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Report of the Audit Committee

Executive Board — Ninety-sixth Session
Rome, 29-30 April 2009

For: **Approval**

Note to Executive Board Directors

This document is submitted for approval by the Executive Board.

To make the best use of time available at Executive Board sessions, Directors are invited to contact the following focal point with any technical questions about this document:

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Report of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the following matters, which were examined at the Committee's 104th meeting held on 2 April 2009.

Review of the consolidated financial statements of IFAD as at 31 December 2008 and high-level review of the IFAD-only financial statements for 2008
2. The Committee considered the audited consolidated financial statements for 2008 (AC 2009/104/R.3) together with the high-level review of the IFAD-only financial statements (AC 2009/104/R.4). The Committee was informed that PricewaterhouseCoopers (PwC), the external auditors, had conducted the audit of these statements and that in their opinion, "the financial statements give a true and fair view of the consolidated financial position of the ... [Fund] ... and of the results of its operations and its cash flows ... in accordance with International Financial Reporting Standards."
3. The Director, Financial Services Division, highlighted the main factors in 2008 that affected IFAD's financial situation and the financial statements (please refer to annex I for the full statement).
 - **Financial markets.** Despite the financial crisis, the Fund's investment income was positive and exceeded significantly the target rate of 3.5 per cent, because of the nature and high quality of the Fund's investment holdings.
 - The deterioration in liquidity in certain markets had an impact on securities lending activities and brought to the attention of many organizations, including IFAD, the relevant disclosure requirements under the International Financial Reporting Standards (IFRS). Consequently, the balances and risks pertaining to these activities are now fully disclosed in the financial statements. Considering that the value of IFAD assets is higher than the value of the liabilities denominated in currencies other than the United States dollar (IFAD's reporting currency), the appreciation of the United States dollar against other currencies in the special drawing right (SDR) basket in 2008 led to a net negative exchange difference as reflected in the statement of revenues and expenses.
 - **Operations.** The significant expansion of direct supervision activities in 2008 did not lead to an increase in Programme Development Financing Facility (PDFF) costs, since the cost of additional staff and consultants engaged in project supervision activities was offset by a decrease in cooperating institution costs. In 2008, a significant number of Debt Sustainability Framework grants became effective and this has led to a significant increase in grant expenses of the IFAD-only portfolio. Two further countries under the Debt Initiative for Heavily Indebted Poor Countries (HIPC) reached decision point in 2008. This led to an increase in the accumulated allowance for the HIPC and the reversal of a significant portion of accumulated allowance for loan impairment losses in 2008.
 - **Resources.** 2008 was the second year of the Seventh Replenishment period. The rate of payment of contributions was higher than the rate of deposit of new instruments of contribution, resulting in a decrease in the contribution receivable balances in 2008. This was also the first year of implementation of the capital budget policy. IFAD adopted a

corresponding accounting policy for the capitalization of fixed assets and the net amount capitalized in 2008 was approximately US\$1 million.

4. Mr John McQuiston, the PricewaterhouseCoopers partner responsible for the IFAD external audit, provided a summary of the main issues that have arisen from this year's audit:
 - PwC confirmed that it will issue an unqualified audit opinion for the IFAD 2008 financial statements and clarified that the auditor's responsibility for the detection and reporting of control weaknesses is limited to such control weaknesses that emerge from the audit work. PwC confirmed that no fraud situations were noted during this year's audit. The main issue that had arisen was the issue of securities lending (further expanded below) and that approximately US\$110 million worth of securities held as collateral against securities lent are currently traded in illiquid markets. These statements were made in a private session with the Audit Committee.
 - Due to the exceptional turbulence in the credit markets in 2008, many institutions faced unexpected losses from their securities lending activity. IFAD was also informed in September 2008 that there were some losses on the fair value of securities invested from cash collateral received through its securities lending activities. IFAD reacted very quickly, exercised due diligence in mitigating risks and addressed several issues that arose. IFAD adopted a prudent and conservative strategy bearing in mind the difficulties of this situation as there are many securities, including those rated triple A, that are difficult to liquidate because of the market situation.
 - PwC further informed the Committee that prior to 2008, the securities lending business was considered a no-risk investment scheme. However, the financial turmoil made it apparent that securities lending activities were also exposed to risks, a situation that was completely unexpected by many financial institutions and investors. PwC informed the Committee that they were working closely with American pension funds that are re-evaluating the cost and the benefits of securities lending, and recommended to IFAD to examine this activity and assess whether it is worth continuing. Although the lending is fully collateralized, several risks remain (such as counterparty, liquidity and accounting risks) and this activity is not expected to generate significant income. Furthermore, it was difficult for the Fund to verify the accuracy of the securities lending income accruing thereto because the investment in the cash collateral was managed as a pool by Northern Trust Global Investments Limited, acting as agent (hereinafter the Agent) under the Securities Lending Authorization Agreement entered into by IFAD, the Agent and Northern Trust Company (the Custodian). In 2008, IFAD earned US\$5 million in securities lending income. The cumulative income to date has been more than offset by the unrealized loss of US\$18 million recorded as at the end of the same year.
5. The Assistant President, Finance and Administration Department (FAD), provided the Committee with the background to IFAD's securities lending activities, and reported on the specific steps, actions and decisions taken from the time IFAD was informed of the collateral deficiency in the European Core Collateral Section determined by Northern Trust under the terms of the Securities Lending Authorization Agreement on 19 September 2008 (please refer to annex II for a full report).
 - IFAD has been involved in securities lending since the early 1990s and the income generated has been used, inter alia, to compensate for the

Custodian's fees. This income had been accounted for and recorded in the accounts. Results had always been favourable and there had been no unrealized losses or gains until September 2008.

