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Terms of Reference for a Comprehensive  
~~Independent External Review of IFAD's Risk~~  
~~Management Policies~~ Financial Risk  
Assessment

Note to Executive Board representatives

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For: Review

The attention of the Executive Board is drawn to the following Terms of Reference for a Comprehensive Independent Financial Risk Assessment. For ease of reference, the proposed additions/modifications to the text of the document are underlined, while deletions are shown in strikethrough. In addition, please note this assessment will focus on risks related to financial operations, and is part of an overall exercise to review, update and strengthen IFAD's Enterprise Risk Management.

## Terms of Reference for ~~an~~ a Comprehensive Independent External Review of IFAD's Risk Management Policies Financial Risk Assessment

### I. Introduction

1. In light of the adoption of the Concessional Partner Loan (CPL) Framework, and continued use of the Sovereign Borrowing Framework, the Executive Board has requested a comprehensive review by an independent external consultancy firm of all relevant aspects of IFAD's financial risk management practices related to its debt repayment capabilities.
2. Over the years, IFAD has continually developed, enhanced and updated its policies to manage risk in its financial operations. IFAD has also augmented the level of staff in its Financial Operations Department to optimize capacity for financial resource management. Several key documents outlining IFAD's policies will serve as a guide for the external review:
  - The Liquidity Policy sets out the policies for maintaining sufficient liquidity for IFAD to meet its obligations, including provisions for unexpected shocks (EB 2006/89/R.40).
  - In 2013, the process for determining resource allocation to IFAD's programme of loans and grants while maintaining sufficient liquidity was updated and documented in the Procedures and Definitions for Determining Resources Available for Commitment Based on Sustainable Cash Flow (EB 2013/108/R.20).
  - The Sovereign Borrowing Framework: Borrowing from Sovereign States and State-Supported Institutions included new risk policies that were enacted as IFAD started accepting bilateral loans (EB 2015/114/R.17/Rev.1), based on a risk analysis of sovereign debt funding undertaken for an informal seminar of the Executive Board on 10 December 2013.
  - In 2011, an internal control framework (ICF) over financial reporting was introduced, with a Management assertion letter on the effectiveness of internal controls over financial reporting, which was then complemented by the external audit attestation of effectiveness, implemented in December 2012 and subsequent years (see document AC 2011/121/R.9).<sup>1</sup>
  - IFAD's Consolidated Financial Statements are prepared in accordance with International Financial Reporting Standards (IFRS). Since 2011, IFRS 7

<sup>1</sup> The **internal control framework over financial reporting** was established based on the revised framework of the Committee of Sponsoring Organizations of the Treadway Commission. It provides the core definition of internal control principles and components (control environment, risk assessment, control activities, and information/communication and monitoring activities) and sets out clear requirements to ensure effective control. All major process flows have been mapped and key controls defined. Since 2011, the framework has been tested on a yearly basis by the Office of Audit and Oversight to support the issuance of the yearly Management assertion letter over financial reporting. Since 2012, the framework is also reviewed by IFAD's external auditors who issue a yearly attestation over the effectiveness of internal controls together with the audit opinion on annual financial statements.

“Financial Instruments: Disclosures” has been adopted as a basis for preparing the financial statements, requiring IFAD to disclose the nature of risk and the extent of risk arising from the financial instruments to which it is exposed during the reporting period and how it manages those risks.

