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Report of the Chairperson on the 157th Meeting of the Audit Committee

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Executive Board — 130th Session
Rome, 8-11 September 2020

For: **Review**

Executive summary

Due to the COVID-19 pandemic, the 157th meeting of the Audit Committee was held virtually.

The Committee discussed a large number of documents, most of which would be presented for review or approval at the 130th session of the Executive Board.

Some of the documents pertained to current reforms intended to align the organization with best industry standards; address Eleventh Replenishment of IFAD's Resources (IFAD11) commitments; and prepare for conversations in the context of IFAD12 on:

- Capital Adequacy Report;
- Accelerated Repayment and Voluntary Prepayment Framework;
- Integrated Borrowing Framework; and
- Oral update on work towards the new Liquidity Policy.

The Office of Audit and Oversight presented its modified 2020 workplan revised in response to the global pandemic emergency.

The external auditors introduced their audit strategy memorandum for the year ending 31 December 2020 and the report on internal control and accounting procedures.

Report of the Chairperson on the 157th Meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 157th meeting of the Audit Committee held on 18 June 2020. In light of the COVID-19 emergency, the meeting was held remotely through Zoom videoconferencing.

Adoption of the agenda

2. The agenda was adopted with the inclusion of a discussion on some internal audit reports in a closed session.

Minutes of the 156th meeting and its closed session

3. The minutes were approved with no changes.

External auditor's report on internal control and accounting procedures (AC 2020/157/R.3) – for review

4. Deloitte & Touche presented the report on internal control and accounting procedures, stating that none of the recommendations had given rise to a qualification of either their audit opinion on the consolidated financial statements or Management's assertion report regarding the effectiveness of internal controls over financial reporting. It was highlighted that there were only two pending recommendations with medium priority.
5. Committee members expressed appreciation for the feedback received, and the document was considered reviewed.

External auditor's audit strategy memorandum for the year ending 31 December 2020 (AC 2020/157/R.4) – for review

6. In presenting the strategy memorandum, Deloitte & Touche informed the Committee that their 2020 audit would be consistent with the prior year and focus on five priority items: (i) the correct application of the International Financial Reporting Standards (IFRS) 9; (ii) fair value calculation on loans for consistency with the IFRS; (iii) accuracy of foreign currency translation calculations; (iv) revenue recognition as required under the International Standards on Auditing, which under ISA-240 also dictate to external auditors to presume a risk of fraud; and (v) as prescribed to auditors by the same ISA-240 principle, the assessment of the potential risk of Management override of controls, focusing on Management's judgement or estimation as an audit risk. Deloitte also highlighted extra audit activities to be performed in order to address possible emerging risks deriving from the COVID-19 emergency: effects on global financial markets could have some accounting implications for the Fund and, in particular, repercussions could be foreseen for IFAD's loan portfolio, contributions and investment portfolio, including an overall higher risk of fraud.
7. Members requested additional details about activities to be performed in relation to COVID-19 as well as the reliance placed by Deloitte on the work performed by the Office of Audit and Oversight for the external auditors. The Deloitte team and Management provided the requested details.
8. Members confirmed their agreement with the audit approach. The document was considered reviewed.

Proposed dates for meetings of the Audit Committee in 2021 (AC 2020/157/R.5) – for approval

9. The Committee agreed to hold the meetings as follows:
 - 160th meeting on 7 April 2021;
 - 161st meeting on 18 June 2021;

- 162nd meeting on 2 September 2021; and
- 163rd meeting on 23 November 2021.

IFAD's Internal Oversight: Modified Approach in Response to the Global Pandemic Emergency (AC 2020/157/R.6) – for review

10. The Office of Audit and Oversight (AUO) presented its modified 2020 workplan to take into consideration changes arising from the COVID-19 pandemic affecting IFAD's risk environment, corporate priorities and work modalities and restrictions. AUO also provided an update on investigation activities.
11. Committee members requested details about some changes made in the 2020 workplan and about the challenges in conducting audit and investigation activities when constrained by travel restrictions and generally by the COVID-19 crisis. AUO provided the requested details, in particularly stating that the effectiveness of auditing was only moderately affected by the Covid-19 restrictions to travel thanks to the possibility to work in remote mode. The document was considered as reviewed.

Capital Adequacy Report (AC 2020/157/R.7) – for review

12. Management provided an overview of the Capital Adequacy Report as at December 2019. It was explained that the report would be submitted to the Executive Board on a semi-annual basis to provide a synopsis of IFAD's capital consumption and trends in its deployable capital ratio.
13. It was noted that additional stress test scenarios had been incorporated as indicative impacts of COVID-19 on the utilization of capital, producing a negative impact on available deployable capital, whose size would depend on the stress scenario. It was also noted that despite the broad range of impact, the potential deterioration of IFAD's credit risk profile was expected to be partially mitigated by its preferred creditor status and shareholder support. Committee members requested details about stress tests and about the impact of non-performing loans and Debt Sustainability Framework (DSF) disbursements on the capital adequacy.
14. Management provided clarifications about the stress test based on rating downgrading in extreme circumstances, noting that this was in line with best practices of other international financial institutions (IFIs). With regard to the DSF, Management clarified that DSF disbursements were an essential part of IFAD's capital planning, and that the stress scenarios related to DSF were the most impactful and aimed to assess the impact of a sudden acceleration of those disbursements on the deployable capital ratio.
15. The document was considered as reviewed.

