

Document: EB 2018/124/R.51  
Agenda: 4(b)  
Date: 6 September 2018  
Distribution: Public  
Original: English

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## Audit Committee Statement on the Corporate Level Evaluation of IFAD's Financial Architecture

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Executive Board — 124<sup>th</sup> Session  
Rome, 11-13 September 2018

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For: Review

## Audit Committee Statement on the Corporate Level Evaluation of IFAD's Financial Architecture

1. The Audit Committee welcomes this Corporate-level Evaluation (CLE).
2. The CLE represents a valuable addition to the instruments at the Board's and Management's disposal for making better choices on how best to support IFAD's strategic mission in the years to come, in the context of the positive common consensus reached during the Consultation on the Eleventh Replenishment of IFAD's Resources (IFAD11) and the ambitious targets that the Member States have identified.
3. The CLE describes IFAD's present financial situation, identifies its strengths and weaknesses, and suggests options to enhance its financial sustainability.
4. At its 150<sup>th</sup> meeting, the Audit Committee extensively reviewed the CLE on IFAD's financial architecture, which is being presented to the September session of the Executive Board. The Committee would therefore like to share its comments and make some recommendations.
5. The Audit Committee's main function is to give reasonable assurance to the Board that risks are properly understood, properly managed and adequately mitigated.
6. The conclusions of the CLE, including its proposals, have risk implications for IFAD. The comments that follow are therefore focused primarily on the risk dimension of the evaluation.
7. First, the Audit Committee recognizes that this is a useful and well-constructed document. We would like to thank the Independent Office of Evaluation of IFAD (IOE) for its fine work, and extend our thanks also to all IFAD staff who contributed to the evaluation.
8. The CLE describes IFAD as presently "too concessional", with a structure and organization that are very much geared to a low risk environment. Moreover, the CLE notes that some aspects, such as the Debt Sustainability Framework (DSF), could place a burden on the Fund's financial sustainability and – if not addressed satisfactorily – could constrain increases in the programme of loans and grants (PoLG).
9. On the basis of a simplified cross-temporal balance sheet analysis, which is supplemented by additional considerations – all of which are supported both by data and by plausible forecasts – the CLE basically suggests the removal of DSF and grants from the balance sheet, and recommends access to the international financial markets in order to expand the portfolio of ordinary term loans through the use of borrowed financial resources. Additional borrowed financial resources would allow for a sizeable increase in lending on ordinary terms at modified prices from the present level.
10. The Committee does not comment on whether IFAD should pursue these recommendations, but reminds the Board that they would lead to a significant shift in IFAD's financial structure, with ramifications across IFAD's business model.
11. If such a configuration of the lending portfolio were achieved, it would – according to IOE's forecasts and simulations – bring in sufficient revenue to render IFAD self-sustainable in the years to come. Break-even would be achieved in 2023 according to the best possible scenario.
12. The CLE also suggests a wide range of ancillary measures and initiatives that IFAD could adopt to make the achievement of the aforementioned target a reality, and minimize various risks.

13. The Committee wishes to express its overall appreciation of the analysis conducted by IOE. There is broad agreement also on the appropriateness of the methodology used. On this latter point, comments are provided in the following sections.
14. In the opinion of the Committee, the factors that constrain the long-term sustainability of the current business model are correctly identified. The solutions suggested are logically coherent with the analysis that has been conducted and they have the potential to be useful for achieving IFAD's targets, should the Board decide to follow the recommendations and should the Membership agree that such a shift in IFAD's business and financial models is desirable.
15. More specifically, the Audit Committee would like to draw the attention of the Board to the following issues:

(a) Risks

The most important risk for the Board, at this juncture, is to accept or reject the conclusions of the CLE without being ready to accept the consequences or fully understand and support the tradeoffs of the choice.

We would like to stress that accepting the conclusions of the CLE will require further debate among the Membership (likely at the level of the capitals).

Rejection of the conclusions, on the other hand, implies, at the least, the need to engage with Management in reconsidering the strategic vision outlined during the IFAD11 Consultation, while noting that some analyses have yet to be conducted and some decision points have not yet been reached.

In making an assessment of the situation going forward, it should be absolutely clear that a residual, unmanageable risk will always remain: external variables are not under IFAD's control nor can IFAD necessarily be fully effective in mitigating all risks. Size also plays a role in this context; IFAD is not of the scale of the International Development Association (IDA); neither is it fully comparable to the other multilateral development banks, or to other funds or even to concessional windows only. Its strategic and operational risks are, to a certain extent, unique.

Members must be aware that the CLE's proposals regarding market borrowing carry several risks. Examples include but are not limited to:

- (i) The risk that demand for ordinary loans will not materialize in a size compatible with early expectations, or that other kinds of impediments may affect the desired results;
- (ii) The risk that a strong credit rating is not achieved, which could have consequences beyond the size of the PoLG and the allocation of resources;
- (iii) The risk that even if an AAA rating is achieved, prevailing financial conditions on the international markets will constitute an obstacle to the full achievement of the targeted borrowing size.