- On 25 September 2008 the Custodian presented IFAD with four options for handling the IFAD securities lending portfolio in the light of the collateral deficiency. The options were analysed, inter alia, by a high-level task force chaired by the Assistant President, FAD, and consisting of the Director, Financial Services Division, the Treasurer and the General Counsel. The task force was set up to monitor and analyse on a daily basis the evolving market conditions and the effect thereof on IFAD's investments portfolio.
- On 1 October 2008, IFAD received payment from Northern Trust in the amount of US\$794,703 to make up a portion of the collateral deficiency and as a sign of support to IFAD "in challenging times". On the same day, an IFAD team visited the London office of Northern Trust to discuss the options mentioned above. On 14 and 17 October, the IFAD internal investment committees analysed and presented the options to the President. On 24 October, representatives of IFAD's Treasury Division and the Office of the General Counsel met again with Northern Trust in London, following discussions with external legal counsels retained specifically to consult on the issue. At the end of October, the Treasurer, the General Counsel, and the Assistant President, FAD, visited and consulted with the World Bank (IFAD's financial adviser).
- IFAD conveyed its final decision to Northern Trust to segregate the IFAD collateral assets from the European Core Collateral Section and, in November, Northern Trust approved this option. This allowed IFAD to segregate its securities lending collateral into a separate fund that permitted the application of more conservative, IFAD-specific investment guidelines.
- On 11 November, the secretariat briefed the Committee and circulated a document that referred to the securities lending issue. In November, two external investment managers reviewed the securities of the IFAD cash collateral fund and advised IFAD whether each holding should be held to maturity or disposed of.
- Following the reappointment of PwC, in mid-November, the external auditors were informed of the securities lending issues and discussions started as to how such should be presented in the financial statements.
- From November 2008 to February 2009, IFAD continued to monitor, discuss and research the financial reporting requirements with the external auditor and through benchmarking with other international financial institutions. Based on the conclusions reached, the securities lending activities are now fully reflected in the financial statements, including the credit ratings of the securities in the IFAD Collateral Account.
- On 5 December 2008, IFAD signed an agreement with Northern Trust to operate the segregated IFAD Collateral Account under new customized, highly conservative investment guidelines. The transfer of investments from the **European Core Collateral Section** to the customized IFAD Collateral Account was carried out on 11 December 2008.
- In 2009, IFAD continued proactive risk management in this area. On 18 March, the Investment Committee recommended a downsizing strategy of securities lending, taking into account the maturity of the securities as well as the market conditions. The President approved the

recommendation. IFAD is using the most conservative approach in managing the downsizing. Eventually an analysis will be undertaken to ascertain whether IFAD should withdraw entirely from securities lending.

- The US\$18 million loss reflected in the accounts is an unrealized loss. As of the end of February 2009, this figure had fallen to about US\$13 million.

6. The Committee expressed appreciation for the background information provided by the secretariat and the external auditor. The Committee expressed concern about the securities lending activities as they exposed part of the IFAD reserves to the market turmoil. The Committee requested that a report on the chronology of events and steps taken by Management to address the relevant issues be circulated and attached to the report (annex II). Further clarification was provided and the Committee found reassuring the fact that the overall estimated net investment return of 5.45 per cent (inclusive of the unrealized loss on cash collateral reinvestment) achieved by IFAD at the end of 2008 exceeded the target rate of 3.5 per cent significantly, notwithstanding the financial environment. Management was reminded of the Committee's preference for a cautious investment policy, especially in government bonds, given IFAD's reliance on income from investment to finance part of its operations. The Committee appreciated the immediate establishment of the high-level financial task force and the corrective action taken by Management to mitigate the risks involved. In response to questions raised by the Committee, the secretariat provided the following information:

(a) On the securities lending:

- The unrealized market loss from securities lending as at 31 December 2008 has no impact on liquidity because it is not expected, at this stage, that the loss will be realized (the loss has gone down significantly since December) and because currently IFAD is very liquid, with more than US\$1 billion in assets that can be liquidated at any time without incurring any losses.
- The secretariat has always been aware of the nature of the securities lending activities managed by the Agent, and has consistently disclosed the income in the accounts. The recording at fair market value and inclusion in the financial statements of the reinvested cash collateral and the corresponding liabilities were required under the IFRS only in 2005. The external auditor confirmed that the relevant requirements had come into effect in 2005 and indicated that Northern Trust had not fully disclosed all securities lending activities directly relating to IFAD in previous financial years. Therefore, reporting requirements had not immediately been implemented. Considering that IFAD's reinvested cash collateral was held in a pooled account, it would still have been difficult to disclose prior to December 2008, when IFAD decided to have its own customized collateral account.
- PwC appreciated the steps taken by Management in addressing the risks during the latter part of 2008 but still consider this activity as a high risk to the organization. In this regard, they indicated that they plan to visit Northern Trust in 2009.
- The secretariat also informed the Committee that IFAD is putting in place a framework of internal controls over financial reporting that will ensure that risks are identified to the greatest extent possible and fully reported in the financial statements.

(b) On the result of the statement of revenues and expenses:

- The reported negative result of US\$208.7 million for 2008 in the income statement is due to three exceptional factors of a temporary nature: the increase in HIPC obligations when no new funding was received from the World Bank Trust Fund in 2008; the significant increase in grant expenses due to Debt Sustainability Framework grants; and the exchange rate loss due to the appreciation of the United States dollar vis-à-vis the other currencies in the SDR basket (it should be noted that the latter has a pure reporting effect). The combined negative effect has therefore temporarily affected the accumulated retained earnings as reflected in the financial statements. The overall adequacy of IFAD resources is managed carefully by the Asset Liability Management section of the Treasury Division, through a model that focuses on actual and projected cash flows and projected resource requirements.
7. The Committee requested that the presentations made by Management on this item be annexed to the Audit Committee report so that the Executive Board will have the benefit of full information on the subject. These presentations are attached as follows:
- Annex I: Introductory statement by the Director, Financial Services Division, on the consolidated financial statements of IFAD as at 31 December 2008 and the high-level review of the IFAD-only financial statements for 2008;
 - Annex II: IFAD's participation in securities lending.

