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Enhancing IFAD's Enterprise Risk Management Framework - Update

Note to Executive Board representatives

Focal points:

Technical questions:

Guoqi Wu
Associate Vice-President
Corporate Services Department
Tel.: +39 06 5459 2880
e-mail: g.wu@ifad.org

Donal Brown
Associate Vice-President,
Programme Management Department
Tel.: +39 06 5459 2448
e-mail: d.brown@ifad.org

Alvaro Lario
Associate Vice-President, Chief Financial Officer and
Chief Controller
Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: a.lario@ifad.org

Dispatch of documentation:

Deirdre Mc Grenra
Chief
Institutional Governance and
Member Relations
Tel.: +39 06 5459 2374
e-mail: gb@ifad.org

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Abbreviations and acronyms

A&M	Alvarez & Marsal
ERM	enterprise risk management
ERMF	Enterprise Risk Management Framework
E&Y	Ernst & Young
MRC	Marsh Risk Consulting
RAS	risk appetite statements

Summary for Review

The Executive Board is invited to take note of this update on ongoing work to enhance IFAD's Enterprise Risk Management Framework, and provide comments on the proposed roadmap, including the revision of IFAD's Enterprise Risk Management Policy¹ and the development of IFAD's risk appetite statements, which will be presented to the Audit Committee and Executive Board in 2020.

A. Context

1. There is broad consensus that IFAD has to revamp its business model and diversify its partners and instruments in order to achieve its mandate in the current challenging context. IFAD has significantly increased its presence in the field and is pursuing new partnership modalities. It is deepening its engagement with the private sector and changing the financial architecture (including initiating a credit rating assessment, with next steps subject to Board approval). At the same time, IFAD is examining the capabilities of its workforce, completing a business process re-engineering review and putting in place the necessary frameworks to support the evolving business model.
2. These initiatives will open up new opportunities for IFAD to deliver on its mandate but may also oblige IFAD to assume additional risks. This needs to be done in an informed manner within a framework that enables accountability for effective risk management in order to mitigate potential negative impacts.
3. Areas of reform such as decentralization, delegation of authority, changes to IFAD's financial architecture and engagement with the private sector require a more integrated approach to enterprise risk management (ERM) at IFAD and a consequent revision of IFAD's ERM Policy and Enterprise Risk Management Framework (ERMF). For example, while decentralization and enhanced delegation of authority may increase certain operational risks, they may reduce some programme delivery risks by bringing IFAD closer to its clients. A renewed ERMF – reinforced by an accountability and internal control framework – will enable Management to identify and prioritize key opportunities and effectively manage the associated risks. An integrated ERMF also facilitates the linking of strategy with the risk profile and risk capacity.
4. The risk appetite statements (RAS) will serve as the cornerstone of the ERMF and are considered the most effective way to communicate risk-taking boundaries across an organization, while ensuring that controls are fit-for-purpose.
5. IFAD operates within an evolving and challenging environment. With an enhanced ERMF, IFAD will be able to measure its risk profile against its risk appetite, and therefore take more and better-informed risks to support rural transformation and help vulnerable people in hard-to-reach areas of the world.

B. Background

6. In 2018, Management committed to enhance its ERMF. To this end, Management selected Alvarez & Marsal (A&M) and Marsh Risk Consulting (MRC) to: (i) conduct a gap analysis of the ERMF and the management of IFAD's financial and non-financial risks; (ii) identify IFAD's top risks; and (iii) propose the composition of a risk function that can be integrated into IFAD's organizational structure.
7. The A&M report and related Management's response were discussed by the Audit Committee and the Executive Board in November 2018, while the MRC report and related Management's response were discussed by the Committee and Board respectively in April and May 2019.

¹ IFAD's Enterprise Risk Management Policy was approved by the Executive Board in 2008.

8. Management generally agreed with the recommendations, noting that they would need to be further defined and tailored to IFAD's evolving business model. The reports included some key immediate actions, such as recommendations regarding financial risk, ERM Policy and governance, IT infrastructure, conduct and financial crime and the need to strengthen IFAD's second line of defence.
9. To support Management in this task, a lean cross-departmental working group was set up to: (i) refine a risk taxonomy suited to IFAD's business model; (ii) develop IFAD's risk appetite statements; (iii) evaluate options for an ERMF governance structure; and (iv) lay out a sequenced action plan to address the recommendations of the MRC report.
10. In June this year, Management discussed a zero draft risk taxonomy and RAS for all key risk domains with the Audit Committee. Subsequently, in line with the Committee's constructive feedback, Management identified the need for expert support to build on the independent risk reports. In early October, with the hiring of Ernst & Young, IFAD started reviewing the ERM Policy and governance structure, and began the more in-depth development of a risk taxonomy and RAS. Based on this work, IFAD's current Corporate Risk Dashboard will be further refined and aligned with risk appetite statements.
11. The purpose of this paper is to provide an update on the status of work to enhance the ERMF and to share the proposed roadmap for ERM actions in 2020.

