations to the President on strategic financial matters, based on information and recommendations provided to it by the FISCO members and/or by the Investment, Finance and Asset Liability Management Advisory Committee (FALCO).
- 1.3 The scope of FISCO's review and recommendations, for final decision as required, by the President, includes:
  - 1.3.1. Financing and resource requirements, including budget status
  - 1.3.2. Financing mechanisms
  - 1.3.3. All financial flows and projections
  - 1.3.4. Investment Policy and minimum liquidity requirement
  - 1.3.5. Investment risk management
  - 1.3.6. Direct charges against investment income
  - 1.3.7. Appointment of investment managers and Global Custodian
  - 1.3.8. Financial market developments
  - 1.3.9. Any other financial matters deemed strategically important

### 2. Membership

- 2.1. The membership of the Committee shall be determined by the President and shall include:
  - The President (Chairperson)
  - Vice-President, Office of the President and the Vice-President
  - Associate Vice-President, Programme Management Department
  - Associate Vice-President, Financial Operations Department
  - Associate Vice-President, Strategy and Knowledge Department
  - Associate Vice-President, Corporate Services Department
  - Director and Treasurer, Treasury Services Division (Secretary)
  - Director, Office of the President and the Vice-President
  - Director and Controller, Controller's and Financial Services Division
  - General Counsel, Office of the General Counsel
  - Director, Office of Audit and Oversight (Observer)
  - Any other member as the Chairperson may decide from time to time

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<sup>13</sup> Terms of reference of FISCO are under revision.



3. Meetings
  - 3.1 Members and the observers will attend all meetings. In the event that they are unable to attend, they will designate qualified representatives by communicating these to the Secretary in writing.
  - 3.2 Other IFAD staff directly concerned with the matters to be discussed may be asked to attend by the Secretary in consultation with the Chairperson.
  - 3.3 A quorum shall consist of the President as Chairperson or, in the event of the President's inability to attend, his/her representative (under a specific delegation of authority from the President); the Director and Treasurer, TRE, as Secretary or his/her representative and the Associate Vice-President, Financial Operations Department or his/her representative.
  - 3.4 Meetings will be held every two months and more often if the business of the Fund so requires.
4. Agenda, documentation and minutes
  - 4.1 The Director and Treasurer of IFAD will act as the Secretary of the Committee.
  - 4.2 The Secretary will be responsible for the following:
    - 4.2.1. Scheduling meetings;
    - 4.2.2. Drafting the agenda in consultation with the Chairperson of FALCO;
    - 4.2.3. Coordinating and distributing documentation to the Committee at least four working days prior to the meeting date. In addition to the specific documentation for each meeting, the committee will receive information, as deemed necessary by the Chairperson or FISCO members, on the strategic financial matters indicated in 1.3.;
    - 4.2.4. Preparing the minutes of the meeting for the Chairperson's approval and an updated tracker of actions required by the Committee. The minutes shall include:
      - 4.2.4.1. Decisions taken by the President
      - 4.2.4.2. Advice, recommendations, substantive observations by the Committee members
      - 4.2.4.3. Actions to be undertaken by responsible officers.
    - 4.2.5. Distributing signed minutes to all members, observers and other participants.

## Rules of procedure and terms of reference of the Investment, Finance and ALM Advisory Committee (FALCO) (Operational committee)<sup>14</sup>

### 1. Purpose

- 1.1 To assist and advise the Associate Vice-President, Financial Operations Department (AVP/FOD) in making decisions on financial or investment management matters that are under his/her authority or under specific delegation of authority from the President of IFAD.
- 1.2 To decide on investment policy and risk matters which fall within the framework of the approved Investment Policy Statement (IPS);
- 1.3 To review, monitor, discuss and make recommendations to the Investment and Finance Advisory Committee (FISCO) for final decision by the President on the following strategic financial matters based on information and recommendations provided to it by the FALCO members:
  - 1.3.1. Financing and resource requirements, including budget status
  - 1.3.2. Financing mechanisms
  - 1.3.3. All financial flows and projections
  - 1.3.4. Investment policy and minimum liquidity requirements
  - 1.3.5. Investment risk management
  - 1.3.6. Financial market developments
  - 1.3.7. Any other financial matters deemed strategically or operationally important.
- 1.4 To review, monitor, discuss and decide on operational matters within provisions of approved financial policies and strategies for final decision by the AVP/FOD, and inform FISCO on decisions taken. The AVP/FOD shall exercise best judgment on any matters to be escalated to FISCO. The scope of the AVP/ FOD's decision includes:
  - 1.4.1. Investment guidelines and subsequent changes
  - 1.4.2. Re-allocations within the approved overall direct charges against investment income
  - 1.4.3. Eligibility criteria for the selection of commercial banks and changes thereto
  - 1.4.4. Individual investment portfolio risk budget parameters within the overall portfolio parameters as approved by the Executive Board
  - 1.4.5. Selection of financial information and advisory services providers
  - 1.4.6. Any other financial and operational matters deemed appropriate.