Recommendation

8. The Audit Committee recommends the Executive Board endorse the IFAD consolidated financial statements for 2008 for presentation to the thirty-third session of the Governing Council.

Annual reappointment of IFAD's external auditor

9. In September 2006, the Executive Board approved the appointment of PricewaterhouseCoopers as external auditor for the audit of IFAD's consolidated financial statements and the financial statements of the Belgian Survival Fund, the Global Mechanism of the United Nations Convention to Combat Desertification and the International Land Coalition for the financial years 2007-2011. Following this approval, IFAD signed a contract with PwC for the audit of the 2007 financial year. This contract was subject to renewal at IFAD's discretion for further periods of one year up to a maximum duration of five years on the same terms and conditions. At its 102nd meeting, the Committee considered and endorsed PwC's proposal and recommended the approval by the Executive Board of the renewal of the contract with PwC for financial year 2008. In the same meeting, the Committee firmly invited Management to deal with the reappointment of the external auditor at an early stage in 2009.
10. The reappointment of IFAD's external auditor for 2009 was discussed both during the private session of the Committee and subsequently in the presence of secretariat staff. PwC presented their workplan for 2009 and an analysis of audit hours by staff classification for the years 2008 (actual) and 2009 (estimate). In addition, the scope of the PwC proposal encompasses: audit of the Global Environment Facility (GEF) activities as requested by Management to fulfil obligations towards the GEF Trustee; the intended audit visit to the offices of the Custodian; and work required in the area of risk management both in general and specifically in relation to security lending. In addition to the extra elements included within the scope of the audit, justifications for the increase in hours were provided as follows:

- IFRS 7 disclosure. In 2007, IFAD implemented IFRS 7 “Financial instruments: Disclosures” and the complementary amendment to International Accounting Standard (IAS) 1 (“Presentation of financial statements”) which permanently introduced new disclosures in financial instruments;
 - The hours estimated for 2006 envisioned improvements in system processes and controls. These were not realized, resulting in:
 - System difficulties of the Loans and Grants System. The software lacks flexibility and certain design functionalities that would facilitate audit testing.
 - Continued use of spreadsheets to support HIPC accounting activities, in the absence of an automated tool.
 - Loan accounting risks for accuracy and integrity of data related to the use of spreadsheets for the fair value calculation (required by IAS 39).
11. On the basis of the expanded scope of the audit and increased number of hours, PwC presented a higher fee of EUR 220,000 (against the 2008 audit fee of EUR 180,000). The 2009 proposal includes the audit of the IFAD consolidated financial statements, the Belgian Survival Fund, the Global Mechanism, the International Land Coalition and the Global Environment Facility.
12. A lengthy discussion on various proposals ensued and concern was expressed by the members on the significant proposed fee increase. The Chair then informed the Committee (before closure of the meeting) that the external auditor had accepted a reduction in the proposed fee for the IFAD audit to EUR 160,000 (i.e. a reduced total fee of EUR 211,000 for the audits of IFAD and all entities housed or managed by IFAD) and that arrangements would be finalized with Management with regard to the planned audit visit to the offices of the Custodian. The fee for the IFAD audit in 2008 was EUR 146,000. If this proposal is endorsed, as per normal practice, PwC will also be engaged to conduct a separate audit on the other entities hosted by IFAD (the Belgian Survival Fund, the Global Mechanism, the International Land Coalition and the Global Environment Facility) for a fee of EUR 51,000.

Recommendation

13. The Audit Committee recommends that the Executive Board accept PricewaterhouseCoopers’ proposal and approve the audit fee of EUR 160,000 for the audit of IFAD’s consolidated financial statements for financial year 2009.

Terms of reference and Rules of Procedure of the Audit Committee of the Executive Board

14. Management presented a revised version of the terms of reference and Rules of Procedures, which reflected the amendments and conclusions reached by the Committee at its 104th meeting. The discussion focused on:
- **Enlisting the support of experts.** Consensus was not reached on this point. Some members were in favour of inviting external experts to attend Committee meetings in an advisory capacity and assist the Committee in performing its responsibilities as deemed necessary. It was felt that this would improve the quality, transparency and objectivity of the Committee’s advice to the Board. Other members were of the opinion that there was no need to resort to external experts since expertise was available in-house. The Committee agreed that Executive Board members who wish to observe Audit Committee meetings but who are not Committee members, may do so by invitation only. This condition is already reflected in the revised terms of reference of the Audit Committee.

- **Scope and mandate of the Audit Committee.** Some members reiterated that the mandate and terms of reference of the Committee should also allow for inclusion of issues such as ethics and governance.
 - **Reporting to the Executive Board.** The proposal to incorporate the minutes of Committee meetings as part of the Audit Committee report to the Executive Board was not considered practical because of the proximity of some Committee meetings to Executive Board sessions. This leaves insufficient time for the approval process whereby the minutes are approved by the Committee before being considered final and valid as the official record of deliberations and decisions taken by the Committee. The Chairperson will report to the Board on the deliberations of the Audit Committee meetings. The report could provide more detail on certain issues, if deemed necessary.
15. Considering that a full consensus was not reached on all sections of the revised terms of reference and rules of procedures and following the request by several Committee members, it was decided to defer discussions and decision on this item until the next meeting. This would afford the new members appointed at the Executive Board session in April the opportunity to provide their views on the document.

