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EBS/01/42

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March 21, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Safeguards Assessments—An Update**

The Executive Board adopted in March 2000 a strengthened framework of measures to safeguard the use of Fund resources, including the conduct of safeguards assessments of central banks. Attached for the information of Executive Directors is a paper updating the Board on early progress with safeguards assessments.

Questions may be referred to Mr. Catsambas (ext. 34017) and Mr. Hemus (ext. 38263).

Att: (1)

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INTERNATIONAL MONETARY FUND

Safeguards Assessments—An Update

Prepared by the Treasurer's Department

(In consultation with other Departments)

Approved by Eduard Brau

March 20, 2001

Contents

Page

Text Tables

Text Box

I. Background

1. On March 23, 2000 the Executive Board adopted a strengthened framework of measures to safeguard the use of Fund resources through the introduction of **safeguards assessments of central banks**. The framework was introduced in the wake of several misreporting instances and allegations of misuse of Fund resources. Revised guidelines on misreporting were put in place and safeguards assessments were adopted as an *ex ante* mechanism to help prevent the possible misuse of Fund resources and misreporting of information.

2. The specific objective of safeguards assessments is to provide reasonable assurance to the IMF that a central bank's control, accounting, reporting and auditing systems in place to manage resources, including Fund disbursements, are adequate to ensure the integrity of operations.[1] The IMF Committee, at its 2000 meetings, endorsed the Board's decision and stressed the "forceful application of the strengthened framework."[2] The new approach was also independently reviewed and endorsed by a panel of external experts. The purpose of this paper is to update the Board on progress with safeguards assessments on the basis of certain early indicators.

3. Safeguards assessments apply to all members with arrangements for use of Fund resources approved after June 30, 2000. Member countries with arrangements in effect prior to June 30, 2000 are subject to transitional procedures. These countries are required to demonstrate the adequacy of only one, key element of the safeguards framework, namely that their central banks publish annual financial statements that are audited by external auditors[3] in accordance with internationally accepted standards.

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[1] See *Summing Up by the Acting Chairman on Strengthening Safeguards on the Use of Fund Resources and Misreporting of Information to the Fund—Policies, Procedures, and Remedies—Preliminary Considerations*, BUFF/00/48 (3/30/00). See, also, the related background papers: *Strengthening Safeguards on the Use of Fund Resources*, EBS/00/29 (2/24/00), *Strengthening Safeguards on the Use of Fund Resources—Independent Review of IMF Staff Proposals*, EBS/00/30 (2/24/00), *Statement by the Staff Representatives on Strengthening Safeguards on the Use of Fund Resources and Independent Review of IMF Staff Proposals*, BUFF/00/33 (3/14/00), and *Supplementary Statement by the Staff on Strengthening Safeguards on the Use of Fund Resources*, BUFF/00/39 (3/22/00).

[2] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, April 16, 2000, paragraphs 10-11. See, also, Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, September 24, 2000, paragraph 23.

[3] The term "external auditor" is used to distinguish the external audit of the financial statements from the activities of the internal audit department that is typically part of a

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II. THE SAFEGUARDS FRAMEWORK

A. Methodology

4. Safeguards assessments consider the adequacy of five key areas of control and governance within a central bank (see Box 1). These five areas can be summarized under the acronym **ELRIC**, as follows:

- **E**xternal audit mechanism,
- **L**egal structure and independence,
- financial **R**eporting,
- **I**nternal audit mechanism, and
- system of internal **C**ontrols.

5. The ELRIC framework is derived from the Fund's *Code of Good Practices on Transparency in Monetary and Financial Polices* and employs International Accounting Standards (IAS), International Standards on Auditing (ISA), and the Fund's data dissemination standards (SDDS and GDDS) as benchmarks. In the area of the legal structure and independence ("L"), there is no generally accepted benchmark for central bank independence and legal structure. The framework, therefore, calls for the identification in the legislation governing the central bank of any provision that could allow for undue interference with central bank operations by outside parties, or that could jeopardize the central bank's governance structure in any way.

6. In order to ensure a reasonable degree of consistency across countries, staff has developed standardized analytical techniques and assessment tools for each element of ELRIC. At the same time, in applying the benchmarks, due consideration is given to the country's degree of economic development and to its central bank's complexity of operations. Such flexibility in the assessment framework is considered necessary to allow for a variety of appropriate remedial actions, ranging from long-term technical assistance to the possibility of prior actions before further Fund disbursements.

B. Modalities

7. **Safeguards assessments are undertaken in two stages. Stage One is a preliminary assessment of the adequacy of the central bank's ELRIC** based on a review of documentation[4] provided by the authorities and, if necessary, discussions with the external

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central bank. The external auditor, usually an accounting firm or a Supreme Audit Institution, is expected to be independent of the central bank.