- IFAD’s Investment Policy Statement (IPS) (EB 2017/122/R.31). The IPS was drafted in accordance with the Chartered Financial Analyst (CFA) Institute’s Elements of an Investment Policy Statement for Institutional Investors which suggest desirable components of an investment policy statement for institutional investors. Minimum IPS components include the governance of investments, objectives for return and risk, and criteria for performance and risk management.
  - Internal Control Framework for IFAD Investments (EB 2017/122/R.31/Add.1). The Internal Control Framework (ICF) for IFAD Investments was first presented to the Executive Board in December 2011 in conjunction with IFAD’s 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.
  - High-level Review of IFAD’s Financial Statements. Since December 2015 includes reference to financial ratios (EB 2016/117/INF.5).
  - Responsibilities of the Enterprise Risk Management Committee 2016 – Update (as communicated in President’s Bulletin PB/2016/03). The Enterprise Risk Management Committee (ERMC) was established in April 2008 to launch and guide the development of enterprise risk management in IFAD. The Committee’s responsibilities were updated on issuance of this President’s Bulletin.
  - The Financial Management and Administration Manual contains procedures which refer to risk-based assurance principles and related guidance to mitigate financial risks in project-related matters.
  - Policies and Criteria for IFAD Financing. At its thirty-sixth session in 2013 (Resolution 178/XXXVI), the Governing Council adopted a revised version of the Lending Policies and Criteria, which is now renamed “Policies and Criteria for IFAD Financing”. The document provides an update of earlier policies relating to IFAD’s financing objectives, project selection criteria, financing, leveraging, implementation and reporting.
  - The Approach to a Transition Framework outlines IFAD’s intended approach in developing a predictable development journey for borrowers and includes topics to be explored in further detail by the related Executive Board working group in the coming months.
3. In 2015, IFAD created an Asset Liability Portfolio, where all the funds obtained through borrowing are segregated and managed separately from the main asset portfolio.
  4. Under the recent evolution of IFAD’s capital structure, borrowing – particularly the use of CPLs – is projected to account for a larger percentage of IFAD’s funding.<sup>7</sup> †Two studies were produced in 2017 addressing new issues and financial risks specific to this policy. These are: Financial Framework and Scenarios for IFAD11 (IFAD11/3/R.3) and Proposal for a Concessional Partner Loan Framework (EB 2017/S10/R.2/Rev.1).
  5. In addition to strengthening and expanding its internal capacity and risk control functions, IFAD has engaged with outside organizations to evaluate its internal processes, including exposure to risk. In 2011, the World Bank conducted a study entitled IFAD Currency Risk Hedging Framework and Implications for IFAD’s Single

- Currency Loans, which focused on single currency lending and the risks inherent in being exposed to currency movements; this study was updated in 2015.
6. Also in 2015, the World Bank conducted a peer review, producing an aide-memoire which included an assessment of IFAD's risks in several areas, particularly with regard to investment management and operational risks. IFAD also worked with the credit rating firm Moody's to gain more knowledge on the credit worthiness of its borrowers. Section II below outlines the different financial and other operational risks that IFAD faces in terms of its repayment ability.
  7. The following are the terms of reference for the procurement of the external provider of the review. These were discussed at the 147<sup>th</sup> meeting of the Audit Committee on 31 January 2018 and were integrated with comments received therein. As discussed at the meeting, the procurement process may benefit from the participation of a member of the Audit Committee, to be indicated by the Committee. The annex outlines the different risks that IFAD faces in terms of its repayment ability. The external consultant firm will be expected to evaluate and provide recommendations on these points in the form of a final report. It is noted this is not an assurance engagement but rather a review of IFAD's risk management policies. The items in the annex will be included in the terms of reference for the review. The scope of this consultancy need not include risk practices regarding IFAD's future plans to borrow in the capital markets as these will be the subject of a separate peer review exercise. The current exercise will be limited to the organization's ability to service and repay its debt obligations.

## II. Terms of Reference for ~~an~~ a Comprehensive Independent External Review of IFAD's Risk Management Policies - Financial Risk Assessment