Annual Report on Enterprise Risk Management Activities in IFAD

16. The Assistant President, FAD, presented on behalf of the Vice-President (now President), as champion of enterprise risk management (ERM), the first Annual Report on ERM Activities in IFAD as set out in the IFAD Enterprise Risk Management Policy. The report provides an overview of ERM activities in 2008 and the next steps towards full implementation. The highlights are summarized below.
- Many key elements of enterprise risk management and internal control practices (results-based strategic planning, investment management) have already been put in place or are under development at IFAD.
 - A formal and systematic ERM framework is being formulated.
 - An ERM policy was developed and presented to the Executive Board in 2008.
 - An ERM Committee – composed of the Vice-President, one other member of Senior Management and senior representatives from each department – was formally established and met five times in 2008. The Director, Office of Audit and Oversight, and the General Counsel participate as observers. The committee guides ERM implementation in IFAD and regularly reviews and monitors the associated processes and outputs.
 - A financial disclosure mechanism is being developed and will soon be piloted. This will require staff with key roles in finance, investment, procurement and external resource management to provide, every year, a signed, confidential statement reporting their significant outside activities and interests.
 - The preparation of a corporate risk profile was initiated in 2008. The exercise involved the participation of some Audit Committee members.
 - Other work included updating of the corporate performance management and reporting process, the launch of the ERM intranet site and initial training and knowledge management activities.
17. In addition to the completion of various activities started in 2008, the ERM forward plan includes the issuance of a Management assertion letter. This is a short statement signed by Senior Management to be issued each year, asserting that the internal controls put in place over financial reporting are functioning and adequate.

The use of the assertion letter will be piloted for the next two years, since changes in existing procedures and guidelines will be required. The feasibility of obtaining an external audit attestation on the assertion will be assessed during the pilot phase. For practical purposes, this transition phase will be aligned with the term of the current external auditor.

18. Members commented that the financial disclosure policy being introduced should be applied as widely as possible and the secretariat confirmed that this is its intention. The launch of a process for producing a management assertion letter on the adequacy of internal controls over financial reporting was commended by members, who expressed the hope that the external audit of this assertion would not entail significant costs. The secretariat indicated that aligning this process with the term of the current external auditor would ensure a cost-effective arrangement, through a competitive process. The Committee took due note of the content of the report, expressed appreciation for the work done so far, and encouraged Management to continue progressing in the area of ERM.

Internal audit activities during 2008 and plan for 2009/Annual Report on Investigative and Anticorruption Activities

19. Due to time constraints and because of the late issuance of the relevant documents, Committee members decided to postpone discussion of agenda items 9 (Internal audit activities during 2008 and plan for 2009) and 10 (Annual Report on Investigative and Anticorruption Activities) to the next Audit Committee meeting scheduled on 9 July 2009.

Other business

20. The Assistant President, FAD, briefed Committee members on a planned induction programme being organized by the secretariat for new members after the Executive Board session in April and on an opportunity to consult informally with and obtain preliminary views and thoughts from members on the proposed integration of the administrative budget and PDFF for the year 2010.
21. In closing the meeting, the Assistant President, FAD, conveyed to Mr Augusto Zodda – on behalf of the President, Management and colleagues – appreciation of his professionalism, work, leadership and of the guidance he had provided to the organization, both as Executive Board Director (November 1998 – February 2009) and as Chairperson of the Audit Committee (since September 2006). She thanked Mr Zodda for his invaluable contributions to IFAD and wished him well in his future endeavours. Other Committee members also expressed deep appreciation for his professional work, invaluable contribution and effective leadership as the Audit Committee Chairperson.

Introductory statement by the Director, Financial Services Division, on the consolidated financial statements of IFAD as at 31 December 2008 and the high-level review of the IFAD-only financial statements for 2008

1. I would first like to apologize to Committee Members for the late submission of these documents. Unfortunately, the additional disclosure requirements this year led to an extended preparation and audit process, which was only completed a few days ago.
2. The consolidated financial statements are presented jointly with a high-level review of IFAD-only accounts for the financial year 2008 (agenda items 3 and 4, documents AC 2009/104/R.3 and AC 2009/104/R.4 respectively). PricewaterhouseCoopers, the external auditors, conducted the audit of these statements in accordance with international standards on audit and, in their opinion, "the financial statements give a true and fair view of the consolidated financial position of the ... [Fund]... and of the results of its operations and its cash flows ... in accordance with International Financial Reporting Standards." As per usual practice, this opinion will be recorded in writing by PwC after this meeting.
3. In introducing these papers, I would like to identify the main factors that have affected the financial situation of IFAD in 2008 and indicate the impact of these factors on the financial statements.

Financial markets

4. The financial crisis and the general reduction in interest rates have had an impact on the investment activities as well as on the valuation of certain assets and liabilities. Specifically:
 - The performance of the IFAD investment portfolio was positively affected because the vast majority of the Fund's holdings are high-grade government bonds, the market value of which benefited from the decrease of yields in fixed-income securities. The overall rate of return achieved was 5.45 per cent, much higher than the target rate of 3.5 per cent.
 - The deterioration in liquidity in certain markets had an impact on securities lending activities and brought to the attention of many organizations, including IFAD, the relevant disclosure requirements. Consequently, we have disclosed the full extent of balances and risks pertaining to these activities in both the balance sheet and the notes to the financial statements. The high quality of the securities held by IFAD as collateral against securities lent ensured that the impact on the IFAD portfolio was minimal.
 - The sharp decrease in interest rates led to a reduction in the discount rates used for the calculation of the net present value of longer-term assets and liabilities. Consequently, the fair value adjustment of almost all non-current assets and liabilities was lower this year despite the increase in the underlying nominal balance in some cases. This can be noted in the cases of contributions receivable (note 5), loans outstanding (note 9), the HIPC allowance (note 10) and deferred revenues (note 13).

5. In 2008, the United States dollar, our reporting currency, appreciated against most of the currencies in the SDR basket. Assets and liabilities denominated in currencies other than the United States dollar are translated at year-end exchange rates for reporting purposes. Consequently, the appreciation of the United States dollar in 2008 led to negative exchange movements for asset balances and positive exchange movements for liability balances. IFAD has more assets than liabilities denominated in currencies other than the United States dollar so the overall exchange movement in the income statement for 2008 was negative.

Operations

- The significant expansion of direct supervision activities in 2008 led to a significant decrease in cooperating institution costs (from US\$12.2 million in 2007 to US\$7.2 million in 2008) and a consequent increase in the costs of IFAD staff and consultants engaged in project supervision activities. Despite the increase in project activities, the overall cost associated with these activities (PDFF) remained at the same level as in 2007.
- 2008 was the first year in which a significant number of Debt Sustainability Framework grants became effective. Grants are recorded as an expense in the accounts when they become effective, resulting in a significant increase in grant expenses of the IFAD-only portfolio.
- **HIPC Debt Initiative.** Two further countries, the Central African Republic and Liberia, reached decision point in 2008. This was the main reason for the increase in the accumulated allowance for the HIPC and the reversal of a significant portion of accumulated allowance for loan impairment losses in 2008.

Resources

- 2008 marked the second year of the Seventh Replenishment period. As expected, at this stage, the rate of payment of contributions is higher than the rate of deposit of new instruments of contribution; consequently, the contribution receivable balances at year-end are significantly lower than the corresponding balances in 2007.
 - Finally, 2008 was the first year of the implementation of the capital budget policy approved by the Governing Council. To facilitate the tracking and reporting of capital budgets, IFAD adopted a corresponding accounting policy for the capitalization of fixed assets based on criteria consistent with the IFRS. The net amount capitalized in 2008 was approximately US\$1 million.
6. The high-level review of the IFAD-only financial statements for 2008 provides additional information and commentary on the main elements of the financial statements.
 7. Finally, I would like to point out two minor corrections. The first relates to the table in paragraph 27 in document AC 2009/104/R.4. The 2008 figures for contributors' promissory notes, for contributions receivable and for contributions should have the opposite sign, i.e. they should read US\$ -3.60 million, US\$ -17.10 million and US\$20.70 million respectively.
 8. The second relates to the dates in note 24 of the financial statements (AC 2009/104/R.3). The reference dates should be the following: the Audit Committee and the Executive Board will examine and endorse the financial statements in April 2009, while the 2007 consolidated financial statements were approved by the Governing Council in February 2009.
 9. We will make the necessary corrections in the document to be submitted to the Executive Board session the end of this month.
 10. We will be pleased to respond to your questions.

IFAD's participation in securities lending

I. General description of securities lending

1. IFAD began involvement in the securities lending activity in the early 1990s. Initially this activity was managed internally and was subsequently dealt with by IFAD's first custodian bank until 2002. Since 2003, a business unit of IFAD's current Custodian – Northern Trust Company – has been managing the securities lending as an agent on behalf of IFAD. The main objective of IFAD's securities lending has been to generate enough income to cover custodial fees.
2. The owner of the securities (**the lender, i.e. IFAD**) lends securities to a **borrower**. The transactions are normally managed by an **agent** (in IFAD's case, Northern Trust Global Investments Limited) based on a Securities Lending Authorization Agreement. As a guarantee, the borrower must provide **collateral** (protection), either in the form of other securities or cash, and in an amount equal to the market value of the lent securities, plus a margin. Usually the value of the collateral is between 102 per cent and 105 per cent of the value of the lent securities.
 - If collateral is provided in form of **other securities** (chart 1), the securities are held in custody by the Agent for the duration of the loan. At the end, the borrower returns the securities to the lender (IFAD) and it also pays the lender a lending fee; and the borrower receives back its collateral.
 - If collateral is provided in the form of **cash** (chart 2), it is reinvested by the Agent in a collateral reinvestment pool or customized collateral account. At the end of the loan, the borrower must return the securities to the lender (IFAD) and the Agent will return the cash collateral to the borrower. The income earned from the reinvested cash collateral will be distributed among the lenders (in the case of a pool) or between the lender (in the case of custom collateral) and the Agent, following deduction of a rebate paid to the borrower.
3. The charts below describe a general securities lending transaction, in the cases of collateralization by other securities (chart 1) and by cash (chart 2).

Chart 1. Securities lending collateralized by other securities

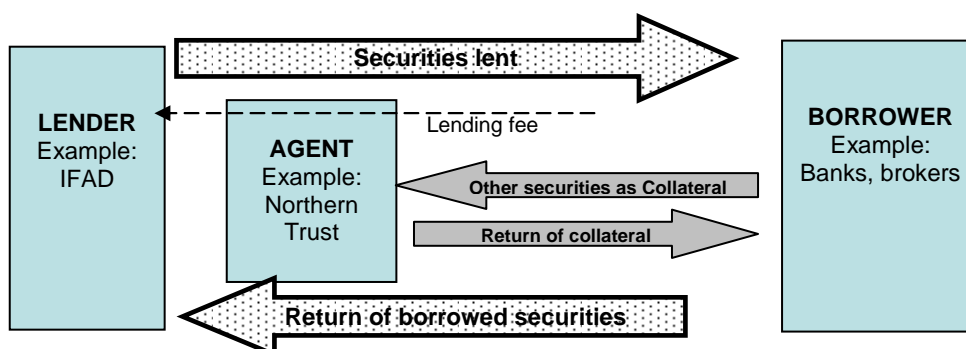
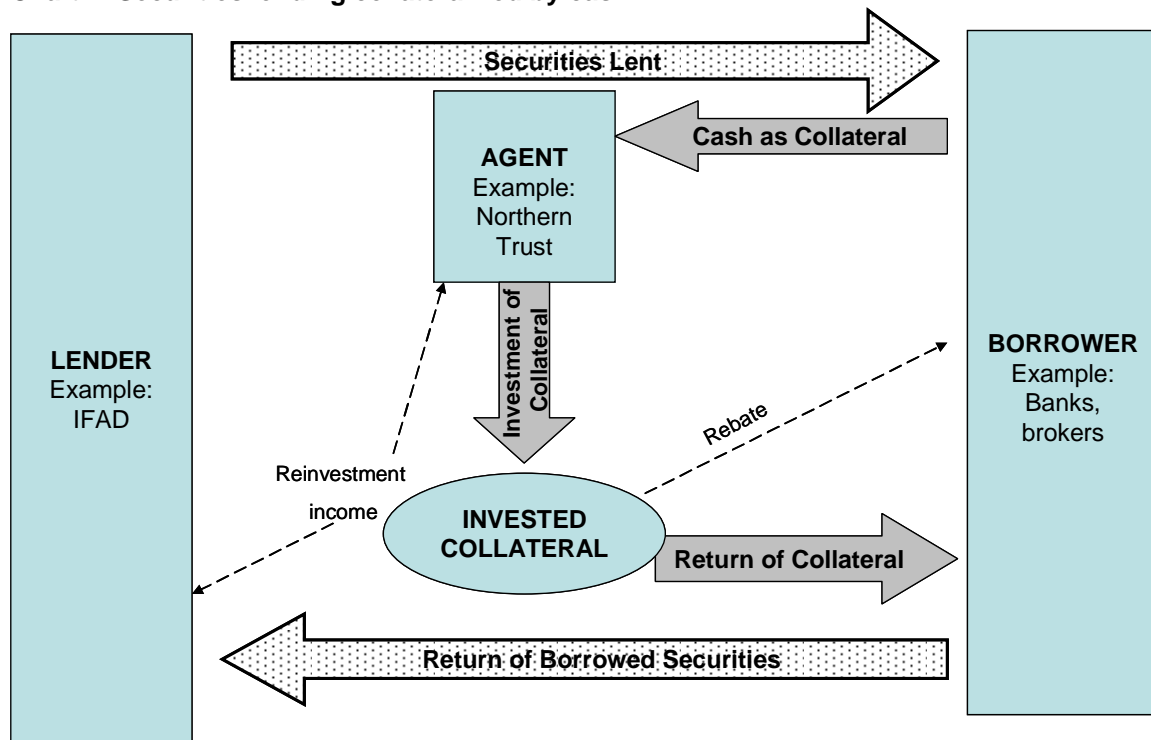


Chart 2. Securities lending collateralized by cash



II. IFAD's current securities lending

4. The amounts of IFAD's securities on loan are US\$526.3 million as at 31 December 2008 and US\$679.0 as at 31 March 2009. The total amounts of collateral reflected at market value are US\$530.1 million and US\$691.6 million, as at 31 December 2008 and 31 March 2009 respectively (table 1).
5. Of the total collateral amount as at 31 December 2008, the cash collateral was US\$455.9 million and the non-cash collateral (securities) was US\$74.2 million (table 1).
6. It is in the cash collateral with a market value of US\$455.9 million that there was a deficiency (unrealized loss) of US\$18.3 million at 31 December 2008, because the amortized cost of this collateral at that time was US\$474.2 million. However, during the first quarter of 2009, the market value of the cash collateral increased to US\$475.5 million and the amortized cost to US\$489.2 million resulting in unrealized gains of US\$4.6 million and a reduced balance of the unrealized loss from US\$18.3 million to US\$13.7 million (table 2).
7. Total amount of income generated from securities lending in 2008 was US\$5.3 million, and for the first quarter of 2009 the estimated year-to-date income was US\$0.9 million (table 3). This income reflects fees and reinvestment income on the cash collateral.

Table 1
IFAD securities on loan and collateral held at 31 December 2008 and 31 March 2009
 (Market value in millions of United States dollars)

	31 December 2008		31 March 2009	
IFAD securities on loan	526.3	-	679.0	-
Cash collateral (reinvested)*	455.9	86%	475.5	69%
Non-cash collateral	74.2	14%	216.1	31%
Total collateral at market value	530.1	100%	691.6	100%

Table 2
Unrealized losses in cash collateral
 (Market value in millions of United States dollars)

	31 December 2008	31 March 2009	First quarter 2009 movement in unrealized losses
Cash collateral amortized cost ^a	474.2	489.2	N/A
Cash collateral market value	455.9	475.5	N/A
Unrealized losses in cash collateral	18.3	13.7	(4.6)

^a The amortized cost is the purchase price of a security adjusted for the period's amortization amount. A period's amortization amount represents a portion of the difference between the purchase price and the final redemption value of a security. Therefore, the amortized cost does not reflect the fluctuation of a security's value due to market price movements.

Table 3
Securities lending income in 2008 and first quarter of 2009 (estimate)
 (Market value in millions of United States dollars)

	31 December 2008	Estimated year-to-date first quarter 2009
Securities lending Income	5.3	0.9

III. Chronology of events and actions in IFAD's securities lending

A. Summary

8. Since 2003, Northern Trust Global Investments Limited (a subsidiary of the IFAD Custodian) has managed IFAD's securities lending activities and has acted as an agent on behalf of IFAD. As explained above, for the lending of its securities, IFAD receives collateral in the form of either securities or cash. The collateral received in the form of cash was reinvested in the **European Core Collateral Section (ECCS)**, a money-market fund managed by the Agent. During the last six years, IFAD has earned approximately US\$9.7 million (between US\$50,000 and US\$500,000 per month, depending on market conditions), which more than covered IFAD's custodial fees¹ in line with IFAD's objective for its securities lending programme.
9. During the recent financial crisis, the decline in market value of some securities in the **ECCS** generated losses. Therefore, on 19 September 2008, the Agent declared a **collateral deficiency** and allocated this expected liability to each participant in

¹ The approximate amount paid by IFAD to Northern Trust for custodial services was US\$3 million over the period 2003-2008.

the ECCS proportionate to their share in the section. Clients were advised that if they wanted to withdraw at that time from the ECCS, they would have to cover their share of the liability. The Agent provided several options to their clients ranging from remaining within the section to immediate withdrawal.

10. To assess the best way forward, based on the options presented by the Agent, IFAD performed thorough **analyses and sought feedback and advice** from several external parties, including its external portfolio managers, its financial adviser (the World Bank), other international financial institutions (IFIs), the United Nations and the United Nations Joint Staff Pension Fund (UNJSPF). IFAD decided to continue participation, for the time being, in the securities lending programme, but to transfer, on 11 December 2008, its share of the ECCS into a customized collateral account managed by the Agent according to more conservative, IFAD-specific investment guidelines. This way, IFAD could benefit from a recovery in market prices and from income based on safer investment guidelines for new cash collateral reinvestments.
11. The events in 2008 also prompted IFAD to undertake more in-depth analyses of the risk/reward profile of securities lending. Based on these analyses, in March 2009, IFAD decided to progressively downsize its securities lending activities/portfolio. The downsizing will be performed by returning the non-cash collateral and by withdrawing maturing amounts from the reinvested cash collateral, to avoid realizing losses from liquidating securities in illiquid market conditions. The securities lending volume will be scaled back in an orderly manner without incurring losses due to illiquid market conditions.

B. Chronology of action taken by IFAD from September 2008 to end-March 2009

12. **19 September.** The Agent informed IFAD that a receivable would be booked to the collateral section from each of the clients participating therein, based on the proportionate interest in the section as at close of business on 18 September 2008. Clients wishing to withdraw immediately from the section would have to cover their portions of the losses.
13. **25 September.** The Agent presented the clients with four options:
 - (a) A phased withdrawal from both the securities lending and the collateral section.
 - (b) An immediate withdrawal from both the securities lending and the collateral section.
 - (c) Maintain participation in the securities lending programme, but with withdrawal from the collateral section.
 - (d) Maintain status quo.
14. **End-September.** A **high-level financial task force** chaired by the Assistant President, FAD, was established and met daily to discuss the options, monitor developments, coordinate interaction with external parties and propose tactical actions and/or decisions.
15. **1 October.** IFAD received payment from Northern Trust in the amount of US\$794,703 to make up a portion of the collateral deficiency and as a sign of support to IFAD in "these challenging times".
16. **1 October.** IFAD's Treasury Division (FT) and the Office of the General Counsel (OL) met with the Agent in London to analyse the current situation of IFAD's investments within the ECCS and explore ways forward based on the options presented by Northern Trust.

17. **14 October (tenth meeting of the Investment, Finance and Asset Liability Management [ALM] Advisory Committee [FALCO]).** The Assistant President, FAD, established a **Northern Trust Working Group** with representatives from FT, Financial Services Division (FC) and OL to analyse the options presented by the Agent.
18. **15 October.** FC began performing analyses, research and benchmarking with other IFIs on **accounting options** for the cash collateral, including their operational implications. The options presented were discussed with external auditors.
19. **17 October (seventh meeting of the Investment and Finance Advisory Committee [FISCO]).** The Northern Trust Working Group presented preliminary **analyses of the pros and cons of Northern Trust's four options.** The chairman requested the group to gather further information, and consult other clients on their knowledge of Northern Trust's solvency status and confer with the UNJSPF and World Bank on their practices with regard to security lending.
20. **20, 21 and 22 October.** The Northern Trust Working Group met to finalize the analyses of Northern Trust's four options in preparation for a meeting with Northern Trust in London.
21. **24 October.** The Assistant President, FAD; FT and OL met with the Agent in London and with an external law firm retained specifically to consult on the issue. The parties agreed with IFAD's analysis of the options and with the option of IFAD breaking away from the ECCS and setting up a **separate collateral account** with customized investment guidelines.
22. **30 October.** As requested by the chairman during the seventh FISCO meeting, FT met with **UNJSPF**. FT was informed that the UNFSPF does not engage in securities lending. In addition, UNJSPF still considered Northern Trust to be solvent and currently one of the most financially solid institutions.
23. **31 October.** An representative of the Office of the President, along with the Assistant President, FAD, FT and OL met with the **World Bank** in Washington to share their knowledge on securities lending and to discuss the most practical way forward. The World Bank described the experience of the World Bank pension fund. Similar to IFAD's plan, the World Bank's pension fund had been able to withdraw from a collateral section and agree on customized guidelines and a ceiling for securities lending.
24. **5 November.** The Assistant President, FAD; FT and OL held a conference call with the Agent. The **Agent confirmed that IFAD could have its own cash collateral fund (cash, non-cash)** managed according to customized guidelines, and composed of a share of the ECCS.
25. **Mid-November.** A proposal was made within the high-level task force to transfer IFAD's share of the ECCS into a customized collateral account to be managed by Northern Trust and that would adhere to tighter investment guidelines.
26. **11 November.** The Assistant President, FAD, briefed the **Audit Committee** on the status of IFAD's investment portfolio. The talking points were distributed later in the month together with a more detailed addendum, indicating also a deficiency relating to unrealized losses in the securities lending programme and IFAD's intention to transfer the collateral to a separate collateral account with customized guidelines.
27. **12 November.** IFAD requested comments from **two external managers** on the cash collateral securities contained in the ECCS.
28. **14 November.** **IFAD instructed the Agent** to take the necessary steps to withdraw from the European Core Collateral Section, establish an IFAD Collateral Account and provide a sample of customized guidelines.

29. **18 November.** IFAD received comments by the **external managers** on the securities in the ECCS. In general, the managers' comments were positive with regard to the safety of the securities and the validity of holding them until maturity. This was in line with Northern Trust's comments.
30. **27 November.** IFAD requested Northern Trust to provide a detailed list of the assets within the European Core Collateral Section and a list of the assets that Northern Trust proposed to transfer into the IFAD Collateral Account.
31. **5 December.** IFAD signed an Agreement to Amend Securities Lending Authorization Agreement with the Agent, which included the new customized investment guidelines for the IFAD Collateral Account. These were: more restricted criteria for securities eligibility; higher credit quality requirements; and shorter maturity.
32. **11 December.** IFAD's collateral was transferred to the IFAD Collateral Account managed by Northern Trust. The main changes to the investment guidelines are:
 - Eligible instruments, apart from cash investments, are limited to the United States Government or its explicitly guaranteed agencies instead of Organisation for Economic Co-operation and Development (OECD) countries.
 - Maximum maturity of new investments shortened to 97 days, with the exception of United States government securities, which may have a maturity of up to one year.
 - Minimum liquidity ceiling available any day raised from 20 per cent to 30 per cent.
 - Asset-backed securities no longer allowed as reinvestment.
 - No more term loans allowed as reinvestment.
33. **15-17 December (ninety-fifth session of the Executive Board).** In the report on IFAD's investment portfolio for the third quarter of 2008, the Executive Board was informed that IFAD had been "advised by its custodian bank of a possible deficiency in the investments funded by the security lending cash collateral and managed by the custodian bank" and that this matter was "currently under review and [would] be reported based on further analysis." At that time, there was still uncertainty about the accounting treatment of the reinvested cash collateral, and the reconciliation process with the Agent had not yet been finalized.
34. **5 January 2009.** IFAD hired a **special consultant** with extensive experience and knowledge to conduct an analysis of IFAD's securities lending.
35. **14 January.** FT held a conference call with the World Bank to receive their comments on the securities transferred the IFAD Collateral Account and on the earlier feedback received from two investment managers. The World Bank underlined the advantages of remaining invested in existing securities and waiting for their scheduled maturities. This observation was in line with the external managers' feedback. This strategy was considered the most profitable: it avoided realizing losses in current market conditions and allowed for benefits from the securities' high-carry value.
36. **15 January.** FT received from Northern Trust the first detailed monthly report on the status of the securities in the IFAD Collateral Account.

37. **22 January (eleventh FALCO meeting)**
- FT reported to the eleventh meeting of FALCO on the transition and on the current status of the transferred securities within the new IFAD Collateral Account.
 - The special consultant presented a preliminary report on the new collateral portfolio for IFAD's securities lending programme.
38. **January and February.** IFAD continued to analyse the risk/reward profile for securities lending also in collaboration with the special consultant and the World Bank, as technical adviser. The Financial Services Division researched extensively and reviewed accounting practices adopted by other IFIs, and also consulted with the external auditors. On the basis of this work, it was decided that IFAD must reflect the IFAD Collateral Account in its books and recognize the unrealized loss in line with IFRS 7.
39. **26 February.** The President endorsed the recommendation to account for the cash collateral portfolio of IFAD as held-for-trading (marked-to-market); reflect this in the consolidated financial statements as at 31 December 2008; and restate the balances of the relevant accounts as at 31 December 2007.
40. **18 March (twelfth FALCO meeting).** Considering the expected risk/return profile of the activity based on the forecasted income and the persistently volatile markets, and after further consultations with financial advisers by FT and FC staff, IFAD decided to downsize its securities lending programme. FALCO analysed three options for downsizing:
- Option 1 – Non-cash collateral downsizing
 - Option 2 – Cash collateral downsizing
 - Option 3 – Non-cash and cash collateral downsizing
41. FALCO did not indicate its preference for any of these options. Rather, it agreed to facilitate a decision by Senior Management at the next FISCO meeting (24 March).
42. **24 March (eighth FISCO meeting).** The meeting reviewed the analyses performed at both the eleventh and the twelfth FALCO meetings. It was decided that the securities lending programme would be downsized through the elimination of the non-cash collateral and the withdrawal of maturing amounts (option 3) in order to avoid realizing losses by liquidating securities in illiquid market conditions. This way, it is expected that a reduced lending level of US\$350 million will be reached by the end of 2009.

IV. Future steps

43. As discussed, IFAD has decided to progressively **downsize** its securities lending during 2009. This will be achieved through a combination of non-cash and cash collateral downsizing, while avoiding the realization of market losses. The targetable collateral/lending level to be reached by the end of 2009 is about US\$**350 million**.
44. IFAD will continue to analyse its securities lending strategy and a possible full exit. The analysis will need to take into consideration the prevailing financial conditions as well as the risk/reward profile of securities lending within IFAD's overall investment policy.
45. A special treasury consultant is currently analysing IFAD's long-term investment policy. The final recommendations will also take into account IFAD's participation in securities lending.