Moreover, while stepping into the international markets for funding would not imply the reconsideration of the Fund's mission (which would still be financial assistance to support rural transformation), the Board should be fully aware that market borrowing will imply the modification of IFAD's financial structure (including pricing) and business model to accommodate a larger scale of operations.

The Audit Committee looks forward to continuing these discussions in the coming months and years, consistent with the road map laid out during the IFAD11 Consultation.

(b) Focus on some areas of the Corporate Level Evaluation

We agree with the CLE that governance and guidance from the Executive Board should be strengthened, and also that the Board should reserve for itself a more decisive role.

The CLE outlines some weaknesses and areas for possible improvement in this respect. It mentions repeatedly that the diversity of expertise among Board members may be too wide, and that the opportunity exists for more extensive use of consultants by the Board and Audit Committee.

While we agree with some aspects of the assessments made, we would like to stress that we consider the wide variety of professional expertise as a factor that helps enrich – not limit – the quality of the debate between the Board and Management. Such debate, at IFAD as in many other multilateral specialized institutions, does not and must not focus exclusively on financial issues.

With regard to ways to enhance governance effectiveness, we think that the suggestion to take advantage of third-party consultants is appropriate. The Committee will soon present to the Board specific requests for the use of consultants in specific assessments that the Committee feels are much needed.

Continuing on the theme of facilitating effective governance, the Audit Committee recognizes and strongly supports the initiatives adopted so far by Management in terms of transparency. The Committee is also pleased to mention the imminent presentation of an additional instrument – the “risk dashboard” – and that of a further instrument for Board members, the “IFAD performance tracker”. Details are currently being discussed with Management.

While we concur with the CLE’s overall positive assessment with regard to Management and staff, and on the overall good quality of the reporting to governing bodies, we would have expected the CLE to touch on two other connected issues.

The first relates to the approaches used within the organization to conduct effective, ongoing monitoring of the overall technical situation of the Fund. The CLE found that some of the issues that constrict the financial viability of the organization could have been brought to the attention of the Board much earlier and possibly with more emphasis.

Second, we would have appreciated some consideration of the opportunity to improve the quality of certain disclosures and assertions by Management with regard to operational matters. The Board – which relies on Management for day-to-day operations – has in some instances not received a clear message of the urgency for the resolution of impending issues. In other instances perplexity arises about certain measures and indicators utilized, for instance those of cost-efficiency which perform relatively poorly in comparison to those of other institutions.

Last, we agree with the recommendations of the CLE regarding strengthening financial governance. The document reminds us that with greater sophistication of the financial architecture and with greater complexity of the business model comes the need not only for staff retraining but also for improving oversight, at all levels.

On this point, the Committee seeks the availability of Management for more intensive engagement, because oversight directly relates to the fundamental duties of the Committee. In particular, we believe that the audit function, which we recognize as fully compliant with international audit standards, will require strengthening (in terms of both skill mix and resourcing) to modernize

and to provide suitable assurance over and support Management's mitigation of the evolving risks IFAD faces as it moves through a period of significant change. The Committee looks to the Office of Audit and Oversight (AUO) for continuous engagement, particularly in relation to the need for alignment with organizational risks, calibration of procedures and scope of audits in the context of a different and more engaging Fund activity. In this context, the Committee would welcome the presentation of an AUO enhancement plan that includes performance and accountability indicators.

(c) Audit Committee recommendations to the Board

Now that the Board has a picture of the structural issues affecting IFAD and some of the options available on the ground, the Committee wishes to reiterate that it may be the time for Member States to engage in constructive discussions on how to proceed.

Without pre-empting any decision, it may be worth considering prioritizing analysis and discussions on adjustments to the financial, operational and oversight systems to facilitate the implementation of effective strategies – whatever the final choices - and correct suboptimal processes and procedures that the CLE has highlighted.

We think that some key aspects of the CLE proposal need deeper analysis. As the CLE itself points out, some conclusions are drawn on the basis of data and information that could be more analytically examined. We refer in particular to:

- (i) Operating expenses forecasts. These are a key input in analysing available options, which are assumed to grow in linear fashion at a rate of 2 per cent per annum. This rate may prove to be non-realistic and should be based on more accurate estimations;
- (ii) Demand for ordinary term loans at the desired yield for IFAD is one of the key variables of the suggested strategy. The Committee requests that the existence and persistence of long-term demand for loans at ordinary terms be more accurately estimated and not assumed based on circumstantial evidence. The forecasting model should consider realistic factors, and allow for the effects on the balance sheet of lags in disbursement and competition from other players. High-quality data and estimation procedures should be utilized in the construction of realistic alternative scenarios that take into consideration the obligation to keep issuing bonds on the international markets in order to maintain the acquired rating. Access to market borrowing is also a key variable in the solutions suggested in the CLE and this implies repayment of the cost of borrowing. This will only be possible if the demand for ordinary term loans is robust; at the same time the capacity to supply project proposals and to deliver them need to follow the same path. These considerations should also be part of the forecasting exercise.

Finally, we believe that the solution of removing DSF and grants from the balance sheet and making the commitment of Member States to contribute to the DSF amortization more stringent requires further, urgent discussion, in order to identify as soon as possible what range of equally valid alternative technical solutions may exist. This would allow the Board to make a well-informed choice.