Accelerated Repayment and Voluntary Prepayment Framework (AC 2020/157/R.8) – for review

16. Management provided an overview of approaches and mechanisms on accelerated repayments and voluntary prepayments, noting that they were a means of increasing IFAD's commitment capacity and liquidity, while minimizing the associated risks and costs. It was noted that several borrowers currently eligible for ordinary term lending had benefitted during their economic journeys from loans provided by IFAD on highly concessional terms. Similarly to peer IFIs, IFAD was proposing a voluntary prepayment framework for these outstanding highly concessional loans, with the commitment of redirecting the resources to the countries most in need. While the voluntary prepayment framework would be immediately operational once approved, IFAD was also proposing an accelerated repayment framework, which required a change in IFAD's general conditions for agricultural financing and it is proposed that only as from IFAD12 onwards related legal clauses would be included in financing agreements of highly concessional and blend term loans.

17. Committee members requested clarifications about the discount rate; changes to basic governing bodies legal provisions; how the triggers would be applied in practice; if both the frameworks were voluntary; provisions for countries in reversal where applicable; and the advantages to countries of repaying their loans early. Management clarified that a revision to the General Conditions for Agricultural Development Financing would need to be approved by the Executive Board. Management also explained that the discount factor would be determined taking into consideration the return on the investment portfolio as well as the lending terms applicable to IFAD loans. On the advantages of the voluntary repayment framework, Management noted that in addition to the economic advantage of service charges no longer falling due, there was a significant signalling effect to the global development community of such a transaction that clearly demonstrated the country's positive transition and also its contribution to those countries that were at a less developed stage. Finally, while it is clear that the voluntary prepayment would be at the discretion of the borrower, Management explained that the Accelerated Repayment Framework would be activated by an external trigger and not at the discretion of the borrower.
18. The document was reviewed. Management would incorporate additional changes and submit a revised document for the Audit Committee's review at its meeting in September 2020 and presentation to the Executive Board in September 2020 for approval.

Integrated Borrowing Framework (AC 2020/157/R.9) – for review

19. Management provided an overview of proposals included in the Integrated Borrowing Framework (IBF). Management highlighted that the IBF was an important building block of IFAD's enhanced financial architecture to further strengthen its financial profile and mobilize resources in order to increase its development impact in upper-middle-income countries as well as in selected low-income and lower-middle-income countries. The IBF was intended to integrate and replace the existing frameworks (the Sovereign Borrowing Framework and the Concessional Partner Loan Framework). Management highlighted that borrowing would be managed prudently and in line with needs and demand. It was also noted that the IBF was not an instrument to access market borrowing.
20. The Committee reviewed the document and provided its feedback. Recommendations were provided to strengthen the IBF, including clarification of proposed due diligence procedures to be conducted on potential new eligible lenders. Some members commented that more assurances were needed as to IFAD's readiness to embark on these new instruments from an operational, commercial, legal, financial and risk management perspective; in particular, the implementation of a new liquidity policy and a strengthened Asset-Liability Management were considered necessary to make sure that funds borrowed at a cost could be onlent at a positive spread. Finally, concerns were raised about the proposed shift in delegation of authority to Management for new borrowing with existing lenders and one member noted that they would not be able to support inter-IFI lending.
21. Management provided the clarifications requested, reassuring the Committee that this framework would introduce prudent innovations that were instrumental to achieving IFAD's goals. Management also noted that IFAD had been preparing for the changes to its financial architecture for the past two years and that it proposed to start gradually, with relatively few "vanilla" transactions in order to mitigate potential risks. Management also indicated that the new liquidity policy would be brought to the Executive Board in 2020.

Standard financial reports presented to the Executive Board

- (a) Report on IFAD's Investment Portfolio for the First Quarter of 2020 (AC 2020/157/R.10) – for review**

22. Management presented the above-referenced document, which contained information as at end-March 2020, and reported on the impacts of the financial crisis being generated by COVID-19. The exceptional turmoil in financial markets produced by the pandemic was the reason behind the negative performance of the investment portfolio. However, as clarified by Management, this loss would have been even greater had IFAD not pursued a derisking process well before the Covid-19 crisis. In addition, at the time of the meeting the loss of the investment portfolio was more than halved with respect to the end of the quarter
23. Committee members reviewed the document noting the opportunity to strengthen investment portfolio safeguards in light of the impact of COVID-19 on the financial market.

Draft provisional agenda for the 158th meeting of the Audit Committee (AC 2020/157/R.11) – for review

24. Committee member approved the provisional agenda for the 158th meeting requesting that enterprise risk management be included for discussion in a forthcoming meeting of the Committee.

Oral update on work towards the new Liquidity Policy – for information

25. Management provided an oral update on the progress made towards the formulation of a new liquidity policy. It was noted that over the last decades liquidity had sharply decreased considering the higher volumes of disbursement needs. It was also noted that the current global pandemic demonstrated the need to hold liquidity, in order to be able to support IFAD's borrowing countries under an economic shock and play a counter-cyclical role. It was noted that IFAD's financial model was under development and would include a more timely and granular approach and stress scenarios. Management shared that the new liquidity policy will be presented to the Committee and Executive Board for review in September and approval in December. The Committee noted the update.

Oral update on the credit rating exercise (closed session)

26. In a closed session, Audit Committee members were updated on developments in IFAD's credit rating exercise.

Other business

27. In a closed session, Audit Committee members considered internal audit reports under other business.