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Report of the Chairperson on the 159th Meeting of the Audit Committee

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Executive Board — 131st Session
Rome, 7-9 December 2020

For: Information

Executive summary

1. In light of the COVID-19 pandemic, the 159th meeting of the Audit Committee was held remotely.
2. The Audit Committee discussed a large number of documents, most of which would be presented to the Executive Board for review or approval at its 131st session. Items included the following:
 - Annual review of IFAD's Investment Policy Statement, accompanied by the Control Framework for IFAD Investments
 - Workplan for IFAD's Office of Audit and Oversight for 2021
 - 2021 Budget allocation pertaining to People, Processes and Technology Plan: Implementation of a Targeted Investment in IFAD's Capacity (TCI)
 - Capital Adequacy Report
 - Lending to Subnational Entities in the Context of IFAD's New Business Model
 - Resources available for Commitment
 - Report on IFAD's Investment Portfolio for the Third Quarter of 2020
 - Asset Liability Management: Mid-year report and way forward
 - New Liquidity Policy
 - Proposed amendments to the basic legal texts of IFAD
3. The Committee was also provided with oral updates on the implications of the interbank offered rate reform, the credit rating exercise and the implementation of enterprise risk management.

Report of the Chairperson on the 159th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 159th meeting of the Committee held on 24 and 25 November 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 no changes.

Minutes of the 158th meeting

3. The minutes were approved with a revision to the minutes of the closed session held during the 158th meeting.

Project Financial Management: Mechanisms, developments, disclosures and results (AC 2020/159/R.6) - for review

4. The Committee was provided with an update on the application and evolution of financial management assurance policies and practice, and the results of the last project audit report cycle. In this regard, the annual review of the principles contained in the Conceptual Framework on Financial Reporting and Auditing of IFAD-financed Projects had confirmed their adequacy and continued applicability, even after considering the impact of the COVID crisis on this activity. Management indeed noted that exceptional measures had been introduced to manage the impact of COVID-19 in order to balance project implementation with the required levels of fiduciary assurance.
5. Committee members requested additional details about the higher balance of unsupported expenditures, collaboration with the Office of Audit and Oversight (AUO) and the Office of Enterprise Risk Management (RMO), the consequences of projects with a residual financial management risk rating of substantial and high (i.e. above the proposed risk appetite of moderate), and the drivers behind regional differences in the quality of financial reporting.
6. Management provided the requested details, informing the Committee about monthly follow up on the remote missions modality. Management also took note of the close collaboration with AUO and strong reliance on project audit reports. Residual risks can be expected to improve over time once physical missions become possible again and the level of understanding of the new risk framework matures, in part through the biannual stock-take meetings for each region on risk ratings within and across portfolios.
7. The Committee commended staff for their work and encouraged Management to keep their guard high with respect to the above mentioned risks, which are more difficult to follow up on a remote basis. The document was considered noted.

Annual review of IFAD's Investment Policy Statement (AC 2020/159/R.7 + Add.1 + Add.2) – for review

8. Management presented the annual review of IFAD's Investment Policy Statement (IPS), indicating that an extraordinary review had been conducted in September 2020 to align IFAD with international peer practice as part of the credit rating exercise. Management underscored that the investment portfolio would be divided into tranches: a transaction tranche to address disbursement needs; a liquidity tranche with instruments that can be liquidated at short notice to replenish the transaction tranche and an investment tranche for funds to be invested with a longer time profile.

9. Committee members welcomed the document and requested clarification regarding governance on IPS decision-making, for example with respect to supporting the President in taking decisions in highly specialized subject areas, and the setting of risk tolerance levels.
10. Management provided the clarifications requested, noting that conditional value at risk is the main risk measure for the investment portfolio as a whole.
11. The Audit Committee reviewed the document, which will be submitted to the Executive Board in December 2020 for approval.