- A. IFAD's ability to honour its debt obligations
  8. In terms of borrowed resources, the most important risk is ascertaining whether IFAD will have the ability to make timely payments on its debt and hence maintain the sustainability of its operations. The external consultancy firm will comprehensively evaluate IFAD's financial risk management policies and highlight any weaknesses that could lead to repayment difficulties for IFAD, including. Not meeting an interest or principal repayment could have reputational and financial consequences and make it difficult for IFAD to borrow in the future. While it is noted that there could be operational risks related to inadequate staffing, legal procedures or IT systems, these are not the object of the present review. Listed below are key risks/policies that could lead to repayment difficulties for IFAD. The external consultancy firm will be expected to evaluate IFAD's risk management policies with regard to the following:
    - Credit risk of borrowers:<sup>2</sup> The risk of IFAD being unable to make required payments to its creditors due to the inability of one or more of IFAD's borrowers to fulfil their payment obligations under loans made by IFAD. Even though IFAD is preparing for implementation of IFRS 9: Impairment Section in 2018, which will provide IFAD with credit risk information by borrower, preliminary work relating to this area can be considered as an input.
    - Liquidity risk:<sup>3</sup> The risk that due to delayed encashments or loan reflows, decrease in investment income or quicker than planned disbursements, IFAD does not have sufficient liquidity to meet its programme of loans and grants (PoLG) obligations or debt repayments. At the moment, IFAD's main policies are referenced in the Liquidity Policy and resources available for commitment reports. However, a more broad-based framework may be implemented.

<sup>2</sup> See EB 2015/114/R.17/Rev.1, paragraph 29.

<sup>3</sup> Ibid.

- Borrowing limits: The current policy for setting borrowing limits was agreed in the context of the Consultation on the Eleventh Replenishment of IFAD's Resources, and based on a percentage of total contributions; IFAD financial ratios also limit total debt amounts. These policies, as with liquidity policies, may be subject to peer reviews with other international financial institutions engaged in market borrowing programmes.
- Resources available for commitment: This document, presented to the Executive Board in 2017 (EB 2017/122/R.5), is based on the sustainable cash flow approach. ~~This policy, which is~~ The approach is heavily dependent on liquidity, and is currently used to determine the size of the lending programme at IFAD. ~~The policy~~ Related policies should be reviewed in conjunction with the prudent introduction of leverage in IFAD's balance sheet.
- IFAD's financial ratios: Adequacy of IFAD's financial ratio policies with regard to expanding its borrowing programme:
  - Debt/equity ratio
  - Debt service coverage ratio
  - Liquidity ratio
  - Other recommended ratios

## B. Asset liability management implications

9. Asset liability management (ALM) is the practice of managing financial risks that could arise due to mismatches between IFAD's borrowings and the loans it makes to its Member States and other recipients of IFAD financing. The consultancy firm will be asked to evaluate ~~and make~~ recommendations on the following ALM risks and the existing policies listed in section I pertaining to IFAD sustainability:
- Currency risk:<sup>4</sup> This could arise if IFAD's ~~country~~ loans and grants are funded by externally borrowed funds denominated in different currencies. If the currency of IFAD's loans weakens versus the currency of the borrowed funds, this could expose IFAD to the risk of being unable to repay a portion or all of its borrowed funds.
    - Example 1. IFAD takes out a loan denominated in United States dollars when the dollar/special drawing right (SDR) exchange rate is 0.714 (i.e. SDR per unit of US\$). IFAD then extends a loan in SDR units at this rate. The dollar subsequently appreciates against the other four currencies in the SDR basket and the exchange rate rises to 0.950. IFAD will continue to receive interest and principal payments based on the 0.714 rate, but will have to buy United States dollars at the higher 0.950 rate, making the loan unsustainable.
  - Term risk:<sup>5</sup> Also known as repricing risk, this is the risk of IFAD being unable to meet the required payments on its borrowed funds (principal and interest) because the amortization schedule under its loan programme has different repayment terms and maturity.
    - Example 2. IFAD enters into a 10-year debt instrument and must pay 2 per cent annually and onlends the funds for 20 years paying 2.5 per cent. Both have straight-line amortization schedules beginning after 3 years. While the interest payments will make the loan profitable, IFAD will have to make higher value amortization payments compared to the incoming funds from the onlending, implying that IFAD will have to use funds from other sources, and therefore is not self-sustainable.

