
Note to Executive Board representatives

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For: Review

I. Introduction

1. Under the Consultation on the Eleventh Replenishment of IFAD’s Resources (IFAD11) and in light of the United Nations Sustainable Development Goals for 2030, Management committed to enhance IFAD’s financial capacity and architecture. This will entail preparing for IFAD's potential access to capital markets – subject to discussions under the IFAD12 Consultation and the approval of the Executive Board and Governing Council – in order to meet the increasing demand for development projects and ensure IFAD’s long-term financial efficiency. Management agreed with Member States that two key initiatives would take place for decision-making purposes:

   (a) A Corporate-level Evaluation (CLE) on IFAD’s Financial Architecture. This was performed by the Independent Office of Evaluation of IFAD (IOE) and presented to the Executive Board in 2018 (see EB 2018/124/R.7). The report indicates the areas of IFAD's financial structure that should be strengthened to achieve financial sustainability, covering a wide range of finance-related operations.

   (b) An External Independent Assessment of IFAD’s Financial Risk Management, which was performed by the consulting firm Alvarez & Marsal (A&M). The scope of the assessment (see EB 2018/123/R.23, Terms of Reference for a Comprehensive Independent Financial Risk Assessment) covered the areas of financial risk, financial governance, IT systems, organizational capacity (the organization of the Financial Operations Department [FOD]), and financial conduct and crime. Although the terms of reference were more focused on risk management, the A&M assessment covers several of the areas evaluated in the CLE, and indicated the need to review IFAD's financial structure.

2. The main findings and recommendations of the A&M assessment were initially presented at an informal seminar of the Executive Board on 8 October 2018. The final version has been shared with Members on the Member States Interactive Platform.

3. This paper outlines A&M’s main recommendations and conclusions, in parallel with the recommendations of the CLE. It sets forth IFAD Management’s appraisal of the recommendations received in both reviews and proposes an action plan that takes into consideration both sets of recommendations.

II. Main recommendations emerging from the CLE and the A&M assessment

4. Both the CLE and the A&M assessment point to the need for IFAD to consider new sources of funding in order to enhance its financial efficiency and sustainability. The A&M report recognizes this as a fundamental strategic decision for IFAD. The report has been shared with the team working on the ongoing Independent Assessment of IFAD's Operational, Programme Delivery and Strategic Risks. Some of the recommendations included in the "other risks" section of the A&M report will be addressed in-depth by this ongoing independent assessment. Once the report of the independent assessment has been finalized, its findings and recommendations and those of the A&M report will be consolidated in order to establish IFAD’s enterprise risk management in a holistic manner. The outcome of this process will be presented to the Board in April 2019.
5. Both the CLE and the A&M reports recommend that IFAD should seek to obtain an external credit rating to support greater leverage of its balance sheet and enhance its financial structure in line with the structure of peer international financial institutions (IFIs).

6. The two reports highlight the steps needed in order to put in place an improved financial risk framework, which is a fundamental prerequisite for a credit rating. The recommended enhancement of IFAD’s financial architecture extends to various areas of risk management, including operational and IT requirements, the risks presented by uncertainties around Debt Sustainability Framework (DSF) funding, and an appropriate level of support by the Member States for Management’s strategic decisions.

A. Capital management

7. A robust capital adequacy framework is currently missing in IFAD’s financial structure and is of the utmost importance. To develop a new capital adequacy framework, IFAD must establish a credit risk measurement for its loans. IFAD can consider more than one option in this regard. Among these, A&M suggest adopting Standard & Poor’s (S&P) Risk-Adjusted Capital Framework Methodology as the best short-term solution. Adopting this methodology would require IFAD to phase in lending limits per country, redefine the credit risk of its loan portfolio and consider the creation of a new lending window not driven by the performance-based allocation system (PBAS) (see A&M Financial Risk Assessment (FRA), section 5.1.3).