C. Progress to Date

Developing IFAD's risk appetite statements

How do the risk appetite statements fit into the ERM framework?

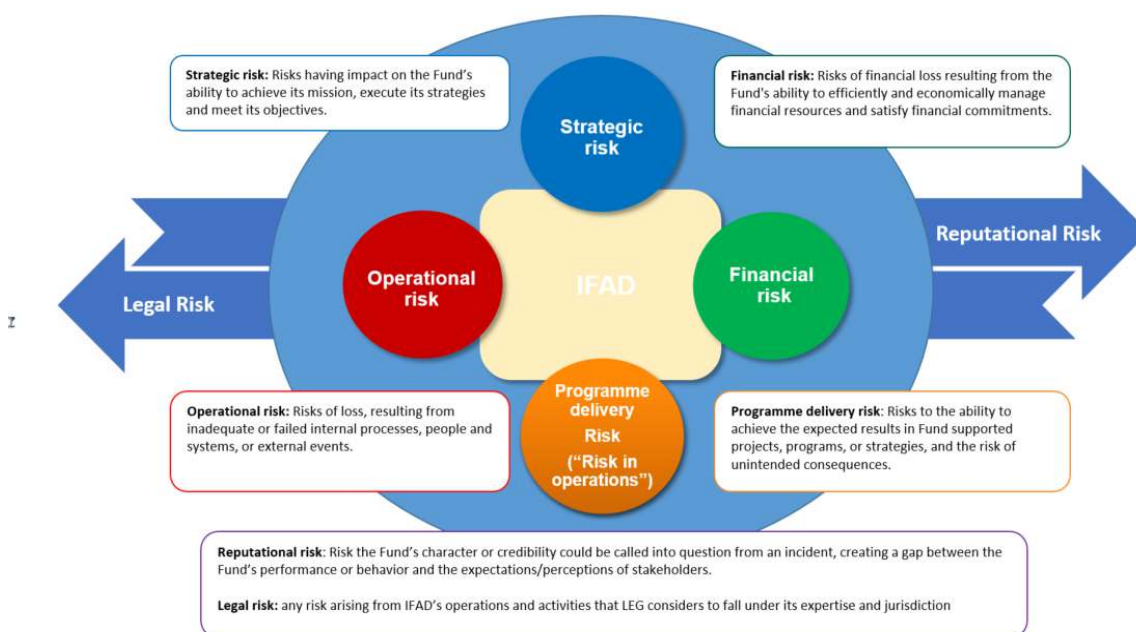
12. As discussed with the Audit Committee in June, the ERMF is composed of policies, procedures, governance structures, controls, systems and a risk culture that together describe how an organization undertakes its risk management. It should also include a risk taxonomy (or categorization), a systematic methodology and a harmonized approach to risk management practices. The ERM Policy is a critical element of the ERMF as it defines a general commitment, direction or intention vis-à-vis risk management. Although IFAD's current ERM Policy makes reference to the usefulness of RAS, it does not contain any. Going forward, the RAS will be an essential part of the revised ERM Policy and enhanced ERMF.

What is the purpose of the RAS?

13. The RAS will set the limits of tolerance for risk in four interlinked risk domains and two cross-cutting risk domains, which will form the basis of regular reporting on risks. Once set by Management and agreed with the Executive Board, the RAS will be communicated to risk owners and staff to ensure a consistent understanding and application of risk management practices in the daily performance of their functions. At the same time, risk shall be measured by reference to and escalated in accordance with the RAS and the prescribed limits.
14. Determining the levels of tolerance within the RAS requires thorough assessment and evidence for each risk and supporting metrics to help IFAD collectively know when it is outside the agreed risk tolerance. In other words, when properly applied, the RAS translate into risk methods and metrics and risk management practices that enable effective business decision-making.
15. IFAD's risk domains are at different levels of development. Some domains such as financial risk can be assessed in a more objective and quantitative manner as the risk indicators and metrics are easier to identify. In other domains such as programme delivery, risk assessment is still more subjective and qualitative, which makes it more difficult to aggregate across the portfolio. Accordingly, the development of the RAS will have to take into account the needed time and resources to build up methodologies, systems and data to allow for the quantification of risks, taking into consideration the uniqueness of some of IFAD's risks, that may be less easily quantified.

