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Report of the Chairperson on the 154th Meeting of the Audit Committee

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Executive Board — 127th Session
Rome, 10-12 September 2019

For: Review

Report of the Chairperson on the 154th Meeting of the Audit Committee

Executive summary

1. The Audit Committee discussed a large number of documents, most of which would be presented for review or approval at the 127th session of the Executive Board.
2. With regard to the following items:

Progress report on the workplan of the Office of Audit and Oversight for 2019
3. The Committee reviewed the midyear progress of the Office of Audit and Oversight (AUO) in implementing its workplan for 2019 and noted that most of the planned activities had been completed or were in progress. During the first semester, advisory input had been provided on the ongoing reforms and policy changes. AUO indicated that salient elements of such advisory work could be summarized in an audit report if deemed useful. The number of allegations and investigations had increased in the first half of 2019. This could be indicative of an increased awareness of IFAD's anticorruption policy. However, some members pointed out that fraud and corruption risk in IFAD operations remained high. Members encouraged AUO to carefully analyse available information in order to enhance mitigation of such risks. In responding to questions about its capacity and skills, AUO indicated that external experts were recruited for technical work and that increased emphasis was being given during the hiring process to data analysis skills and experience. The Committee considered the progress report reviewed.

High-level preview of IFAD's 2020 results-based programme of work and regular and capital budgets, and the preview of the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2020 and indicative plan for 2021-2022 (for review)
4. The Committee reviewed the budget preview. The budget proposal was currently set at US\$160.57 million, representing zero real growth and a nominal increase of 1.49 per cent over the 2019 budget. The capital budget proposal was estimated in the range of US\$2.0 million to US\$2.5 million in line with previous years. The target programme of loan and grants for delivery was set at US\$1.36 billion. The IOE budget proposal for 2020 was approximately US\$6.15 million.
5. A wide-ranging discussion touched upon the need to consolidate the many recent initiatives to revise processes and policies. Members noted that there was still ground to cover and that the 2020 budget would be functional to this end. Greater clarity on cost drivers was expected in the final document. Members flagged the need to discuss in depth the rationale for one-off budget requests.

Internal Control Framework (for review)
6. Members welcomed the document noting that it formed part IFAD's integrated accountability, risk and control approach. It was also noted that the framework was based on leading industry practice and established a key pillar of the second line of defence risk governance model at IFAD. The Committee further welcomed the implementation guidance document (presented for information), which set out IFAD's key control standards, implementation phases and timeline. The governance structure of the ICF and the implementation aspects were discussed at length, in order to receive assurances from Management on their being fit for purpose in the context of IFAD's evolving risk management architecture.

Capital Adequacy Framework (for review)
7. Members welcomed the document noting that the establishment of a capital adequacy framework was the natural response to the advancement of the institutional profile needed to maximize IFAD's developmental operations and

impact, which entailed a transformation of IFAD's financial architecture. The approach was aligned with best industry standards. The framework would enable the Fund to better forecast capital needs, measure the incidence of risk in the Fund's endowment, and allow for enhanced and more efficient resource allocation.

Update on Debt Sustainability Framework reform (for review)

8. Members reviewed the document and noted the progress made on the reform of the Debt Sustainability Framework (DSF). They expressed their support for the current approach and appreciation for a DSF reform that avoids the establishment of legally binding instruments and the creation of special trust funds.
9. The proposal would consist in the following flexible measures:
 - (a) Recognition of a required minimum replenishment target, covering at least the agreed level of grant financing (past and future DSF, regular grant programme, general operating costs and, eventually, contributions to medium- and long-term capital sustainability) which would avoid erosion of IFAD's capital over time.
 - (b) Establishment of a dynamic pre-funded mechanism to ensure that new DSF approvals were linked with Member States' upfront commitments on a replenishment-by-replenishment basis.
 - (c) Introduction of granularity for the countries eligible for DSF, tailored to concessionality levels.
 - (d) Allocation of IFAD's scarce DSF grant resources to support especially countries in high debt distress and the poorest and most vulnerable countries.
 - (e) Introduction of new lending terms with a higher concessionality level known as a super highly concessional loan.

Report of the Chairperson on the 154th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 154th meeting of the Committee held on 3 September 2019.