[4] The set of documentation requirements for both safeguards assessments and the transitional procedure reports was specified in the Board's adoption of the safeguards assessment framework—see the attachment to BUFF/00/48.

Box 1. The Safeguards Framework

The five key areas of the safeguards framework are as follows:

1. The External Audit Mechanism. The external audit mechanism comprises the practices and procedures in place to enable an independent auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an established financial reporting framework. An external audit mechanism is important for the credibility of a central bank; the objective of the assessment is to establish whether an independent and high-quality external audit of the central bank's financial statements is conducted regularly and whether previous recommendations made by the auditors have been implemented. The assessment will also ascertain whether an audit opinion is published with the financial statements.

2. The Legal Structure and Independence. Government interference with central bank operations can undermine a central bank's autonomy and increase the risks to which it is exposed, particularly if agencies other than the central bank have responsibility for reserves management. The objective in assessing this area is to ensure that (i) the arrangements whereby the central bank extends credits, advances or overdrafts to the government follow legal procedures, and that the government has not interfered with these regulations; and (ii) for those agencies that share monetary authority with the central bank, the legal basis of their relationship to the central bank, their role as a monetary authority, and the responsibility for reserves management are transparent and explicit.

3. The Financial Reporting. Adequate financial reporting practices are an essential element of effective central bank operations and encompass the provision of both internal information (including financial, operational and compliance data) and external market information about events and conditions that support decision making. For such information to be useful it must be relevant, reliable, timely, accessible and provided in a consistent format. The objective in assessing financial reporting practices is to ensure that the central bank adheres to international good practices in its accounting principles, financial statement presentation and disclosures, coverage of operations, and reporting of statistical data. Non-adherence to accepted good practices might be an indicator of a lack of transparency and accountability.

4. The Internal Audit Mechanism. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of its risk management, control, and governance processes. The objective in assessing the internal audit function at a central bank is to evaluate its effectiveness by considering the organizational independence and objectivity that allows the internal audit activity to fulfill the nature and scope of its work program and the procedures for communicating results unencumbered from external interference.

5. The System of Internal Controls. Internal control is a process comprising all the policies and procedures effected by the board, management, and other personnel of a central bank to assist in achieving (i) the effective and efficient conduct of its business, (ii) its compliance with applicable laws, regulations, policies, plans and internal rules and procedures, and (iii) the timely preparation of reliable financial information. A system of effective internal controls is a critical component for the sound operation of central bank activities, including the safeguarding of assets, the prevention and detection of fraud and error, and the accuracy and completeness of accounting records. The objective in assessing internal control systems is to determine whether appropriate procedures are in place, at all levels, to provide reasonable assurance that material risks that could adversely affect the central bank's operations are being continuously recognized, assessed, and mitigated. The main focus is on controls over the banking, accounting and foreign exchange operations of the central bank.

auditors. Requests for documentation are normally transmitted to country authorities at least three months before the anticipated date for Board discussion of the new arrangement. Central banks are asked to provide the information one calendar month thereafter, or no later than two months before the anticipated Board date, whichever is later. In addition to providing the requested information, central banks are expected to grant permission for staff to hold discussions with the banks' external auditors. Vulnerabilities identified during a Stage One assessment are documented, together with the staff's judgment about whether or not a Stage Two (on-site) assessment is necessary. The decision about whether a Stage Two assessment would be undertaken is made by Fund management. In cases where a Stage Two assessment is not considered necessary, but vulnerabilities are nonetheless identified, the staff recommends remedial actions which, if endorsed by management, are discussed with country authorities and presented to the Executive Board in conjunction with other program issues.

8. **Stage Two (on-site) assessment missions confirm or modify the preliminary conclusions drawn by the Stage One assessment and propose specific remedial measures to alleviate confirmed vulnerabilities in a central bank's ELRIC.** Multidisciplinary teams led by Fund staff and including external experts conduct Stage Two assessments, which are concluded no later than the first review under the Fund arrangement. The Stage Two assessment report is discussed with country authorities and their official response is included in the final report, which is transmitted to Fund management. Subject to management's approval, the remedial actions are incorporated into the member's program of reforms. The results of safeguards assessments are made available to the Executive Board in summary form through staff reports related to the ongoing use of Fund resources under arrangements.

9. The modalities for **transitional procedures** (which are applicable to countries with Fund arrangements in effect prior to June 30, 2000) are similar to a Stage One assessment, except that the central bank is subject to assessment in only one of the areas of the safeguards framework, namely the external audit mechanism, and there is no Stage Two assessment. Central banks whose financial statements are presently not audited by external auditors are expected to commit at the next program review to implement an acceptable external audit mechanism under an agreed-upon timetable. For central banks that have an external audit mechanism and vulnerabilities are identified, staff recommends specific remedial actions in the same manner as for Stage One assessments.[5]

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[5] An issue related to the current dichotomy between transitional and full Stage One assessments is discussed in paragraph 17.