16. IFAD's risk profile, risk appetite and risk management will also require regular assessment and adjustment in accordance with IFAD's evolving business model.
- What is the value added of the RAS for the Executive Board, Management and staff?**
17. IFAD's Management, workforce and governing bodies may have different views on the level of risk that IFAD should take. The ERM Policy and the RAS are expected to support a convergence of views by providing clear, high-level statements on how much risk IFAD is willing and able to take in various high-level categories to pursue its strategy. This will allow for a consistent dialogue with external parties and within the institution. For example, the policy and RAS will help clarify how much risk the institution is willing to take with projects that have environmental or social risks but could deliver a high return in the form of transformative change for smallholder farmers or with projects in fragile situations and countries where climate risks are extremely high. Together with the new business model and financial architecture, a clear definition of IFAD's willingness to take risks and seize opportunities improves its competitiveness, sustainability and business processes, thereby better positioning it as a partner of choice for the private sector.

Figure 1. Risk taxonomy



18. As indicated in figure 1, IFAD's enterprise risk landscape has four interlinked risk domains (level 1): strategic risk, operational risks, financial risk and programme delivery risk. In June, Management presented a similar version of this figure to the Audit Committee. While the main risk domains remain the same, the definitions have been further refined to show the interrelationships that exist between each risk domain. In addition, two cross-cutting risks (legal and reputational) have been recognized and embedded throughout the entire risk taxonomy.
- Why is a risk taxonomy key to IFAD's work?**
19. Risk taxonomy is basically the hierarchical categorization of IFAD risks types. A good risk taxonomy has four key elements: (i) comprehensive coverage, with a mapping of all key risks; (ii) the right amount of granularity; (iii) clear and unique risk definitions; and (iv) a stable taxonomy over time, such that definitions and classification remain relevant and allow for proper risk management while the risk profile changes.

20. For each of its four risk domains, IFAD is currently identifying a comprehensive set of risk subdomains, each of which has underlying risk drivers. Based on this taxonomy, appropriate risk indicators can be identified for major risk drivers and tracked in the Corporate Risk Dashboard.
21. A robust risk taxonomy is a fundamental component of the overall risk management framework. Therefore, to develop well-defined risk concepts and taxonomy, intensive work is being done across IFAD involving approximately 50 staff members and Management in risk-focused working sessions coordinated by the ERM working group and Ernst & Young. An informal session on risk appetite was also conducted by E&Y with Audit Committee members.

Governance

22. Reaching an agreement on common language and the risk taxonomy is critical for the enhancement of the ERMF governance structure and for defining clear roles and responsibilities within it. This, in turn, enables early identification of material risks, a clear path for escalation and, ultimately, effective decision-making on how to manage and mitigate those risks. While developing a robust risk taxonomy tailored for IFAD takes time and investment; providing training and tools will help to promote a common risk culture to ensure consistent application, regular monitoring, timely escalation and effective governance.
23. Management has worked extensively on an ERM governance structure and is currently reviewing options that will enable optimal integration of risk management and are lean, agile and appropriate for IFAD's size. The governance structure should also embed clear, easy-to-apply and systematic risk escalation modalities.