Adoption of the agenda

2. The agenda was adopted with a request by a Committee member to include under other business a conversation on the IFAD Private Sector Engagement Strategy 2019-2024. However, this topic was subsequently discussed bilaterally by the member and Management and the request was withdrawn.

Minutes of the 153rd meeting of the Audit Committee

3. The minutes were approved with no changes.

Progress report on the workplan of the Office of Audit and Oversight for 2019 (for review)

4. The Committee was provided with a summary of the activities of the Office of Audit and Oversight (AUO) for the first six months of 2019. The Committee was informed that most of the planned activities had been completed or were in progress. The remaining three actions would start in the coming three months. The first semester of 2019 registered a significant improvement in the average time overdue for agreed Management actions, although there had been some increase in the number of actions pending implementation. During the first semester, AUO provided advisory input for the ongoing reforms and policy changes. Changes made to the 2019 workplan included the addition of an audit on the Benin country programme in replacement of the planned audit on fraud risks associated with IFAD cash flow and assets, which was postponed to early 2020. The recruitment process for three AUO positions was near completion. The number of allegations and investigations continued to be high in the first half of 2019, indicating increased awareness of IFAD's anticorruption policy.
5. Members noted the trends of increasing allegations and investigations, as well as the vast number of issues related to project procurement. As pointed out by members, this could indicate increased awareness of IFAD's anticorruption policy but could also be indicative that fraud and corruption risk in IFAD operations remained high. Members encouraged AUO to carefully analyse available information with sophisticated techniques to better understand these trends and consequently undertake initiatives to enhance mitigation of such risks. Some Committee members requested clarification about the motivation for the changes to the 2019 workplan, the IT audit and AUO's capacity for IT-related work. Members also wished to know how AUO planned to provide assurances on the new hub arrangements; to what extent the work on certification by the Government of Italy of the expenditures for IFAD headquarters also covered negotiations with the lessor of the headquarters building. The Committee also enquired if – or how – AUO advisory feedback on enterprise risk management (ERM) or other key corporate activities would be shared with the Executive Board.
6. AUO provided feedback on the issues raised. It clarified that the changes to the 2019 workplan were triggered by risk concerns linked to microfinance projects. AUO noted that the implementation of the Internal Control Framework would further support the prevention of fraud. It also highlighted the extensive advisory role it had played during 2019 in particular vis-à-vis the ERM-related actions. The Committee was informed that the Independent Office of Evaluation of IFAD (IOE) was within AUO's mandate for internal auditing. Finally, AUO indicated that emphasis was being given to data analytical skills and experience in recent recruitment processes and that other training efforts were under way to develop the skills set of the audit team.

7. The Committee considered the progress report reviewed.
Proposal by the Audit Committee to obtain outside expert advice (for approval)
8. Management provided an update on the selection process for a consultancy firm to provide non-binding expert advice to assist the Committee in discharging its duties. The Committee's request to initiate the procurement process through a negotiated procedure was noted, as was the request to invite the two vendors that have recently worked with the Fund on the topic of risk management – Alvarez & Marsal and Marsh Risk Consulting – to participate in the tender.
9. The terms of reference were approved with no changes. Members were invited to volunteer as observers during the procurement process.
Draft provisional agenda for the 155th meeting of the Audit Committee (for review)
10. The draft provisional agenda for the 155th Committee meeting was reviewed. The Committee requested the inclusion of a closed session to discuss AUO reports on consultancies.
IFAD's interest rates for the third quarter of 2019 (for review)
11. Management presented the document highlighting the interest rates applicable to the third quarter of 2019.
12. The Audit Committee reviewed the document noting the increased quality of the information provided.
13. Some members flagged the need to evaluate the adequacy of the current system of determining IFAD's reference rates, taking into account reasonable forward-looking scenarios and the possible evolution of external variables and internal operational factors.
Standard financial reports presented to the Executive Board (for review)
 - Report on IFAD's Investment Portfolio for the second quarter 2019
14. Management presented the above-referenced document, which contained information as at end-June 2019. The further decrease in the risk profile of the investment portfolio was noted.
High-level preview of IFAD's 2020 results-based programme of work and regular and capital budgets, and the preview of the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2020 and indicative plan for 2021-2022 (for review)
15. Management presented the budget proposal noting that it incorporated numbers and assumptions of the main costing elements of the 2020 IFAD programme of work. The final budget proposal would present more details and analyses than the high-level preview to facilitate the Board's deliberations. The document also presented the preview of IOE's results-based work programme and budget for 2020 and indicative plan for 2021-2022. It was noted that 2019 was an important year for consolidating reforms to reinforce delivery and efficiency, while 2020 would be a year to operationalize lessons learned with the key objective of pursuing the implementation of an effective and efficient business model. In 2020, IFAD aimed to achieve the optimum balance between containing costs and higher delivery, without compromising on quality, which remained pivotal to maximizing impact and catalysing investments. Therefore, the primary objectives would be to: (i) enhance quality of the project portfolio; (ii) increase engagement with stakeholders for the Twelfth Replenishment of IFAD's Resources (IFAD12); (iii) finalize the build-up of a strong financial architecture, thus ensuring a strong credit rating; (iv) enhance the internal control framework in order to achieve better risk detection and mitigate risk deriving from an evolving operational context; and (iv) improve, and possibly