III. Implementation and Initial Observations

A. Progress with Implementation of Safeguards Assessments

10. The first requests for safeguards documentation from central banks were transmitted on June 1, 2000. Since then, documentation has been requested from 63 central banks, 32 of which are subject to Stage One assessments; the remaining 31 are covered under the transitional procedures (Table 1). The response rate from country officials to the requests for documentation has been favorable. As Table 1 shows, 58 central banks have responded at least in part to the request, although the extent of documentation provided varies somewhat. The staff follows up on missing documentation through area departments and reminder letters. As of mid-March 2001, 14 assessments had been completed.

Table 1. Country Responses and Status of Assessments[1]

	Transitional Procedures	Stage One Assessments	Total Number
Central banks subject to assessment[2]	**31**	**33**	**64**
Documentation received	**30**	**28**	**58**
Assessments Completed[3]	10	4	14
Assessments Pending	20	24	44
Documentation not yet received	**1**	**5**	**6**
Central banks with documents overdue	1	3	4
Central banks with documents pending	0	1	1
Documents not yet requested	0	1	1

[1] Data as of March 15, 2001.

[2] The total number of central banks reflects 74 member countries subject to safeguards assessments. This is because the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) and the Banque des Etats de l'Afrique Centrale (BEAC), include 12 member countries with Fund arrangements. Both institutions are subject to Stage One assessments.

[3] Stage Two assessments have been completed for two of the four countries for which a Stage One report was prepared.

11. **The time required to complete an assessment varies significantly across member countries.** The Stage One reports took an average of 3-4 months from the time of documentation request to the issuance of the final report. The Stage Two process added a further 2-3 months. This would suggest a life cycle of approximately six months for a safeguards assessment that involves Stage Two, although staff cautions against drawing definitive conclusions after relatively little experience. The life cycle is more variable in the case of transitional procedure reports—the assessments completed so far have taken anywhere from one to six months, depending on the nature of the findings. In general, the nature of the assessment determines the length of its life cycle: countries requiring a Stage

Two assessment take longer than those that do not, and Stage One assessments take longer than transitional procedure assessments.

12. However, **country-specific factors can also have a marked impact on the length of time** between the initial request for documentation and the issuance of the final report to management. These factors include (i) the speed with which member country officials respond to the request for information, (ii) the amount of submitted documentation and the original language, (iii) the need for follow-up to obtain missing information and clarify certain issues, (iv) the nature and extent of identified vulnerabilities, (v) the extent of cooperation by the external auditors, and (vi) the logistics of staff visits and missions, including the involvement of external experts. Notwithstanding the relatively long life cycle of safeguards assessments **the Board's deadline of completing Stage Two assessments no later than the first review under the Fund arrangement has so far been met.**

B. Findings and Issues: Initial Observations

13. It is too early to judge the benefits arising from safeguards assessments, but one factor already stands out: The central bank authorities have been cooperative in the provision of information, the acceptance of identified vulnerabilities, and the willingness to consider and adopt remedial actions suggested by staff. The heightened awareness regarding transparency and governance issues in central bank operations is likely to improve the overall framework of safeguards employed by central banks.

14. An immediate and significant consequence of the safeguards policy has been the initiative taken by several central banks to improve the transparency of their operations. **At least ten central banks have recently appointed or are currently in the process of appointing external auditors for the first time.** They are Albania, Brazil, the Banque des Etats de l'Afrique Centrale (BEAC), Cambodia, Croatia, the former Yugoslav Republic of Macedonia, Peru, Romania, Turkey and the Federal Republic of Yugoslavia. Some of these appointments can be directly attributed to the advent of safeguards assessments and several members have sought staff's advice in this matter. Another salutary by-product of the safeguards policy has been the central banks' analysis of their ELRIC safeguards for the first time in several cases, in response to the staff's request for documentation.

15. Table 2 indicates the early findings of safeguards assessments for both countries with arrangements in effect prior to June 30, 2000 (transitional procedures) and those with new arrangements. Central banks reviewed under the **transitional procedures** have fallen into one of three categories: (i) central banks whose financial statements are not externally audited (Romania), (ii) those whose financial statements are audited, but not in line with international auditing standards (São Tomé and Príncipe and Uruguay), and (iii) those whose financial statements are audited in accordance with internationally accepted standards (Argentina, Bolivia, Bulgaria, Estonia, Latvia, Lithuania, and Ukraine). Taken together with the earlier finding of central banks introducing an external audit mechanism for the first time, the staff believes that an increasing number of central banks will be publishing financial statements that are independently audited by external auditors.