**Workplan for IFAD's Office of Audit and Oversight for 2021
(AC 2020/159/R.8 + INF.1) – for review**

12. AUO introduced the agenda item, highlighting that the 2021 workplan takes into consideration AUO's expected capacity in 2021 and uncertainties in relation to ongoing process changes and the evolution of COVID-19 related risks. AUO provided a detailed plan of 2021 audit activities and information on recent investigation and anticorruption trends. AUO informed the Committee that although the AUO 2021 budget allocation was lower than the resourcing requirement stated in this proposal, no adjustments to the workplan were being proposed as Management had indicated that it would consider assigning additional resources to AUO in early 2021.
13. Committee members underscored the importance of ensuring that AUO was provided with adequate resources to avoid compromising its capacity to perform the audit function and to fully undertake planned operations, which are all the more important in the current COVID-stressed environment.
14. The Committee reviewed the workplan, which will be submitted to the Executive Board at its forthcoming session for confirmation.

People, Processes and Technology Plan: Implementation of a Targeted Investment in IFAD's Capacity (TCI) (AC 2020/159/R.4) – for review

15. Management provided a comprehensive report on progress made on implementing this initiative. Good progress had been made despite the challenges posed by the COVID crisis. The strategic workforce planning exercise had been completed, with training needs identified and a separation programme developed. A new performance management framework had been approved, with implementation to start in 2021. The Committee was also informed of progress made in the areas of process and technology work streams (e.g. the talent management platform). An update was provided on the PPTP budget usage, which would be approximately 80 per cent with the unused portion to be made available in 2021. The Committee was also informed that the 2021 drawdown request of US\$4.165 million dollars would be submitted to the Executive Board at its forthcoming session for approval.
16. Committee members requested information on the new performance management tools and measures to ensure that new full-time equivalent positions (FTEs) proposed for 2021 would be offset by a reduction in staff numbers with the lower budget allocation for separation. Additional information was requested on the job audit to be conducted in 2021.
17. The Staff Association delivered a brief statement informing the Committee about its involvement in the various activities.
18. Management clarified that the staff reduction would be ensured by a mix of measures including staff separations and further decentralization of certain existing functions from headquarters to country offices at a lower cost. The job audit would be conducted by an external firm.
19. The document was considered reviewed.

Enterprise risk management - for information

20. Management provided an oral update on recent developments in enterprise risk management (ERM), touching on the establishment of the new Enterprise Risk Management Office and initiatives currently under way to advance the implementation of ERM reforms in an integrated manner across the organization. A full second line of defence had been established with the creation of the independent Office of Enterprise Risk Management (RMO) headed by the Director and reporting to the Vice-President. Although still under construction and not yet fully staffed, the RMO is intended to support ERM implementation by identifying emerging risks to the Fund's capital and balance sheet position, providing oversight on risk management by risk owners (first line), providing support and guidance in risk matters and ultimately ensuring that IFAD's mandate is implemented effectively and in a sustainable manner. All these activities were also intended to protect the Fund's credit rating. In closing the presentation, Management highlighted the commitment to and existence of robust engagement with Executive Board representatives, Audit Committee members and Lists. Management also highlighted the commitment to constantly improving the quality of information and the increased focus on the risk dashboard and on data quality and frequency.
21. Committee members welcomed the update, called for briefings on progress made at forthcoming meetings and requested clarifications on the oversight of all risk categories. In particular, while noting that financial risk oversight is at an advanced stage and operational risk policy implementation will be further articulated with the hiring of a dedicated staff member, their questions focused also on other non-financial risks, such as programme delivery and reputational risk.