- optimize, IFAD's human capital endowment in order to more efficiently pursue critical goals.
16. For 2020, the programme of loans and grants (PoLG) would be planned at US\$1.36 billion. It was noted that the IFAD11 PoLG was expected to reach or exceed US\$3.5 billion.
 17. The major cost drivers for the 2020 budget preview were identified in: (i) the planned deferred positions that formed part of the 40 full-time equivalent (FTE) reduction for the 2019 budget, partially offset by additional reductions resulting from the fit-for-purpose exercise conducted in 2019; (ii) minor adjustments to staffing complements at hubs for operational capacity enhancement; (iii) increased engagement with governing bodies as part of IFAD12 preparation; (iv) depreciation and other recurrent expenses related to capital budgets; (v) other potential real increases and price increases.
 18. The proposed 2020 budget would be as follows:
 - (i) Regular budget: The 2020 regular budget has been proposed at US\$160.57 million representing zero real growth and a nominal increase of 1.49 per cent over 2019;
 - (ii) Capital budget: The total capital budget for 2020 is expected to be in line with prior years in the range of US\$2.0 million to US\$2.5 million. It was noted that additional capital funds could be required to address treasury and risk management and to upgrade human resources systems.
 19. To deliver on this ambitious agenda, IFAD highlighted the need to invest further in critical measures to ensure it has the adequate human capital, skills mix and technology to respond to its current and future challenges. This could require the intervention of a timely upfront and one-time targeted investment boost to address the recommendations of the ongoing comprehensive HR study.
 20. IOE introduced its work programme and the 2020 budget, highlighting that it would complete the corporate-level evaluation on IFAD's support to innovation and productivity growth for inclusive smallholder agriculture. It was noted that in 2020 IOE would conduct a joint evaluation with the Food and Agriculture Organization of the United Nations and the World Food Programme on Rome-based agency collaboration. To embed recommendations arising from the recent external peer review, IOE would introduce, from 2020, thematic evaluations. In particular, a thematic evaluation on IFAD's contribution to smallholder adaptation to climate change was proposed. IOE would also conduct new country strategy and programme evaluations and prepare one evaluation synthesis report. The proposed IOE budget for 2020 would be US\$6.15 million, including a figure of US\$150,000 for the recruitment of the new IOE Director. By excluding this item, the 2020 IOE budget would be US\$5.95 million, representing a 0.5 per cent nominal decrease against the 2019 approved budget. The proposed IOE budget would be therefore 0.43 per cent of IFAD's expected PoLG for next year, and therefore below the IOE budget cap of 0.9 per cent adopted by the Executive Board.
 21. The Committee reviewed the document and extensively debated its main aspects. Members requested several clarifications, in particular about budget prioritization criteria; the inflation rate quantification; the need for enhanced transparency on the allocation of the 3 per cent carry-forward; and the priorities set for the allocation of capital budget. Members requested that the final document contain detailed information on the cost drivers of the budget one-time boost request and requested that the HR evaluation, including the skills assessment exercise be discussed extensively with the Executive Board. Some Committee members requested details on savings derived from the Operational Excellence for Results (OpEx) exercise.