8. The CLE is very specific in this regard, recommending that IFAD revise the financing allocation system by creating a new window for ordinary term loans separate from the PBAS. This relates to the need for IFAD to create a new capital adequacy framework, to be able to better align the deployment of capital. IFAD needs to develop a comprehensive capital management policy, and be ready to align its sources of funding with its programme of loans and grants (PoLG) (see recommendation 3 of the CLE, executive summary [ES], para. 60).

B. Liquidity risk

9. The current approach to liquidity management is based on a cash flow model applied over a 50-year time horizon. A&M recommends moving to a short-term liquidity measure, which would allow IFAD to better manage its liquidity risk and be better aligned with other IFIs. A new liquidity risk measure over a 1 or 2 year horizon is the initial key recommendation for IFAD to restructure its liquidity risk management framework, complemented with a well-defined set of stress scenarios (A&M FRA, section 5.2.3).

10. In the CLE, IOE comments that IFAD’s liquidity policy is “conservative and prudent” (although this does not form part of a recommendation). However the CLE also mentions that, going forward, “the policy may require adjustment as IFAD continues borrowing, to take all cash-flows into account, not just disbursements” (CLE para. 244).

11. The change recommended by A&M will keep the liquidity policy conservative and prudent, but more appropriate to IFAD’s current needs. As a capital adequacy framework is established, the liquidity policy will have a secondary role in the definition of the capital available for commitment, and will assume a fundamental role in more efficient planning of short-term cash flows.

C. Currency risk

12. As IFAD’s balance sheet is exposed to significant foreign exchange (FX) risk, A&M recommends that IFAD develop the use of derivative instruments to hedge against FX fluctuations that could affect its books. Another recommendation is to reconsider the definition of functional currency to reduce profit and loss (P&L)
volatility for significant unrealized currency losses/gains. This change – which will have an accounting rather than an economic impact – would result in more stable P&L figures and better P&L projections. Moreover, it is suggested that hedge accounting also be used to minimize P&L volatility, an option that needs to be further investigated (A&M FRM, section 5.3.3).

13. The CLE contains a clear recommendation to encourage the use of derivatives to better manage foreign exchange risk and discusses the impact of significant currency losses throughout the report. This is fully in line with A&M’s recommendations to increase derivative use for hedging purposes and try to reduce volatility of the reported P&L (CLE, ES para. 37).

D. Credit risk

14. IFAD’s lending activities, both concessional and ordinary lending, expose the organization to significant credit risk. A&M suggests that IFAD follow best practices implemented by peer IFIs such as the International Development Association (IDA) and the European Bank for Reconstruction and Development (EBRD) by establishing a new credit risk framework. A&M recommends monitoring borrower exposure and concentration across the loan and investment portfolios, so as to increase transparency and demonstrate a strong internal control framework. This would also avoid excessive country or regional risk concentration and ensure a strong risk and compliance function to oversee treasury activities.

15. Furthermore, should IFAD decide to access capital markets, the A&M report recommended establishing an allocation mechanism for ordinary loans (A&M FRA, section 5.4.3).

16. The CLE does not contain a specific recommendation on credit risk, even though it is addressed in several sections of the report, predominantly in connection with the Treasury Services Division (TRE) investment portfolio. As the A&M report points out, it is of great importance for IFAD to look at the credit risk embedded in its loan portfolio as well as its investment portfolio (CLE, ES para. 36).

E. Debt Sustainability Framework

17. The A&M report recognizes the threat that DSF poses for IFAD’s sustainability and acknowledges that this issue is currently being examined. IFAD must prevent capital erosion by DSF grants and define a future sustainable solution before approaching a credit rating agency. A&M however provides no advice on how to proceed in this regard (A&M FRA, section 4.2.1).

18. The CLE extensively examines this issue and the risks associated with the DSF. The current set up has been shown to lead to systematic financial losses and harm IFAD’s sustainability. In particular, the CLE points out that the DSF and the related capital erosion create additional uncertainty that could negatively impact IFAD’s credit rating and potential access to capital markets. The CLE proposes specific solutions to the problem, including holding DSF funds in separate accounts; making DSF compensation legally binding; or changing the arrangements for future loans (CLE, ES paras. 43-46).