Table 2. Summary of Findings and Remedies

	Transitional Procedures[1]	Stage One[2]	Stage Two
Assessments Completed	Argentina Bolivia Bulgaria Estonia Latvia Lithuania Romania São Tomé and Príncipe Ukraine Uruguay **(10)**	Albania Kenya Macedonia, FYR Pakistan **(4)**	Kenya Pakistan **(2)**
Findings			
No further action	7	--	--
Stage Two required	n/a	3	n/a
Ad hoc remedies in areas of ELRIC			
- *Establishing* an External audit mechanism	1	1	--
- *Improving* the External audit mechanism	2	1	3
- Legal structure and independence	n/a	--	3
- Financial Reporting	n/a	1	6
- Internal audit mechanism	n/a	--	2
- Internal Controls	n/a	1	4

[1] Under the transitional procedures, there is no Stage Two and the "LRIC" areas are not examined.

[2] Of the four Stage One reports completed, Stage Two assessments were recommended for Kenya, former Yugoslav Republic of Macedonia (FYRM) and Pakistan. In the case of FYRM, the completion of Stage Two has been delayed until an external audit mechanism is in place. In the case of Albania, no Stage Two assessment was considered necessary, but *ad hoc* remedies were proposed.

16. Of the member countries subject to **full safeguards assessments**, four Stage One (Albania[6], Kenya, former Yugoslav Republic of Macedonia, and Pakistan) and two Stage Two assessments (Kenya, Pakistan) have been completed so far. The Stage Two assessments generally confirmed the vulnerabilities identified at Stage One and appropriate remedies are being incorporated into program conditionality. The sample of completed cases is too small to confirm a trend, but recurring themes are (i) opaque financial reporting, (ii) weak oversight by central bank Boards over control, audit and financial reporting mechanisms, and (iii) inadequate reconciliation between audited balances and data used in the monitoring of Fund-supported programs. The staff's key recommendations to remedy these vulnerabilities

[6] As a country with an existing arrangement at June 30, 2000, Albania would normally be subject to the transitional procedures. However, since the authorities proactively provided all the documents necessary for a Stage One assessment and a successor arrangement is likely to be approved before end-2001, staff undertook a full Stage One assessment.

have been the adoption of International Accounting Standards (IAS), the establishment of a properly structured audit committee, and regular reconciliations between the financial statements and relevant program data. Both the Kenya and the Pakistan central bank authorities have supported the proposed remedies in what the staff believes are important areas of central bank operations.

17. **An issue has arisen from the separation of "E" from "LRIC" in the case of the transitional procedures for member countries with existing Fund arrangements.** The ELRIC framework is a holistic approach that considers complementary safeguards spanning the entire operations and activities of a central bank. For example, the quality of an external audit ("E") is unrelated to the quality of accounting standards ("R"), but both areas are equally important for the quality of the financial statements. The transitional procedure countries are subject only to an assessment of "E", which may not guarantee transparent financial reporting because no assessment of the underlying accounting standards is performed. Similarly, a high-quality audit does not guarantee that internal controls are satisfactory. While conducting the assessment of "E", staff may become aware of significant "LRIC" vulnerabilities from the external auditor's management letters. In such cases, staff seeks clarification of those issues from the authorities and notes the identified vulnerabilities in the transitional procedures report, but does not undertake a full assessment of the adequacy of safeguards in these areas. Such an assessment would take place if the member country sought a new arrangement at the expiration of its current arrangement.

18. **Progress with safeguards assessments has been slower than expected.** This is mostly due to the long life cycle of the assessments, but also reflects the significant start-up investment that had to be made for the establishment of assessment tools, such as questionnaires, checklists and report templates, and other matters. In addition to internal resources, specialized staff had to be hired externally which took longer than anticipated due to the market shortages in this field. Notwithstanding the slower than expected initial progress, measures have been taken to attain an acceleration in the rate of assessments for 2001.

19. Safeguards assessments are still new, and are built on analytical techniques, tools and methodologies that are evolving over time as all parties involved in the process learn from experience. Consequently, while the central focus of the assessments will remain to safeguard Fund resources, the precise modalities and implementation will continue to be refined and improved over time.

IV. Next Steps

20. **Safeguards assessments will continue to be undertaken under the procedures described earlier until the latter part of 2001, at which time a Board review, aided by a panel of external experts, will take place.** By that stage, staff expects to have accumulated sufficient experience with the assessments to allow the Board to undertake the review envisaged when the safeguards policy was adopted for an initial experimental period of 12-18 months. The tentative timing for the next steps is as follows:

- Issue an update paper for the information of Directors on progress with safeguards assessments before the October 2001 Annual Meetings.
- Issue a review paper, together with an independent analysis by the panel of experts, for discussion by the Board in early 2002.