22. Management provided feedback, highlighting that the inflation rate used for the 2020 budget was derived from an average of indices in different geographical areas and that it had been calculated with standard methodology. Management provided details about IFAD's strategic prioritization process and noted that a higher carry-forward budget was an incentive for increased cost-consciousness towards the end of the fiscal year. It was also highlighted that the carry-forward of the 2018 budget had been used to finance the innovation challenge programme and address some unplanned activities arising from the global staff survey and the staff exchange programme. More information would be provided in the final document. Management informed the Committee that the institution had commenced a comprehensive human resources study that included an analysis of compensation aspects of IFAD's employee value proposition to attract new talent. The Committee was assured that the results of the human resources study would soon be shared with Executive Board representatives. The Committee was also informed of Management's intention to produce a final report on the OpEx exercise, inclusive of information on the savings generated by the Voluntary Separation Programme and backfilling budget provisions.
23. The document would be submitted for the review of the Executive Board.
Internal Control Framework (for review)
24. Management presented the updated Internal Control Framework (ICF) and its associated implementation guidance document, noting that it formed part of IFAD's integrated accountability, risk and control approach. It was noted that the ICF had been prepared in line with leading industry practice and based on the model and principles of the Committee of Sponsoring Organizations of the Treadway Commission (COSO).
25. Management noted that the ICF set out the core control standards, oversight and monitoring tools, and roles and responsibilities for internal controls across IFAD. It was also highlighted that the associated implementation guidance document, which encompassed a phased-in implementation approach for each component of the ICF, such as governance, risk taxonomy/appetite, risk assessment, response and monitoring tools, communication/culture, reporting and technology/systems.
26. The Committee expressed their appreciation for the document and asked about the status of key pillars in the implementation approach, and the timing and interaction of the first and second lines of defence. Details were requested on the proposed governance structure of the risk management function and on resources and technology tools. Some members recognized that the configuration of the risk management function, as proposed, was aligned with best practice but noted that its functionality with respect to IFAD's needs must be reassessed in view of the opinion – if any – expressed by rating agencies and/or by the results achieved in the area of effective risk mitigation.
27. Management responded to all questions and gave a summary of the status of each key pillar in the implementation approach. It was noted that it is essential for IFAD to have optimal controls and new monitoring mechanisms, particularly in light of decentralization and increased materiality of field transactions. Regarding governance of the ICF and the control function, a dedicated risk committee would be established to ensure regular reporting. This committee would escalate operational risk information to Senior Management or the Enterprise Risk Management Committee as necessary. Operational risk appetite, as set in the risk appetite statement (currently under development) and monitored by the second line of defence, would be reported via the corporate risk dashboard to governing bodies. Regarding technology/systems management, a repository of incidents/losses/near misses was being developed and piloted. Other system tools, dashboards and reporting protocols via a Controller's scorecard would be phased in per the implementation timeline. Regarding communications and training, it was

noted that the Financial Operations Department/Accounting and Controller's Division had engaged the Chartered Institute of Public Finance and Accountancy to develop a comprehensive risk and controls training programme to cover a wide range of staff from first-line/field staff to Senior Management. The programme would be delivered in seven sessions from January to June 2020 in order to enhance risk and control culture.