### 2. Membership

- 2.1 The membership of the Committee shall be determined by the President and include:
  - Associate Vice-President, Financial Operations Department (Chairperson)
  - Director and Treasurer, Treasury Services Division (Secretary)

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<sup>14</sup> Terms of reference of FALCO are under revision.

- Director and Controller, Controller's and Financial Services Division
  - Director or representative, as designated by the Associate Vice-President, Programme Management Department
  - Team Leader, Financial Planning and Analysis Unit
  - Manager, Accounting and Financial Reporting, Controller's and Financial Services Division
  - Manager, Loans and Grants, Controller's and Financial Services Division
  - Assistant Treasurer, Treasury Services Division
  - Investment Management Senior Officer, Treasury Services Division
  - Cash Management Senior Officer, Treasury Services Division
  - Director, Budget and Organizational Development Unit
  - Legal Counsel, Office of the General Counsel
  - Treasurers of the Food and Agriculture Organization of the United Nations (FAO) and the World Food Programme (WFP) as observers
  - Any other member as the Chairperson may decide from time to time
3. Meetings
- 3.1 Members of the Committee will attend all meetings. In the event that they are unable to attend, they will designate qualified representatives by communicating these to the Secretary in writing.
- 3.2 A quorum shall consist of the AVP/FOD, the Secretary and five members including at least one each from Treasury Services Division, Controller's and Financial Services Division and Financial Planning and Analysis Unit, or their representatives.
- 3.3 Meetings will be held every two months (to be aligned with the FISCO meetings) and more often if the business of the Fund so requires.
4. Agenda, documentation and minutes
- 4.1 The Director and Treasurer of IFAD will act as Secretary of the Committee.
- 4.2 The Secretary will be responsible for the following:
- 4.2.1. Scheduling meetings
- 4.2.2. Establishing the agenda
- 4.2.3. Coordinating and distributing documentation to the Committee at least two working days prior to the meeting date. In addition to specific documentation for each meeting, the Committee will receive regular information, as deemed necessary by the Chairperson or Members, on the strategic financial and operational matters indicated in 1.2
- 4.2.4. Preparing the minutes of the meeting for the Chairperson's approval and an updated tracker of actions required by the Committee. The minutes shall include:
- 4.2.4.1. Decisions taken by the AVP/FOD
- 4.2.4.2. Advice, recommendations, substantive observations by Committee members
- 4.2.4.3. Actions to be undertaken by responsible officers
- 4.2.5. Distributing signed minutes to all members and other participants.

## Reference to the new principles in the COSO Internal Control – Integrated Framework in the context of IFAD's investment-related activities

### I. Control environment

1. The organization demonstrates a commitment to integrity and ethical values: Specific policies and procedures that fall under IFAD's Policy on Enterprise Risk Management (ERM) require (a) an annual certification of compliance with the IFAD Code of Conduct and declaration of non-IFAD income, goods, services or assets; (b) Management assertion and external audit attestation of internal controls over financial reporting and (c) financial disclosure statement for selected staff members. These points – referred to in section II.C of the ICF – demonstrate a commitment to integrity and ethical values.
2. The board of directors demonstrates independence from Management and exercises oversight of the development and performance of internal control: IFAD's Governing Council, Executive Board and Audit Committee are independent from Management and exercise oversight as referred to in section II.A.
3. Management establishes, with Board oversight, structures, reporting lines, and appropriate authority and responsibilities in the pursuit of objectives: Section II. B describes the investment-related roles and responsibilities of key parties responsible for oversight and decision-making of investment-related activities. Chart 1 illustrates IFAD's governance structure and chart 2, the internal flow of financial information in terms of investments.
4. The organization demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives: IFAD's Human Resources Implementing Procedures state that "Screening will be conducted with professional rigour ... and selection processes ensuring that candidates are assessed on the basis of the highest standards of competence, integrity, and appropriate experience to carry out IFAD's objectives and avoid potential conflicts of interest."<sup>15</sup>
5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives: Section 3.1 of IFAD's Human Resources Policy<sup>16</sup> states that IFAD staff accepts responsibility to "discharge their functions and regulate their conduct solely with the interest and objectives of the Fund in view."