Capital Adequacy Report (AC 2020/159/R.9) for review

22. Management introduced the capital adequacy report as at of June 2020 noting that all ratios were in compliance with the limits established in the Capital Adequacy Policy. The deployable capital ratio of 40 per cent remains relatively stable when compared to December 2019 figures. It indicates that IFAD's current capital position is sufficient to absorb potential losses arising from its development operations, including those that could potentially arise from unlikely stress events. Management noted that as the COVID-19 pandemic is still a major risk for IFAD's borrowers the risk of potential impact is continuously being assessed and is expected to be mitigated to some extent by the preferred creditor status. Management expects to incorporate some enhancements to the current approach, which would be submitted to the Executive Board in the future. Note was taken of the additional information provided in the report regarding an alternative methodology to measure operational risk.
23. Committee members welcomed the report and requested further details about the potential impact of the increased borrowing activities and about stress testing. In this last respect, the Committee considered stress testing a very useful exercise and encouraged Management to refine its articulation and presentation in future reports.
24. The document was considered reviewed and will be submitted to the Executive Board for review at its forthcoming session.

Lending to Subnational Entities in the Context of IFAD's New Business Model (AC 2020/159/R.12) – for review

25. Management introduced the agenda item, noting that additional details had been included to follow up on feedback provided by the Executive Board and the Audit Committee at previous meetings. The document now includes an analysis of the opportunities, experiences of other organizations and possible demand. Also, it reflects the legal approach indicated by Executive Board representatives in their written comments, calling for engagement with subnational entities only with the

support of an explicit and enforceable sovereign guarantee that meets IFAD's criteria. This would entail an amendment to the Agreement Establishing IFAD and the Policies and Criteria for IFAD Financing.

26. Members requested clarifications on the proposed language for amendments to the governing documents to reflect the sovereign guarantee requirement, with one Member State considering that the amendment of the Agreement Establishing IFAD in relation to lending to subnationals was not necessary. In addition, some clarifications were sought about pricing and risk mitigation measures, the effectiveness of the preferred creditor status mechanism in this case and the need to clarify the concept of additionality.
27. Management provided further information and agreed to reformulate in a more prudent manner the draft amendments to the Agreement Establishing IFAD and submit it to the Committee in connection with agenda item 15 pertaining to the proposed amendments to the basic legal texts of IFAD. Noting the call for caution by several members, the Committee considered the document reviewed.

Update on the implementation of the Anti-Money-Laundering and Countering the Financing of Terrorism (AML/CFT) Policy and Controllership (AC 2020/159/R.11) – for review

28. Management provided an update on the implementation of the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) Policy and the IFAD Internal Control Framework, following their approval by the Executive Board in 2019. Management noted the creation of two units within the Financial Controller's Division (FCD), namely the Third-Party Integrity Due Diligence Unit and the Controllership Unit. The Committee was informed of progress made in the implementation of the policy, in particular in the screening of individuals and companies in IFAD's vendor master files, as well as staff – using industry standard databases, launch of a know-your-customer questionnaire as well as the incorporation of key AML-CFT clauses in various agreements, procedures and guidelines. The work done to enhance monitoring, validation and documentation of controls across IFAD and the creation of a Controller's scorecard was also noted.
29. Committee members welcomed the progress made, asked questions about the actions taken by Management in the event of a significant adverse money laundering alert and requested details on coordination efforts with other divisions.
30. Management provided further details explaining the measures taken in 2020 when some significant adverse alerts were noted. The vast training programme launched by FCD was also noted. The Committee was also informed about the strong relationship and collaboration on this topic with AUO and RMO.
31. The update was noted and Management was commended and encouraged to keep their guard high throughout the organization in view of the reputational risk that IFAD could face if even only one transaction escaped the control framework.

Resources Available for Commitment (AC 2020/159/R.14) for review

32. Management introduced the agenda item noting that the definition of Resources available for Commitment (RAC) is transitioning to fully embed new Liquidity Policy requirements. It was also noted that the RAC document presents a funding plan for the first time.
33. Committee members welcomed the document and requested additional details on the high undisbursed balances as well as the discrepancies between the 2021 levels of the programme of loans and grants as specified in the budget and the RAC document.
34. Management provided the details requested, clarifying that there is a trade-off between increased disbursement, efficiencies and appropriate liquidity levels.

35. The document was considered reviewed and will be submitted to the Executive Board for approval at its forthcoming session.