F. Governance

19. To better align IFAD with the best practices of other IFIs, the A&M report advises that the Investment and Finance Advisory Committee (FISCO) be repurposed and renamed as the Asset and Liability Management Committee (ALCo) with an expanded scope covering policymaking, monitoring and oversight of all financial risks, excluding credit risk. A&M provides guidance on the role of such a committee in peer institutions such as IDA, the International Bank for Reconstruction and Development (IBRD), EBRD and the African Development Bank, and describes the high-level scope of responsibility that the committee would assume. The ALCo would be mainly responsible for the prudential management of the balance sheet,
but would still bear all the responsibilities currently covered by FISCO. Additionally A&M recommends a review of the Audit Committee composition, membership and required expertise (A&M FRA, section 6.1.2).

20. The CLE recognizes the need to strengthen IFAD's financial governance and to create an asset and liability management committee. It followed a similar approach to A&M in assessing the governance structure, and noted that IFAD had a different set up from most of its peers. The evaluation also recommended that Audit Committee members have at least basic qualifications in terms of financial background (CLE para. 230).

G. IT infrastructure

21. A&M concludes that while the IT financial systems used by the Treasury Services Division (TRE) and FOD seem to be appropriate for the current level of TRE operations, these systems might not be sufficient to meet additional requirements such as a change in risk measures, increased product complexity and larger volumes. In this event, A&M recommends that the IT systems currently in place for TRE should be better integrated within IFAD's wider IT infrastructure, and that the TRE database be replaced by a robust standard system. This would eliminate the significant risks related to dependency on key staff in the current landscape. IFAD's data warehouse should be used to provide timely and accurate data analytics in support of the treasury and controllership functions and models. A new treasury management system may be considered, although the associated investment costs may be relevant (A&M FRA, section 7.1.4).

22. The CLE makes no specific recommendations in this area. The evaluation concluded that IFAD had an adequate IT system for the current operating environment and that IFAD's IT security architecture was robust. However, the CLE stressed the potential future necessity to improve the IT infrastructure should IFAD decide to expand its balance sheet and use derivatives more actively (CLE, para. 233).

H. Financial Operations Department organization

23. A&M recommends an increase in staffing to reflect the growing requirements of FOD. In particular, it recommends hiring an experienced asset and liability management (ALM) manager to manage liquidity, interest rate and FX risk, and a head of a treasury risk unit to provide oversight of TRE and of overall credit risk assessment (A&M FRA, section 7.2.3).

24. There were no recommendations in this area in the CLE.

I. Financial crime risk

25. A&M outlines a set of recommendations related to financial crime. These include undertaking a holistic review of non-prudential risks and setting an appropriate risk tolerance level; introducing sanction checks prior to transactions being approved; and reviewing IFAD's conflict of interest policy (A&M FRA, section 8.1.3).

26. There were no recommendations in this area in the CLE.
III. Management position and action plan

27. IFAD Management welcomes all the recommendations outlined in the two independent reports prepared by A&M and by IOE. It is to be noted that a Management response has already been provided for the CLE (see EB 2018/124/R/Add.1)

28. Management recognizes the importance of the changes suggested in the reports: they have sparked several discussions at both the Management and the stakeholder level as to the most appropriate steps to be taken as follow-up.

29. It is important to note that even though both reviews envisage the possibility of accessing new sources of funding – including the capital markets – and leveraging IFAD's capital, all the recommendations taken on board by Management have the aim of strengthening and ameliorating IFAD's financial structure.

30. The following paragraphs list the 10 most urgent initiatives that Management believes should be implemented over the coming 12 to 24 months.

(1) Measures to strengthen capital management

31. Management has already started work on introducing a more rigorous approach to capital management at IFAD in order to be able to adequately measure levels of capital usage and allocation. Starting in the first quarter of 2019, TRE and the risk management function will work on further expanding the capability of IFAD's financial model. This will include adding functionality aimed at projecting balance sheet levels, capital absorption and risk-adjusted capital levels. A capital adequacy framework will be developed, taking into account all the parameters needed to perform supporting analyses, such as probability of default, loss given default, and correlation.

