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**ANNUAL REPORT OF THE CHAIRPERSON OF THE AUDIT COMMITTEE
JULY 2013 TO JUNE 2014**

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Annual Report of the Chairperson of the Audit Committee – July 2013 to June 2014

The Audit Committee of the Board of Executive Directors met on 34 occasions over the past year, of which 18 were in formal session and 16 were informal meetings. The Committee held twenty joint sessions with the Budget and Financial Policies Committee (BUFIPOL) and met jointly with the Organization, Human Resources and Board Matters Committee (OHRA) on one occasion.

The workload of the Committee was divided between recurrent issues like the financial statements, internal and external audit, effectiveness of internal controls and others, 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 2013 (FN-680-3)

The Committee met on 21 February 2014 to consider the “IDB Information Statement and Other Bank Funds Financial Statements, as of 31 December.” A session with the Bank’s external auditors - KPMG - was held in this same meeting. Committee members welcomed the incorporation in the document of key changes to the financial statements compared to previous years. Issues discussed included administrative expenses and the funding status of pension plans. The external auditors confirmed that no material weaknesses in internal controls over financial reporting had been detected and that they were in a position to issue an unqualified opinion on the financial statements. They also noted that the deficiency identified in 2012 had been addressed but expressed words of caution regarding the implementation of program Optima. Intensive testing of the new solutions should be carried out to avoid potential deficiencies or material weaknesses. 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 2013, to present the “KPMG FY 2013 Integrated Audit Plan” and the second, in January 2014, to update the Committee on the status of its implementation. The auditors confirmed that the most significant areas for the FY 2013 audit would remain broadly the same as the previous year, but monitoring of the implementation of program Optima would be carried out.

2. Effectiveness of Internal Controls over Financial Reporting (FN-586-32, FN-586-33 and FN-586-34)

Three meetings were held to consider the subject, two to consider the quarterly progress reports and the third dedicated to the 2014 plan. The Risk Management Office (RMG) informed the committee that no material weaknesses or significant deficiencies had been detected. The deficiency identified in the 2012 assessment had been addressed by using manual controls in 2013 and by preparing a plan to automate them that would be implemented in 2014.

The main areas to be covered by the 2014 plan had to do with training of functional units, continue the rollout of risk and control self-assessments, establishment of key indicators and the new COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework. The team would also collaborate and monitor corporate initiatives like program Optima and the consolidation of the private sector activities of the Bank Group.

3. Financial Risk Report on the Ordinary Capital (FN-682-1, FN-682-2, FN-682-3, FN 682-4 and FN-691)

The Committee held 5 meetings jointly with the BUFIPOL 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. The major subjects discussed had to do with the new Capital Adequacy Policy in preparation, the Bank's ratings and risk-weighted assets (RWA) and Standard & Poor's new rating methodology, concentration risk in the IDB's SG portfolio, Capital Utilization Ratio (CUR) and Risk Adjusted Capital (RAC), program Optima, operational risk and risks associated to the Bank's retirement plans, risks related to the restructuring of private sector operations and the new Liquidity Policy, also in preparation.

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 country exposure swaps.

4. KPMG Fiscal Year 2013 Integrated Audit Plan (XR-7)

KPMG Fiscal Year 2013 Integrated Audit Interim Status (XR-7-1)

KPMG Fiscal Year 2013 Integrated Audit Results (XR-7-2)

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, to discuss the final results.

At the first meeting, KPMG explained that the audit areas for 2013 would remain broadly unchanged from the previous year but that additional attention would be granted to the

implementation of program Optima. Discussions with Management about Optima's internal controls and governance would be maintained throughout the year.

In January 2014, KPMG reported on the status of implementation of the audit. The most significant areas audited had to do with valuation of financial instruments, allowances for loan losses, pension and postretirement benefits and IT controls in general and more specifically automated controls. At that time, no significant deficiencies or material weaknesses had been detected.

In February 2014, KPMG presented the audit, confirming that no material weaknesses in internal controls over financial reporting had been identified. Regarding program Optima, the external auditors expressed concern about the expected release of the SAP solution close to the end of the year as it would only allow a short timespan to correct potential problems. An unsuccessful implementation could result in KPMG identifying significant deficiencies or material weaknesses in the 2014 audit. At a later stage, Management decided to postpone the rolling out of the SAP solution for 2015.

5. Office of the Executive Auditor. 2014 Risk Based Annual Plan (GN-2743)

The Committee endorsed the 2014 Audit Plan and recommended close follow up by the Office of the Executive Auditor (AUG) of the ongoing debate on the restructuring of the Bank Group's private sector operations. It was also agreed that AUG would report to the Committee on the implementation of the Optima program and, if necessary, would carry out an audit on the implementation of the Bank's Travel Policy.

6. Office of the Executive Auditor. 2013 Risk-based Audit Plan Semiannual Progress Report (GN-2688-2)

The Committee welcomed the decrease in the number of open recommendations, continuing the downward trend from the past few years and the proactive dialogue between the Office of the Auditor and the Board was noted. The Executive Auditor acknowledged the Committee's recommendation regarding the priority to be given to the implementation of program Optima in general and in particular to potential changes in scope, timelines and possible additional funding needs.