Training

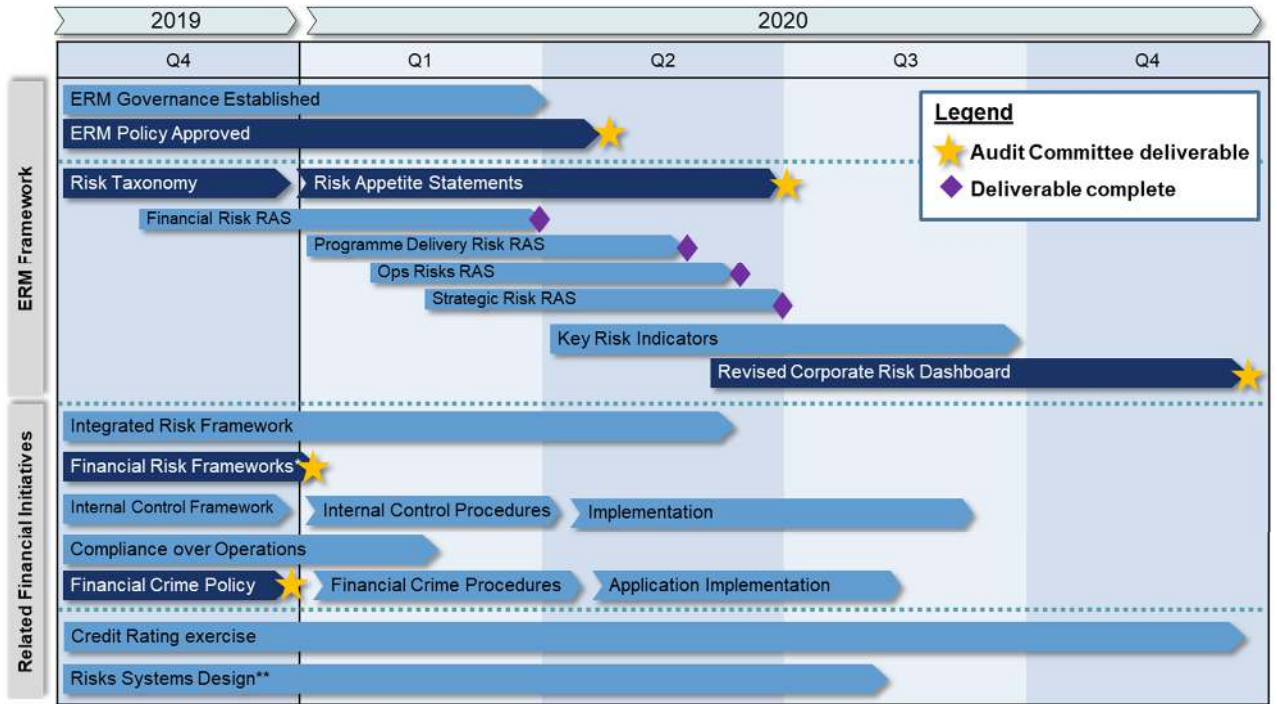
24. Over the past months, IFAD has increased risk awareness among staff, consultants, and Management on the ERMF, including the roll-out of the new edition of IFAD's Operations Academy with specific segments focused on programme delivery risks and the overall ERMF. The recent operational global retreat attended by 200 staff members also featured a dedicated session on programme delivery risk with E&Y and lessons learned.
25. In addition, E&Y conducted risk appetite overview training sessions across all level 1 risk domains for all members of Management, heads of units and approximately 100 field and headquarters staff members across IFAD. Information sessions on financial concepts have been conducted for the Executive Board and dedicated risk sessions for staff are being planned.
26. IFAD has also scheduled training of up to four modules on ERM, internal control and financial crime in 2020. Over 100 IFAD staff members are expected to receive the training.

Roadmap

27. Appendix I shows the proposed roadmap and the key ERMF documents that are expected to be submitted to the Audit Committee and to the Executive Board in 2020.
28. By the end of the second quarter of 2020, IFAD Management expects to propose a risk appetite statement for each of the four key risk domains.
29. By midyear, Management expects to have a revised ERM Policy and governance structure, which will give effect to the core elements of a strengthened ERMF for IFAD.
30. By the end of the third quarter of 2020, Management expects to have the necessary data to identify the appropriate key risk indicators (KRIs) for IFAD's top risks. By the end of 2020, the Corporate Risk Dashboard will be revised and presented with KRIs that are aligned with the new risk taxonomy and with each of the risk appetite statements.
31. Other key documents that support ERM or its related processes include financial risk frameworks, the internal control framework and the financial crime policy, all of which are expected to be completed and presented by end-2019. Compliance for

operations is expected to be finalized in the first quarter of 2020 and the risks systems design will continue into the third quarter of 2020. The credit rating exercise will continue into the fourth quarter of 2020.

32. Throughout each step, Management will closely collaborate with the Audit Committee, which has been playing a key role in providing guidance and feedback on this initiative.



*Financial Risk management frameworks include Capital Policy, Capital Adequacy Framework, Debt Sustainability Framework, Foreign exchange policy, interest rate risk policy, liquidity requirement, concentration and country ratings.
 **Risk systems may include Governance, Risk and Compliance, Financial Crime, and Treasury Risk System