### II. Risk assessment

6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives: The Governing Council adopted the Financial Regulations of IFAD. Regulation VIII, paragraph 2 states that "in investing the resources of the Fund the President shall be guided by the paramount considerations of the security and liquidity. Within these constraints the President shall seek the highest possible return in a non-speculative manner".

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<sup>15</sup> IFAD's Human Resources Implementing Procedures Chapter 2: Staff recruitment and appointment 2.3.1(iii).

<sup>16</sup> EB 2004/82/R.28/Rev.1

7. The organization identifies risks to the achievement of its objectives across the entity and analyses risks as a basis for determining how the risks should be managed: Through the IPS the organization identifies an investment universe to achieve the above-mentioned objective as detailed in section III.A, whereby it stipulates asset classes, credit rating floors, durations and corresponding benchmarks. Section III.C identifies various risks (i.e. market risk, currency risk, liquidity risk, credit risk, counterparty risk and operational risk) associated with IFAD's investment portfolio and describes how these risks are mitigated and managed by IFAD. Table 2 summarizes established limits, monitoring/reporting frequencies and what alert actions are to be taken.
8. The organization considers the potential for fraud in assessing risks to the achievement of objectives: IFAD addresses this through its Policy on Preventing Fraud and Corruption in its Activities and Operations,<sup>17</sup> which aims to: "(i) affirm and communicate the Fund's resolve to prevent and combat fraud and corruption in its activities and operations; (ii) describe the ongoing efforts of the Fund in this area; and (iii) outline actions that the Fund will be taking in implementing this policy".
9. The organization identifies and assesses changes that could significantly impact the system of internal control: The annual review of the IPS and ICF provides a framework to identify the adequacy of IFAD's internal controls, which is then reported to the Executive Board and Audit Committee. IFAD's two-tier investment committees (i.e. FISCO and FALCO) meet regularly to review emerging challenges and risks and to discuss and endorse mitigation strategies.

### III. Control activities

10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels: Sections III.C and III.D stipulate IFAD's risk assessment, controls and monitoring activities to mitigate risks. These are further summarized in table 2.
11. The organization selects and develops general control activities over technology to support the achievement of objectives: Section III.D highlights the control and monitoring activities, specifically in relation to IFAD's risk management system (BarraOne) and compliance monitoring system (a web-based application supplied by IFAD's global custodian). Furthermore, IFAD is continuing to develop and improve the internal information technology systems pertaining to financial risks and controls.
12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into action: Section II.C outlines the IFAD investment-related policies and procedures that govern IFAD's investment processes and controls. It makes reference to IFAD's Financial Regulations, the ERM policy, the IPS, the liquidity policy, investment guidelines, the ICF, investment management and master custody agreements, the Treasury Manual, and FISCO and FALCO. Table 2 summarizes established risk limits, monitoring/reporting frequencies and procedures/actions to be taken in the event risk levels are breached.

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<sup>17</sup> EB 2005/85/R.5, subsequently revised as EB 2005/86/INF.8.

#### IV. Information and communication

13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control: As summarized in table 2, specifically under column "monitoring frequency/tool", quality information is regularly collated by IFAD to generate compliance and risk reports to support the functioning of internal control.
14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control: Section II.B. of the ICF, illustrates and details how financial information (in terms of investments) is communicated within the organization. This includes objectives and responsibilities for internal control. Risk levels are also reported to IFAD's lower tier investment committee (FALCO). Chart 3 presents the flow of control and communication for investment risks to internal parties including but not limited to the Treasurer and AVP FOD.
15. The organization communicates with external parties regarding matters affecting the functioning of internal control: The IPS and ICF, together with the annual revisions, provide a channel for the organization to communicate matters affecting the internal control over investment-related activities to external parties.

#### V. Monitoring activities

16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components or internal control are present and functioning: The effective functioning of internal controls over investments are subject to separate independent reviews by IFAD's Office of Audit and Oversight, together with periodic reviews by IFAD's external auditors.
17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate: On an annual basis the IPS and ICF is reviewed to identify any potential deficiencies with IFAD's internal controls in relation to its investment activities, with proposed improvements and changes reported to the Audit Committee and Executive Board. Furthermore table 2 summarizes the frequency and timeliness of communicating any investment-related internal control breach to relevant parties, including the Treasurer, AVP FOD, IFAD's investment committees as well as the Executive Board and Audit Committee.

