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CONFIDENTIAL

April 6, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Strengthening Safeguards on the Use of Fund Resources and
Misreporting of Information—Draft Report of the Acting Managing
Director to the International Monetary and Financial Committee**

Attached for consideration by Executive Directors is the draft report of the Acting Managing Director to the International Monetary and Financial Committee on strengthening safeguards on the use of Fund resources and misreporting of information.

It is not proposed to bring this matter to the agenda of the Executive Board for discussion unless an Executive Director so requests by noon on Friday, April 7, 2000.

Mr. Lane (ext. 37668), Mr. Catsambas (ext. 34017) and Mr. Leckow (ext. 34799) are available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads



INTERNATIONAL MONETARY FUND

Report of the Acting Managing Director to the International Monetary and Financial Committee on Strengthening Safeguards on the Use of Fund Resources and Misreporting of Information

April 6, 2000

1. **Reliable information is essential to every aspect of the Fund's work, including surveillance, financing and technical assistance, and is critical to ensure that the Fund's resources are used for their intended purposes. The Fund has relied primarily on a relationship of trust with members as a basis for the integrity of the information it needs to operate effectively within a broad framework of rules and safeguards.**
2. **The existing safeguards for the reliability of information stem from program design, conditionality, and monitoring, and the availability of technical assistance, as well as the transparency and governance initiatives; the latter include the establishment and monitoring of codes and standards for data dissemination, fiscal transparency, and transparency in monetary and financial policies. The Fund also has legal tools for addressing cases of misreporting that arise.**
3. **Several recent episodes of misreporting and allegations of misuse of the Fund's resources have led us to reassess the adequacy of the Fund's existing procedures. The Fund views these episodes with the gravest concern, as they represent a breach of trust by certain members and could undermine the Fund's credibility and reputation as a careful and prudent manager of the resources entrusted to it, and provider of financial assistance and policy advice to its members. This in turn could in the longer term undermine the Fund's ability to operate effectively.**
4. **In September 1999, the Interim Committee called on the Fund to perform an authoritative review of its procedures and controls to identify ways to strengthen safeguards on the use of its funds. In October 1999, the Fund's Executive Board initiated a review of the Fund's legal framework, policies, and procedures related to misreporting. The review of safeguards was aided by a panel of eminent outside experts, who provided the Executive Board with an independent assessment of staff proposals.**
5. **Subsequently, the Executive Board has extensively discussed both misreporting and safeguards issues; the Chairman's summing up of these discussions is attached. The discussions resulted in Executive Board agreement on a multi-faceted approach that is now being put in place to strengthen the safeguards on Fund resources.**

Safeguards within member countries

6. A key element of safeguards within member countries is that central banks publish annual financial statements, independently audited in accordance with internationally accepted standards. Starting in mid-year 2000, this will be a requirement for all current and future Fund programs.

7. The Fund will also introduce two-stage Safeguards Assessments to assess and strengthen control, accounting, reporting, and auditing systems within member country central banks. The assessments are intended to ensure that these systems are adequate to control and monitor the resources entrusted to these central banks, including those provided by the Fund. In the first stage, the central bank will be asked to provide information and documents relating to its internal control and external auditing procedures (see the attachment to the Summing Up). If these procedures are judged to be adequate, the Fund will regard the Safeguards Assessment as complete. In other cases a second stage, of on-site assessment, will follow. The assessment teams for the second stage will be headed by Fund staff, and will include experts from central banks, multilateral agencies, and private accounting firms. Fund staff will then propose action to address any identified weaknesses in internal procedures.

8. The Safeguards Assessments will be required, on an experimental basis, for all countries with new Fund programs approved after mid-year 2000. The experience with these assessments will be reviewed with the involvement of a panel of eminent outside experts within 12-18 months.