(2) Measures to strengthen liquidity risk management

32. Management is working on the definition of a new Liquidity Policy that will update the current policy (see EB 2006/89/R.40), which is focused on long-term cash flow planning. As suggested in both reports, the new policy will be more focused on short-term liquidity planning under stress scenarios to improve operational efficiency. The new policy document will be submitted to the Executive Board in 2019.

(3) Measures to strengthen credit risk management

33. Management has already started focusing on debt issues generically and credit risk specifically:

- An informal seminar of the Executive Board was held in July 2018 on debt trends.

- The revised PBAS methodology includes in the rural sector performance scores an element relating to the debt status of a country.

- The implementation arrangements for the DSF – which feed into the determination of country financing terms – already foresee that technical economic country analyses should be performed. Such analyses will be refined as IFAD develops its internal capacities and increasingly monitors experiences and trends globally, and at the IFI and country level.

- Each new country strategic opportunities programme and project concept note already contain a light debt assessment; these will be strengthened in the near future.

Several credit risk metrics have been computed with the assistance of a reputable external vendor to assess the expected credit losses of the loan portfolio and new guidelines will be in place to monitor the evolution of the credit risk at IFAD.

Starting in 2019, the risk management function will further enhance the credit assessment of both the loan and the investment portfolios. The monitoring and reporting systems will also be improved through the implementation of the credit risk framework and exposure management measures. In particular, as part of the country credit risk framework, Management will reinforce the assessment of key economic conditions of borrowing countries, notably with respect to debt sustainability issues.

It is anticipated that a non-concessional borrowing policy will be in place from 2019, which is a pillar of credit risk management and a cornerstone for the consideration of additional financing outside the current PBAS framework.

(4) **Measures to improve currency risk management**
34. Management has been working on the introduction of derivatives. IFAD’s first International Swaps and Derivatives Association (ISDA)\(^1\) documentation was signed in 2017. The first interest rate swaps have been executed and it is foreseen that the volume of derivative trades will increase to address current risks and mismatches, also in the form of additional products, such as cross currency swaps. For 2019, it is envisaged that TRE and the Office of the General Counsel will continue working on finalizing between four and six additional ISDA documents in order to expand and diversify the pool of available derivative counterparts.

(5) **Measures to improve governance**
35. In 2019, Management will create a new finance and risk management committee to oversee IFAD’s financial risks. The new committee may take on the role currently played by FISCO and may introduce appropriate levels of delegation from the President (who currently chairs FISCO) to the Chief Financial Officer.

(6) **Measures to address Debt Sustainability Framework issues**
36. Management has prepared a paper containing possible solutions to DSF issues to be examined by the Audit Committee and by the Executive Board at its session in December 2018. A working group is currently considering multiple options as possible solutions. These will be included in the paper presented to the Audit Committee and Executive Board. Among the possible solutions, the working group is considering the creation of a legally binding compensation instrument, the establishment of ex ante DSF compensation, accelerated compensation or discontinuation of DSF financing from IFAD12 onwards.

(7) **Measures to improve the IT infrastructure**
37. In 2019, Management will make significant capital investments to improve and strengthen the IT infrastructure serving the risk management function and TRE and to integrate it within the wider IFAD IT landscape. In particular, two areas will be targeted:

(a) An expansion of the electronic platforms to support execution and portfolio analytics related to derivatives and ALM;

(b) A further re-engineering of the IFAD financial model, building on the one implemented in late 2016, to support more sophisticated analysis and scenario stress-testing related to credit rating and credit risk management.

(8) **Measures to prepare for the credit rating exercise**
38. As envisioned in the IFAD11 commitments, Management will engage with the credit rating agencies during the third quarter of 2019 in order to start the credit rating

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\(^1\) Contractual documentation to allow two counterparts to negotiate derivative contracts according to predetermined legal clauses.
process. Management will hold an informal seminar during 2019 to clarify the timing and steps of the process.