7. Office of the Executive Auditor. Report on an External Assessment of Internal Audit Quality (GN-2725)

The Committee welcomed the conclusions of the assessment that AUG had adopted internal auditing best practices and endorsed its key recommendations and proposed action plan. AUG acknowledged the concerns expressed regarding the need to better define and delimit the oversight functions and mandates with the Office of Institutional Integrity (OII) and the Office of Evaluation and Oversight (OVE). The question related to the coverage of the IIC and MIF was discussed. Several Directors recommended that services provided to the IIC and MIF should be similar to those provided to the Bank, rather than through the current service agreements. AUG acknowledged the concerns but noted that additional services would have budgetary implications that might not be possible to accommodate within its current budget.

8. Risk Taxonomy of the Inter-American Development Bank. November 2013 Update (GN-2547-12)

The Risk Taxonomy was adopted in December 2010 and updated in March 2012. This second update aimed at combining risks that are closely related, classifying each risk category considering root causes in lieu of functions or risk impacts, and aligning the financial and operational risk categories to industry best practices. The new classification made it possible to identify two areas of risk that previously had not been explicit, namely, the reporting on trust funds and the governance of pension and post-retirement benefits plans. Regarding the latter, a proposal was submitted to the OHRA (Organization, Human Resources and Board Matters Committee) in May 2014. The Committee endorsed the updated Risk Taxonomy.

9. Risk Appetite for Pension Funds (GN2599-34)

Management made a preliminary presentation to the Committee on the subject, which is one of the deliverables of the Pension Reform Steering Committee. Committee members asked Management to include several options and identify tradeoffs between them in the recommendation to be submitted to the Board for approval. It was agreed that the formal proposal should be considered in a joint meeting of the Audit and OHRA Committees in the fourth quarter of 2014, after the approval of the new Capital Adequacy Policy.

10. Office of Institutional Integrity. Semi-Annual Report on Prevention Activities (2013 GN-2366-19)

Sanctions System Joint Semi-Annual Report 2013 (GN-2736)

Office of Institutional Integrity and Sanctions System – Annual Report 2013 (GN-2736-1)

The Committee considered the semi-annual and annual reports of the Office of Institutional Integrity (OII) and that of the Sanctions System jointly. The Annual Report of OII and Sanctions System were, for the first time, prepared as a single public document. OII reported on its prevention activities and the investigative phase of the sanctions system and the Case Officer and the Chairperson of the Sanctions Committee centered on the adjudication phase of the sanctions system. Several chairs raised concerns regarding the risks arising from the involvement of offshore financial entities in the implementation of Bank financed projects. Committee members welcomed the joint annual report, considering it a significant improvement over previous reports.

11. 2012 Annual Report – Office of Ethics (GN-2737)

2013 Annual Report – Office of Ethics (GN-2764)

Owing to some delays in the preparation of the 2012 report, the Committee considered it in October 2013 and that of 2013 in March 2014. The Office of Ethics highlighted the major changes introduced in the Bank's Ethics System during the past year: (1) the update of the Bank's Code of Ethics and Professional Conduct; (2) the training on the Code carried out and made mandatory to all staff; (3) the strengthening of the Declaration of Interests program; and, (4) the reinforcement of the Whistleblower Reporting and Protection Policy.

12. Review of the Bank's Capital Adequacy Policy

This review stemmed from the recommendations of the Task Force Report on the 2013 MSA Review (document GN-2633-26). Management was asked to prepare a work program and timetable for the Board's consideration. As a result, the Committee met informally jointly with the BUFIPOL on 5 occasions to discuss a review of the Bank's Capital Adequacy Policy. Formal consideration of the revision of the Capital Adequacy Policy will commence in the second semester of 2014.

13. Non-Sovereign Guaranteed (NSG) Risk Framework (GN-2739)

The Committee met jointly on two occasions with BUFIPOL to consider the NSG Risk framework. The framework was developed to articulate the risk profile of the NSG portfolio required to implement the Bank's strategy in the private sector and responded to a

recommendation by OVE. It also complied with the Governors' mandate to maintain sound credit quality to support the Bank's credit rating. The proposed changes were consistent with related policies already approved by the Board and were in line with the current strategic risk framework. The Committees agreed to the proposed elimination of the limit related to the aggregate exposure to financial institutions per country, which was becoming a constraint for further lending to some countries. The proposal and the sector limits will be revisited once the renewed vision for the Bank Group's private sector operations is approved. It was agreed that, in addition to Management's commitment to review the methodology to set portfolio exposure limits every three years, an interim review of the framework would be undertaken 18 months after its effectiveness.

14. Amendment to the current Ordinary Capital Liquidity Policy (FN-600-14)

Proposal to Lower the Investment Risk Limit in the Capital Adequacy Policy (FN-568-11)

In a joint meeting with the BUFIPOL, the Committees endorsed Management's proposal to increase the current liquidity policy ceiling. This review stemmed from the recommendation contained in the Task Force Report on the 2013 MSA Review (GN-2633-26). The proposed amendment would allow the Bank to increase its level of liquidity in order to maintain a "strong" liquidity assessment from S&P for 2014 as well as improve the Bank's ability to fund itself on a cost effective basis for 2014.

In order to continue meeting the Bank's liquidity goals at an expected annual cost of carrying liquidity of close to zero but at a lower risk level deemed feasible, Management also recommended reducing the risk tolerance or limit for the investment portfolio. The Committees agreed to the proposal.