Oral update on interbank offered rates (IBOR) reform for information

36. Management provided an oral update on the status of the IBOR reform, including an overview of financial and operational considerations for IFAD. Management noted that a cross-divisional working group with participants from the Financial Operations Department and the Office of Enterprise Risk Management had conducted a preliminary assessment on the main areas of repercussion for IFAD. For bank accounts and investments, no action will be required by Management as the new reference will be applied by the banks or bond issuers. There will be no need to change IFAD's loan agreements, as they contain a generic reference to "IFAD reference interest rates". However, close communication channels with borrowers will be established to ensure clarity about the transition. Existing borrowing agreements are linked to the Euro Interbank Offered Rate (Euribor), and since Euribor will not be replaced, there will be no need to amend those agreements. There will be some impact on IFAD's accounting processes, although not on the actual methodology for the fair valuation of financial systems; while for the time being the impact on IT systems will be minimal, as only the data source will change. The Audit Committee will be updated again during 2021.
37. The Committee noted the relevance of this topic from a legal, operational and financial viewpoint, including pricing, and requested additional future updates.

Standard financial reports presented to the Executive Board – for review

Report on IFAD's Investment Portfolio for the Third Quarter of 2020 (AC 2020/159/R.16)

38. Management briefed the Committee on the investment portfolio document, which contained information as at end-September 2020. It was noted that the year's performance to September 2020 was slightly positive.

Oral update on the credit rating exercise – for information

39. Management provided an oral update on the credit rating exercise, which had recently led to achieving a second rating provided by S&P as an AA+ with stable outlook.
40. The Committee was also informed about the main criteria and points taken into consideration for the assignment of this rating, which for IFAD are: (a) a strong enterprise risk profile and extremely strong financial risk profile; and (b) preferred creditor status, which partially compensates for the lack of callable capital.
41. Management also reiterated the importance for IFAD to maintain this credit rating, which will be regularly screened and assessed by the agencies, and emphasized the importance of the new Liquidity Policy and the proposed Integrated Borrowing Framework in supporting the strong ratings.
42. The Committee congratulated Management for the great work and results achieved. In order to preserve the excellent rating score over time, the Committee also indicated the need for the sound implementation of policies already approved as well as those yet to be approved. The update was considered noted.

Asset Liability Management: Mid-year report and way forward (AC2020/159/R.10) – for review

43. Management provided an update on the progress made on implementing the asset liability management (ALM) function, including an analysis of overall financial risks and feedback for a comprehensive ALM report.
44. Committee members noted the progress made, and requested additional information on the report frequency and format, the potential impact of the IBOR

reform particularly with regard to basis risk and on plans to track the delivery of milestones in the implementation of the ALM Framework. It was also requested that references to market borrowing be avoided in the document. Overall, the Committee recommended that Management develop a roadmap to fully implement the policy, particularly regarding all metrics envisaged and the interest rate mismatches that are likely to arise with the increased use of borrowed resources.

45. Management clarified that a comprehensive report will be provided on a yearly basis and agreed to remove the references to market borrowing.
46. The document was considered reviewed and will be submitted to the Executive Board at its forthcoming session for review.

New Liquidity Policy (AC 2020/159/R.5) – for review

47. Management introduced the agenda item, noting that the document had been updated to incorporate Audit Committee and Executive Board feedback provided during previous meetings in September. The policy now includes stress tests on the administrative expenses and other stressed cash flows affecting the target liquidity level (TLL). The document now reflects the establishment of the RMO. This version of the policy provides a better description of the double layer liquidity requirements.
48. Committee members welcomed the revised policy. Members requested clarifications on the recalibration of liquidity levels prior to implementation in 2022 to ensure compliance with the new minimum requirement, in addition to further details on early-warning indicators of MLR and TLL levels. Further details were also requested on contingency planning and their triggers.
49. Management provided several clarifications. In particular, it was noted that the MLR, as the anchor of the Liquidity Policy, is more stable, while the TLL is a range that will depend on replenishment contributions and will be built up gradually to create liquidity buffers.
50. Noting Management's plans to comply with both liquidity indicators by the end of IFAD12 and the fact that the Liquidity Policy states that the TLL would be met within 2 to 5 years of the Policy's implementation, the Committee observed that setting intermediate targets would be appropriate to avoid cliff effects and considered the document as reviewed, and ready to be submitted to the Executive Board at its forthcoming session for approval.