(9) Measures to improve organization of FOD

39. In the remainder of 2018 and in 2019, Management will continue to strengthen the newly created risk management function. Currently reporting to the Chief Financial Officer, this unit grew in capacity from one consultant to two staff members in 2018. For 2019, additional staff are envisaged pending budget considerations. The new team will develop IFAD's policies in the areas of sovereign risk, balance sheet management, capital adequacy and asset and liability management, working closely with TRE. With regard to TRE, additional staffing may be needed for asset and liability management and derivative execution. The strengthening of these functions in FOD will allow for better alignment of responsibilities across the department, ensuring that the proper checks and balances are in place regarding policy establishment, execution of functions, and controls.

(10) Measures to address financial crime risks

40. Although A&M notes that action in this area is still subject to the outcome of the ongoing Independent Assessment of IFAD’s Operational, Programme Delivery and Strategic Risks, the Executive Management Committee has tasked an interdepartmental task force to enhance IFAD’s management of compliance risks, including those deriving from the exposure of third parties to potential money-laundering, terrorism financing and tax evasion activities, adverse political environments or unethical behaviour (including corruption) and conflict of interest. The task force is defining an IFAD institutional policy position on compliance risks, inclusive of criteria for risk appetite and adequate assignment of responsibilities, taking into consideration the outcome of the two external risk reviews. The action taken by the task force, together with the revision of the IFAD anticorruption policy (presented to the Executive Board for approval in December 2018) is expected to address the A&M findings and recommendations on financial crime and fraud risks.