## Glossary of risk measures and related terms

**Active risk:** The risk a portfolio or fund acquires when it is actively managed, especially when its managers attempt to outperform some benchmark. More specifically, the more a fund or portfolio differs from the benchmark upon which it is based, the more likely it is to underperform or outperform that same benchmark. This extra risk is active risk. For example, a one-year forward-looking active risk of 0.2 per cent means that, over the coming year, the portfolio excess return over the benchmark is expected to be in the range of +/- 0.2 per cent of its mean value.

The active risk can be predictive (or ex ante), based on expected return, or ex post, derived from the actual returns of the portfolio.

**Alpha:** Alpha is a risk-adjusted measure of the so-called "excess return" on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index or "risk-free" investment.

**Benchmark:** A benchmark is a standard against which the performance of a security or manager can be measured. The benchmark should be an investment instrument that has certain characteristics of transparency and replicability so as to best represent the performance of a certain investment universe. In financial markets, the most popular indices are used as benchmarks. For example, the Standard & Poor's 500 is a widely used benchmark for United States "large-cap" equities markets.

**Beta:** Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison with the financial market as a whole.

**Conditional VaR:** CVaR is a measure of the average expected loss of a portfolio assuming that the value at risk has been reached. Since assumption is made that the portfolio loss has exceeded the VaR, the CVaR gives an indication about the magnitude of the losses in "the tails" of the distribution, i.e. in extreme loss cases. The higher the CVaR, the more a portfolio is expected to lose in extreme scenarios and, hence, the riskier it is.

**Confidence level:** This is the range (with a specified value of uncertainty, usually expressed in percentage terms) within which the true value of a measured quantity exists. It is also the level of certainty to which an estimate can be trusted.

**Duration:** This is a measure of the sensitivity of a bond's price to changes in the level of market yields. For bonds, prices and yields have an inverse relationship. If the yields increase, the bonds' prices decrease. A bond with longer duration is more sensitive to changes in market yields meaning that, all else equal, its price will decline more for a given increase in yields than the price of a bond with shorter duration.

**Fat tails:** A fat-tailed probability distribution is one in which extreme events are more probable.

**Historical simulation:** Historical simulation is a procedure for predicting the values of a portfolio deriving such values from historical portfolio data.

**Information ratio:** This is a measure of risk-adjusted performance. The information ratio measures the relation between the portfolio's average excess return (in excess of the benchmark return) and its tracking error. A higher information ratio indicates a better reward for the portfolio's tracking error, thereby indicating also more successful investment management skills.

**Risk-adjusted return:** This is a measure of how much an investment returned in relation to the amount of risk it took on. It is often used to compare a high-risk, potentially high-return investment with a low-risk, lower-return investment. A simple risk-adjusted return measure is dividing the portfolio's annual return by its annual standard deviation. This ratio gives an indication of the amount of return generated by each risk unit. The higher the ratio, the better the risk-adjusted return.

**Risk-free rate:** This is the theoretical rate of return of an investment with no risk of financial loss. The risk-free rate represents the interest that an investor would expect from an absolutely risk-free investment over a given period of time. Risk-free assets usually refer to short-dated government bonds. For United States dollar investments, usually United States Treasury bills are used, while a common choice for euro investments are German Government bills or the Euro Interbank Offered Rate (Euribor).

**Sharpe ratio:** This is a measure of risk-adjusted performance. It measures the relation between the portfolio's average excess return (in excess of risk-free return) and its standard deviation. The higher the Sharpe ratio is, the better the reward for market risk.

**Standard deviation:** This is a measure of the volatility of a certain value around its average. The higher the standard deviation, the more the value is dispersed around its average. In the case of portfolio returns, the higher the standard deviation of returns, the more returns are expected to vary around the average expected return. Therefore, a portfolio with a high standard deviation is considered more risky than one with a lower one, all else being equal.

**Value-at-risk:** This is the maximum potential loss an investment can incur over a defined time horizon within a specified confidence level. If an investment portfolio of US\$100 million has a three-month VaR of 1.5 per cent with a confidence level of 95 per cent, the maximum amount that could be lost over the next three-month period is US\$1.5 million; and this estimate can be trusted with 95 per cent certainty, meaning that it is expected that the estimate is correct 19 times out of 20 (95 per cent of the times).

**Volatility:** This is a measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns.