

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**ANNUAL REPORT OF THE CHAIRPERSON OF THE
AUDIT COMMITTEE
JULY 2014 TO JUNE 2015**

Annual Report of the Chairperson of the Audit Committee – July 2014 to June 2015

The Audit Committee of the Board of Executive Directors met on 24 occasions over the past year, of which 18 formally and 6 informally. The Committee held several joint sessions with other Committees, namely with the Budget and Financial Policies Committee (BUFIPOL) and the Organization, Human Resources and Board Matters Committee (OHRA). One meeting was held with OHRA and 17 meetings with BUFIPOL, of which 6 were informal. I wish to thank Directors Echeverry, Carneiro and Kreuz, with whom I had the pleasure of co-chairing Committee meetings over the past year.

The workload of the Committee was divided between recurrent issues like the financial statements, internal and external audit, effectiveness of internal controls over financial reporting and specific topics like Capital Adequacy. Below is a summary of subjects considered.

1. IDB Information Statement and Other Bank Funds Financial Statements, as of 31 December 2014. Revised version (FN-690-4)

The Committee met on 24 February 2015 to consider The “IDB Information Statement and Other Bank Funds Financial Statements, as of 31 December”. The meeting included a session with the Bank’s external auditors – KPMG. The auditors confirmed that they were in a position to issue an unqualified opinion on the financial statements. They informed that a significant deficiency had been detected regarding a money market position recorded before year end that should have been recorded after. This meant that the amount in question showed on the Bank’s balance sheet both as an asset and as a liability, resulting in overstating the Bank’s assets and liabilities. The auditors noted that this accounting error did not impact the Bank’s income statement, equity, cash flows or liquidity ratios. The Committee agreed to submit the financial statements to the Board of Directors to authorize their transmission to the Board of Governors for approval.

Prior to this meeting, KPMG appeared before the Committee on two occasions, first in September 2014, to present the “KPMG FY 2014 Integrated Audit Plan” (document XR-13) and the second, in January 2015, to update the Committee on the implementation of the audit plan.

2. Effectiveness of Internal Controls over Financial Reporting (ICFR) (FN-586-35, FN-586-36 and FN-586-37)

Three meetings were held to consider the subject, the first two to consider implementation updates and the third dedicated to the 2015 plan. Considering that minor deficiencies were dealt with directly with Management and not reported to the Committee, several Directors wanted to have a better understanding of the differences between minor and significant deficiencies. The Risk Management Unit (RMG) provided examples of a range of deficiencies and the external auditors reiterated that according to auditing standards, only significant deficiencies and material weaknesses were brought to the Board’s attention in order to allow this body to focus on strategic and oversight issues. Regarding the significant deficiency identified by the external auditors concerning the money market transaction referred above, RMG confirmed that appropriate measures had been taken to remediate the error and prevent reoccurrence.

For the 2015 plan, RMG identified four areas of additional focus: 1. The remediation of the significant deficiency detected; 2. Program Optima; 3. The impact of NewCo on the ICFR; and, 4. Fraud and risk assessment. Responding to questions regarding the scope and coverage of the ICFR, RMG explained that, currently, it was limited to the Ordinary Capital, the Fund for Special Operations, the Intermediate Financing Facility and the IDB Grant Facility. It was agreed

that RMG would present to the Committee information on the future scope of coverage and potential costs of expanding coverage.

3. Financial Risk Report on the Ordinary Capital (FN-691-1, FN-691-2, FN-691-3 and FN-691-4)

The Committee held 4 meetings jointly with the BUFIPOLE to discuss these reports. RMG presented its quarterly Financial Risk Reports on the Ordinary Capital, which provide highlights of the financial risk exposures of the Bank. RMG introduced in these reports a one-page summary of key financial risk indicators and also information regarding compliance with the Bank's Liquidity Policy. The major subjects discussed had to do with the Capital Adequacy Policy, the Bank's ratings and Standard & Poor's new rating methodology, concentration risk, Capital Utilization Ratio (CUR) and Risk Adjusted Capital (RAC), program Optima, operational risk, risks associated to the Bank's retirement plans and the situation of the Bank's private sector portfolio. The potential risks related with the consolidation of private sector operations were also discussed on several occasions. Some committee members expressed interest in having a more forward-looking approach in the Financial Risk Reports.

The calendar for discussing and approving the new Liquidity Policy was agreed and it will be followed by the agreement by the Board of Directors regarding the new Income Management Model (IMM) which will subsequently be submitted to the approval of the Board of Governors. Only with the approval of the IMM by Governors will the new Capital Adequacy Policy become effective.

Management kept the Committees informed about the ongoing dialogue with rating agencies in general and also regarding discussions with sister institutions about the possibility of carrying out exposure swaps.

The new Risk Management Chief joined the Bank in the second quarter of 2015.

**4. KPMG Fiscal Year 2014 Integrated Audit Plan (XR-13)
KPMG Fiscal Year 2014 Integrated Audit Interim Status (XR-15)
KPMG Fiscal Year 2014 Integrated Audit Results (XR-15-2)**

The KPMG team met with the Committee on three occasions, first to present the audit plan, second, to inform on the plan's implementation and third, for the final results.

At the first meeting, KPMG explained that the audit areas for 2014 would be: 1. Program Optima; 2. Internal controls; 3. A new valuation system for financial instruments; 4. Trust Funds under IDB administration; and, 5. Private sector operations and their reorganization.

In January 2015, KPMG reported on the status of implementation of the audit. They commended Management for the work undertaken regarding the implementation of the new COSO 2013 internal control framework. The external auditors provided the Committee with information on the changes introduced by the new guidelines in the areas of IT, fraud risk assessment and governance.

In February 2015, KPMG presented the 2014 audit and reported a significant deficiency resulting from the improper recognition of a committed position for a pending money market transaction which did not meet the criteria for recognition in the financial statements as of 31 December 2014. KPMG asserted that the error had promptly been corrected by Management and that it had no impact on equity, net income or cash flows, and was not related

to valuation or estimates made by Management. The external auditors also informed that a number of minor deficiencies had been reported to Management but that none of these deficiencies individually or in the aggregate arose to a level of significant deficiency. They confirmed that the implementation of program Optima remained largely on track and that they would continue to closely monitor its progress.

5. Office of the Executive Auditor. 2014 Risk-based Audit Plan Semiannual Progress Report (GN-2743-2); 2015 Risk Based Audit Plan (GN-2793); and, 2014 Annual Report (GN-2743-3)

The Office of the Executive Auditor (AUG) presented the Risk Based Audit Plan together with its program and respective budget proposal. The Committee endorsed the plan insisting particularly on the need for close monitoring of the private sector merge-out process. The Executive Auditor acknowledged the importance of the subject referring that, though it was too early to have matters to audit, advisory services could be provided, if necessary. The implementation of Optima was also referred by a significant number of chairs and the Auditor noted that AUG was closely monitoring developments and would be ready to advise the Board on issues related to scope, funding and timing as warranted.

AUG presented the 2014 Annual Report in May 2015 and informed that all projects included in the plan had been completed on time and within the allocated budget. The role of AUG regarding NewCo was debated and the Executive Auditor noted that AUG was ready to adjust its 2015 audit plan to reflect work related to perceived risks as well as the nature of the audit work to be carried out regarding NewCo. Considering that audit reports undertaken by AUG were not circulated to the Board of Directors, it was agreed that the Office of the Secretary would send notifications to the members of the Board whenever completed reports were posted on the AUG website.

Committee members congratulated AUG for having received the highest rating from the Institute of Internal Auditors.

6. Regulations Governing the Implementation of the Capital Adequacy Policy (FN-568-26)

This review stemmed from the recommendations of the Task Force Report on the 2013 MSA Review (document GN-2633-26). The Audit and BUFIPOL Committees jointly held 3 informal meetings and 3 formal meetings to discuss the Regulations of the Capital Adequacy Policy.

RMG provided detailed information about the treatment of the preferred creditor status, the level of undisbursed balance, and the calibration of total capital requirements for the Bank's risk metric. Management also laid out the possible options for the countercyclical capacity: (i) reserving some kind of capacity for countercyclical products as part of the CCR capital base requirements, including the CCL (Contingent Credit Line for Natural Disasters) and the DSL (Development Sustainability Credit Line); (ii) including a buffer capacity of US\$2 billion for the CCL and US\$6 billion for the DSL only until the end of 2015 and lowering this amount from 2016 on; or (iii) engaging in a more strategic discussion about the Bank's countercyclical products to decide exactly how much capital should be reserved. RMG also emphasized the need to have clarity on the buffers in order to define the possibility of transferring capital to the New Corporation.

RMG also requested the Committees' guidance with respect to the proposed delegation of authority by the Board of Governors to the Board of Executive Directors to consider and

approve subsequent amendments to the Regulations upon the first anniversary of its date of effectiveness. The Committees agreed to recommend that the Board of Executive Directors approve a revised version of the “Regulations Governing the Implementation of the Capital Adequacy Policy”, separating the decision on the Regulations from the decision on the delegation of authority, contained in Appendixes I and II of the proposal. Upon the Board of Executive Director’s agreement, the two resolutions were submitted to the Board of Governors for approval via electronic vote.

The Board of Governors approved the proposed Capital Adequacy Policy Mandate and Regulations in February 2015. The policy will become effective upon approval of the Bank’s new Income Management Model by the Board of Governors, expected to happen in the third quarter of 2015. The resolution regarding the delegation of authority was not approved.

7. Risk Appetite for Pension Funds (PP-649)

As agreed in 2014, the subject was considered jointly by the Audit and OHRA Committees. Management made a detailed presentation at an informal session of the Committees covering the reforms undertaken in previous years and explaining the details and implications of potential risk metrics. The objective was to hold another informal meeting in early July, after the circulation of the specific proposal, followed by a formal session of the Committees and submission of the proposal to Board approval. Subsequently, an Assets Liability study will be carried out and serve as the basis for the preparation of a new investment policy. A proposal for a multi-year stable contribution by the Bank to the pension funds will be submitted in the second semester of 2015.

8. Office of Institutional Integrity and Sanctions system. Report of Activities 2014 (GN-2780-1)

The Committee considered and took note of the annual report of the Office of Institutional Integrity (OII) and Sanctions System for 2014. The report summarized the activities undertaken by OII, the Case Officer and the Sanctions Committee, which together constitute the Sanctions System and bear primary responsibility for ensuring that activities of the Bank Group are free of fraud and corruption.

The Committee discussed the future coverage intended by the Sanctions System of the New Corporation and Management explained that the IIC was currently part of the System and that the relation with NewCo would be through service agreements to be considered in the context of the reform of the Bank Group’s private sector operations.

The issue regarding the use of Offshore Financial Centers was discussed on several occasions and Management organized a technical briefing in April 2015. It was agreed that the subject will be treated jointly by the Audit Committee and the Committee of the Board of Executive Directors of the IIC. External advice will be used and joint informal meetings will be held in the second semester of 2015, prior to the preparation of a formal proposal to be submitted to the Committees and subsequently to the respective Boards of Executive Directors.

9. Office of Ethics. 2014 Annual Report (GN-2806)

The Office of Ethics presented its 2014 Annual Report, highlighting that the office had provided responses to a high volume of requests for advice from employees, reduced case processing times and achieved 100% compliance with the annual declaration of interests exercise. The Ethics Officer also noted that the office completed in 2014 the delivery of its flagship employee

ethics training – “Ethical Leadership for IDB Employees” – with extremely high attendance by staff.

10. Legal Department Report to the Audit Committee: January to December 2014
(GN-2300-14)

In compliance with instructions from the Board of Directors, the Legal Department (LEG) presented its annual report to the Audit Committee, by confirming that the Bank's borrowing activities were concluded in accordance with the policies and regulations in force. LEG reiterated not being aware of any threatened or pending litigations, or other events that would have material adverse impact on the Bank's financial statements that had not been reported in regular disclosure documents. LEG also presented a brief summary of the cases considered by the Bank's Administrative Tribunal over the period and also of cases pending.

11. Request for concurrence for the designation of the Bank's Sanctions Committee Chairperson (GN-2440-34)

In accordance to its Terms of Reference, the Audit Committee concurred with the appointment by the President of Mr. Andres Rigo as the new Chairperson of the Sanctions Committee

12. Board Workshop on Financial Risk Management

As part of the Board's training program, the Knowledge and Learning Department (KNL) organized a workshop on Financial Risk Management in June. It was a full day event and during lunch, KPMG made a presentation regarding the role and best practices of audit committees. Attendance was quite high and several Directors believed the experience should be repeated.