Proposed amendments to the basic legal texts of IFAD (AC 2020/159/R.13) – for review

51. Management introduced the document, noting that the changes are being proposed to: (i) codify existing practices, including in relation to borrowing, and lending to subnational entities such as national development banks; (ii) implement recently approved policies and strategies, including the Debt Sustainability Framework reform and the Accelerated Repayment and Voluntary Prepayment Framework; and (iii) recognize the strategic objectives of the IFAD12 period and provide for any changes where discussions are well advanced with Member States but not yet approved (e.g. the Integrated Borrowing Framework and early encashment mechanism).
52. Based on comments received from Member States during the proceedings of the Audit Committee, a communication was prepared and forms an integral part of the document AC 2020/159/R.13. It will be presented in the form of a corrigendum to the Executive Board in December to clarify the following four points:

- Lending to subnationals
Replace the wording of article 7, section 1(b) of the Agreement Establishing IFAD that a government guarantee "may be required" with "the Fund shall normally require a suitable governmental or other guarantees, unless the Executive Board decides otherwise on the basis of a thorough assessment concerning related risks and safeguards". This modification will provide more clarity that the general rule shall be that a sovereign guarantee is required, while any potential exceptions to this general rule would need to be carefully reviewed by the Executive Board.
 - Borrowing activities
The proposed amendment to article 10, section 2(d) – Privileges and Immunities, is further amended to correct a typographical error. There is no change in the wording itself – the change is simply to move the wording "provided, however, that" to the next line.
 - Voting rights for early encashment
Clarify in article 4, section 5(e) and article 6, section 3(c) of the Agreement Establishing IFAD that early encashment could generate a discount but also a credit.
 - Accelerated repayment and voluntary prepayment
Clarify in the Policies and Criteria for IFAD Financing and in the General Conditions that the repayment mechanism is governed by the Accelerated Repayment and Voluntary Prepayment Framework, rather than "an accelerated repayment framework", which was considered too vague. The General Conditions are further amended to clarify that the accelerated repayment and voluntary prepayment concern not only the principal of the loan but also the interest.
53. Some Committee members expressed concern about providing feedback at this stage of the process, since some decisions would be formalized only later during the forthcoming Executive Board and Governing Council sessions. The Audit Committee Chairperson clarified and reiterated that the role of the Audit Committee is to review documents prior to Executive Board consideration.
54. The Committee provided specific feedback on some sections of the document:
- There was broad consensus on the section on lending to subnational entities, however, one Committee member expressed concern about the need to amend the Agreement Establishing IFAD;
 - There was also broad consensus on the wording of the section on borrowing activities, although one Committee member was not in favour of what they considered to be rather "broad" text while all other members were supportive of the proposed changes as drafted.

In response to concerns regarding a broad text, Management clarified that the approval of this text will not imply access to market borrowing. Further approvals by the governing bodies – i.e. the Executive Board and Governing Council – will be needed as they will be asked to approve several documents pertaining to the implementation of any future market borrowing activity. Management further noted that a narrower, more prescriptive text could present challenges for potential lenders.
 - The section of the document on voting rights for early encashment was favourably received by all Committee members.
55. The document was considered reviewed and will be submitted to the Executive Board at its forthcoming session together with a corrigendum for review.

Audit Committee work programme for 2021 (AC 2020/159/R.15) – for approval

56. The 2021 work programme was approved with the inclusion of an additional update on IBOR reform.

Other business

57. No additional items were put forward as other business.