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<thead>
<tr>
<th>Area</th>
<th>A&amp;M Financial Risk Assessment (FRA) recommendations</th>
<th>CLE recommendations</th>
<th>Management appraisal</th>
<th>Expected date of implementation</th>
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</table>
| Capital management          | • Develop a capital policy to allow for capital planning and profit and loss (P&L) projection  
                                  • Establish a capital adequacy framework  
                                  See FRA section 5.1.3 | • Revise financial allocation system and introduce a two-window system  
                                  See CLE, executive summary (ES) para.60 | • Management supports the recommendations made  
                                  • It will be relatively easier to implement the Standard and Poor (S&P) approach to capital adequacy than a full capital adequacy model, and this would still guarantee that IFAD is seen as having a strong risk management approach  
                                  • Management will consider the creation of single country lending limits and a new lending window outside the performance-based allocation system (PBAS) in consultation with all stakeholders  
                                  • The PBAS formula was approved for IFAD11 and Management agrees to its revision for IFAD12  
                                  • It is advised that IFAD support this recommendation | Q2 2020 |
| Liquidity risk              | • New liquidity measure should focus on 1- or 2-year period  
                                  FRA section 5.2.3 | • No specific recommendation  
                                  • Liquidity Policy may need adjustments in the future  
                                  CLE para. 244 | • Management supports the recommendations made  
                                  • Financial Operations Department (FOD) is already working to change the current minimum liquidity requirement (MLR)  
                                  • This work will have repercussions for the way in which the resources available for commitment are calculated | Q4 2019 |
| Currency risk               | • Increase use of derivatives for hedging of foreign exchange (FX)  
                                  • Consider change of functional currencies  
                                  FRA section 5.3.3 | • Encourage use of derivatives to manage FX risk  
                                  CLE, ES para. 37 | • Management supports the recommendations relating to the use of derivatives (FOD is already taking action in this respect)  
                                  • Regarding the recommendation to change the definition of functional currency to reduce volatility in the P&L, IFAD will explore the feasibility of this option  
                                  • The recommendation to minimize P&L volatility can also be supported, however more work is needed to investigate if hedge accounting is the preferable solution for IFAD | Q2 2020 |
| Credit risk                 | • Country exposure limits and guidelines  
                                  • Monitor borrower exposure and concentration across the loans  
                                  FRA section 5.4.3 | • No specific recommendation  
                                  • Address credit risk with respect to Treasury Services Division (TRE) investment portfolio and lower the investment risk profile  
                                  CLE, ES para. 36 | • Management supports the recommendations made  
                                  • The likely implications of the suggested approach on IFAD’s lending in terms of single country and regional exposure will be considered in consultation with all stakeholders (as is the case for the capital management recommendation)  
                                  • With respect to IFAD’s investment portfolio, Management is working on the reduction of its credit risk exposure | Q4 2019 |
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| Debt Sustainability Framework (DSF) | • DSF threatens sustainability and leads to capital erosion  
• A solution needs to be defined before approaching credit risk agencies  
FRA section para. 4.2.1 | • Current framework could negatively impact IFAD's credit rating  
• Hold DSF funds in separate accounts, make DSF compensations legally binding, or change the loan arrangement  
CLE, ES paras. 43-46 | • A dedicated IFAD working group will present a paper on possible solutions to the 125th session of the Executive Board for review in December and to the 126th session in April 2019 for approval  
• Management intends to discuss the following options with stakeholders:  
  – The creation of a legally binding instrument  
  – Ex ante DSF compensation  
  – Accelerated compensation or discontinuation of DSF financing from IFAD12 onwards | Q3 2019 |
| Governance | • Repurpose and rename Investment and Finance Advisory Committee (FISCO) as an Asset and Liability Management Committee (ALCo)  
FRA section para. 6.1.2 | • Strengthen financial governance and create an asset and liability management committee  
• Align IFAD with governance practices of other international financial institutions (IFIs)  
CLE para. 230 | • Management supports the recommendations. It is considering discontinuing the current FISCO and establishing an overarching risk and finance committee bringing credit risk also under the responsibility of the newly created committee, in addition to the responsibilities of a traditional ALCo | Q2 2019 |
| IT Infrastructure | • Better integration of TRE IT systems into wider IFAD IT landscape  
• Decommission the TRE database and replace with robust standard treasury solution  
• Leverage existing data warehouse  
• Eliminate manual process  
FRA section para. 7.1.4 | • IT system is adequate for the current operating environment  
CLE par. 233 | • Management supports the recommendations. A stronger IT financial platform is necessary to achieve a good credit rating  
• Management will be considering the most efficient modalities in terms of alternatives between building on the existing infrastructure or considering new tailor-made solutions. Globally, given budgetary constraints, Management plans to implement this over two years | Q4 2020 |
| FOD organization | • Increase staffing to reflect additional requirements  
FRA section 7.2.3 | • No specific recommendation | • Management supports the recommendations made and is examining them from a positive but critical perspective. Prima facie, Management intends to implement all these recommendations in 2019 and 2020, while looking at other possible efficiency gains within FOD. Transitional measures include possible secondments /staff exchanges with other IFIs and/or Member States | Q2 2019 |
| Financial crime risk | • Undertake a holistic review of non-prudential risks  
• Set an appropriate risk tolerance level  
• Introduce sanction checks  
FRA section 8.1.3 | • No specific recommendation | • Management supports the recommendations  
• An interdepartmental task force to enhance IFAD’s management of compliance risks was created to tackle exposure of third parties to potential money-laundering, terrorism financing and tax evasion activities, adverse political environments or unethical behaviour (including corruption) and conflict of interest | Q1 2019 |
### Main governance and institutional milestones for IFAD’s financial strategy (GC 41/L.3/Rev.1)

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<th>Milestone</th>
<th>2018</th>
<th>2019</th>
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<td>Capital management</td>
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<td>Liquidity risk</td>
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<td>Currency risk</td>
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<td>Review governance structure</td>
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<td>Revision of DSF mechanism</td>
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<td>IT systems upgrade</td>
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<td>Improve FOD organization</td>
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<td>Financial crime risk</td>
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<td>Credit rating evaluation (6-9 months)</td>
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<td>Proposed changes to the Agreement Establishing IFAD</td>
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<td>Decision of the Executive Board and Governing Council on IFAD’s market</td>
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<td>borrowing activities</td>
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<td>IFAD12 Consultation</td>
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