28. The document would be submitted to the Executive Board for approval.
Capital Adequacy Framework (for review)
29. Management introduced the agenda item noting that the establishment of the Capital Adequacy Framework would be the natural response to the advancement of the institutional profile needed to maximize IFAD's developmental operations and impact, which entailed a transformation of IFAD's financial architecture. This approach was aligned with best industry standards and comprised a quantification of risks aimed at ensuring solvency when ascertaining resource availability. The purpose of this framework was to establish principles to determine the amount of capital required to maintain the institution's equity position and to optimize the use of donors' core contributions, thereby ensuring the continuity of IFAD's developmental operations, even in times of stress. Management also noted that IFAD would move from a purely liquidity management approach to a more integrated strategy. The adoption of a Capital Adequacy Policy was key to supporting current strategic discussions with respect to IFAD's risk appetite statement, its PoLG growth and the introduction of new financial operations and instruments while ensuring sustainability and prudence.
30. Members reviewed the document and welcomed the framework, noting the alignment with best practice. They requested clarification on the linkages to the performance-based allocation system (PBAS); certain limits contained in the document; stress-testing and the generation of possible equity buffers. While fully recognizing the validity of the framework, some Committee members highlighted the need for continued vigilance with respect to some important features of the framework – namely the methodology for quantifying capital charges and the preferred creditor treatment for calculation of said charges – simply because these were key elements of the capital structure of an international financial institution (IFI) with IFAD's specific characteristics.
31. Management clarified that the allocation of IFAD's resources would continue to be driven by the PBAS. It was also noted that this approach is a key element of IFAD 2.0, therefore a minimum replenishment target would be set up to cover past and future DSF and operational costs and the remainder would be deployed for new PoLG investments. On the basis of this approach a new definition of the liquidity policy would be developed. Management also highlighted that the methodology embedded a feature to preserve the preferred creditor status and therefore was essential for the credit rating assessment. Management provided some details on stress-testing, clarifying that this would be comprehensive of countercyclical events.
32. The document would be submitted to the Executive Board for review.
Enterprise Risk Management (ERM) (for review)
 - (a) Update on ERM progress and roadmap/sequencing plan
 - (b) IFAD's risk dashboard – status report
33. Having reviewed the requirements for developing a robust, internationally sound ERM Framework and the work that other IFIs and comparable United Nations agencies have undertaken, Management decided to engage, as of October, expert consulting support for the technical work to implement the needed actions.

34. As the ERM enhancement moves forward, the corporate risk dashboard will be aligned with the risk appetite statement (also under revision) and support Management and the governing bodies in their responsibilities to monitor and manage risk effectively.
35. Management would share details on progress made with the Audit Committee in November and would also present the ERM work sequence plan.
36. The Audit Committee supported Management's decision and noted the feedback provided on both agenda items.

Update on Debt Sustainability Framework reform (for review)

37. Management introduced the agenda item noting the pivotal relevance of this topic for the future development and sustainability of IFAD's business model. The proposal was a set of combined flexible measures to continue supporting countries in debt distress and ensure financial sustainability. The goal of this reform was to create a more predictable link between Member State support for poor indebted countries and IFAD's ability to provide financing to these countries in a sustainable manner. It was noted that the proposal contained the following elements:
 - (a) Recognition of a required minimum replenishment target, covering at least the agreed level of grant financing (past and future Debt Sustainability Framework [DSF], the regular grant programme, general operating costs and, eventually, contributions to medium- and long-term capital sustainability) which would avoid erosion of IFAD's capital over time.
 - (b) Establishment of a dynamic pre-funded mechanism, which would ensure that new DSF approvals were linked with Member States' upfront commitments on a replenishment-by-replenishment basis.
 - (c) Introduction of granularity for the countries eligible for DSF, tailored to concessionality levels.
 - (d) Allocation of IFAD's scarce DSF grant resources to support especially countries in high debt distress and the poorest and most vulnerable countries.
 - (e) Introduction of new lending terms with a higher concessionality level known as a super highly concessional loan.
 38. Members reviewed the document and noted the progress made on the DSF reform. They expressed their support for the current approach and expressed appreciation for a DSF reform that avoided legally binding instruments and the creation of special trust funds. Clarifications were requested on the effect of the proposed reform on the demand for IFAD's products; the approach of the International Monetary Fund (IMF) and World Bank on this topic; the impacts of capital consumption; the experience to date in IFAD11 regarding uptake of the optional highly concessional loans by countries.
 39. Management provided the required details noting that the reform and proposed lending terms would be aligned with concessionality criteria and would be also based on debt assessments and be within the minimum concessionality boundaries set by the IMF and International Development Association. It was clarified that in order to ensure financial sustainability within the concept of capital adequacy, funds would be first allocated to cover DSF commitments. The current uptake of the optional highly concessional loans was described; it had been extremely positive to date for countries in both high and moderate debt distress.
 40. The document would be submitted to the Executive Board for review.
- Other business
41. No item was discussed under other business.