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<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

- Example 3. IFAD enters into a 20-year debt instrument and must pay 2 per cent annually, and onlends the funds for 10 years paying 2.5 per cent. Again, both have straight-line amortization schedules beginning after 3 years. While both the incoming amortization and the interest payments will be higher than its outflows, after 10 years IFAD will have to onlend the funds at over 2 per cent to be able to continue servicing the loan. IFAD is therefore exposed to reinvestment risk and the loan could be unsustainable if interest rates have fallen below 2 per cent.
- Interest rate risk:<sup>6</sup> The risk of IFAD being unable to repay interest due to a mismatch between the interest rate stipulated on its borrowed funds and the interest rate applicable to IFAD's loan portfolio.
  - Example 4. IFAD enters into a debt agreement paying 2 per cent annually, and then finds it can only onlend the funds on a concessional basis, earning the annual fee of 0.75 per cent. The loan would be unsustainable and other funds would be needed for IFAD to honour its debt payments.
  - Example 5. IFAD enters into a debt agreement paying 2 per cent annually, and onlends the funds tied to a floating rate plus a spread, such as the six-month US\$ LIBOR interest rate plus 60 basis points (0.60 per cent). ~~Currently For example, if the LIBOR rate were~~ approximately 1.60 per cent, ~~the~~ interest received from onlending would total 2.20 per cent, making the loan sustainable. However, in one year's time, ~~if the LIBOR rates would have had~~ declined to 1.10 per cent, making the interest coupon received by IFAD to be 1.70 per cent, ~~this would make making the loan unsustainable. unsustainable.~~

### C. Operational risks in financial operations

10. Operational risks can result in potential losses resulting from inadequate or failed internal processes, staff issues and systems, or external events including legal risk. Risk mitigating procedures, if not well developed, can lead to IFAD incurring losses or missing debt payments. The consultancy firm will be expected to thoroughly review and provide recommendations on the following operational concerns:
- Institutional and organizational capacity: The risk that the current Financial Operations Department structure does not have the necessary resources or organizational capabilities to manage increased borrowing, lending and debt servicing functions, including an appropriate distribution of roles and responsibilities.
  - Staffing: The risk that there are insufficient human resources or that the current staff do not have all the necessary experience.
  - IT systems: The risk that current IT systems are not adequate to guarantee business continuity in financial management; monitor appropriately the financial risks mentioned in sections A and B above; and safeguard IFAD's financial assets from external threats such as cyber attacks.
  - Legal: The risk that legal agreements do not adequately protect IFAD's interests and, as a result, the institution incurs losses.

### D. Other risks

11. Two other risks faced by IFAD, which the consultancy firm will be asked to evaluate, are conflicts of interest and ethical risks.

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<sup>6</sup> Ibid.

- Conflict of interest risk: Conflicts of interest may arise ~~are inherent~~ in certain ~~most~~ financial transactions. The risk is that a potential conflict of interest can arise when the interests of IFAD are different from those of the potential lender. This could take the form of the lender dictating that its loan be directed to a specific country, ~~or project~~ or thematic area, or attempting to set the terms for the onlending.
- Ethical risks: These include financial losses such as asset theft and other fraud, regulatory violations, allegations of bribery and corruption, and reputational risk (e.g. relating to breaching environmental safeguards or accessing funds from illicit sources). Ethical risks also include unsatisfactory conduct or misconduct such as a breach of IFAD's whistle-blower protection procedures.

#### E. Expected output of the review

12. The output of the review, in the form of a final report, is expected to cover all forms of borrowing and lending products and their related terms. The report will also address ~~cover~~ the additional financial implications and incremental risks arising for IFAD's financial sustainability due to expanded borrowing activities. The report will include:
  - (i) An assessment with conclusions in each of the areas outlined in sections A through D above;
  - (ii) For each assessed area, recommendations that Management could consider to improve financial management, risk management and treasury functions, including expected costs and implications in terms of human resources.
13. It is noted that this is not an assurance engagement but rather a review of IFAD's risk management policies and procedures. The items in section II will be included in the terms of reference for the review.