Remedial actions on misreporting

9. Recent experience has underlined the need to ensure that the Fund's framework of rules adequately covers cases of misreporting that may arise. The main pillars of the Fund's existing legal framework for addressing cases of misreporting are its Articles of Agreement and the 1984 Guidelines on Misreporting and Corrective Action for the Fund's general resources (as well as analogous guidelines adopted in 1998 for the Poverty Reduction and Growth Facility (PRGF)). The Articles establish member countries' obligation to provide the Fund with information it needs for its work and specify legal remedies—such as a temporary declaration of ineligibility to use the Fund's resources—in case a country breaches this obligation. The Guidelines state that, if the Board has approved a country's use of the Fund's resources on the basis of information that turns out to be incorrect, the country is expected to repay the Fund promptly.

10. The Executive Board has agreed (1) to broaden the application of the tools for addressing misreporting when it comes to light, and (2) to make more frequent and systematic use of the legal remedies provided. The staff will return to the Board with detailed proposals for implementation. The Executive Board has also decided to make public appropriate information on each case of misreporting, after the Board has made its determination, and with Board review of the text.

Fund procedures

11. The Fund's procedures for gathering and using information are being reinforced. These procedures have typically been among the institution's strengths, as the process of assembling information to form an overall assessment of the economic situation provides the opportunity to cross-check, question, and refine the information initially received. Staff are taking steps to tighten up procedures further, and in particular to extend existing best practice throughout the institution. They will continue efforts to ensure that the information on which the Fund's decisions are based is the best available.

Conclusion

12. The Fund has been able in the past to rely primarily on trust in member's readiness to provide needed information, and to use the Fund's resources for the purposes envisaged. It should be able to continue to operate on that basis. However, recent cases of misreporting have driven home the need to strengthen the Fund's procedures. The Fund's response to misreporting of information and the misuse of the Fund's resources combines three elements: strengthening safeguards within member countries, broadening the application and making more systematic use of the available legal tools, and strengthening procedures for handling information in the Fund. None of these is necessarily sufficient in itself to prevent misreporting—particularly if such misreporting is intentional. But a combination of action on all three fronts, as agreed by the Executive Board, represents a constructive way of addressing these issues and narrowing the scope for potential problems. This is an extremely serious issue and the Fund is determined to deal with it with the seriousness it deserves.



BUFF/00/48

March 30, 2000

**Summing Up by the Acting Chairman
Strengthening Safeguards on the Use of Fund Resources and
Misreporting of Information to the Fund—Policies, Procedures, and
Remedies—Preliminary Considerations
Executive Board Meeting 00/32
March 23, 2000**

Reliable information is essential to every aspect of the Fund's work—surveillance, financing, and technical assistance—and is particularly important in ensuring that the Fund's resources are used for their intended purposes. As has been the practice over many years, the Fund must depend primarily on trust in members' readiness to provide the information needed and to use the Fund's resources for the purposes envisaged.

While known incidents of misreporting and misuse of the Fund's resources have been rare, many Directors noted recent instances involving allegations of misuse of Fund resources and cases of misreporting, and emphasized the importance of preserving the integrity of the Fund's reputation as a careful and prudent provider of financial assistance to members. Directors agreed that these events further underscore the need to strengthen the Fund's existing safeguards on the use of its resources.

The September 1999 Interim Committee emphasized the importance of strengthening governance at the national and international levels, and in this context called on the Fund to perform an authoritative review of its procedures and controls in order to identify ways to strengthen safeguards on the use of its funds and to report on this review at its next meeting.

In considering strengthened safeguards for the use of Fund resources, Directors noted the importance of the safeguards already in place, in particular program design, conditionality and monitoring, the availability of technical assistance, the transparency and governance initiatives, including the establishment and monitoring of codes and standards, and the recent use of special audits and the SDR-account mechanism in selected cases. They stressed that these areas of Fund operations should continue to play a central role in promoting public sector integrity and accountability, thereby contributing to the safeguarding of Fund resources. Directors also noted that policies on noncomplying purchases are *ex post* in nature, in that they rely on the disincentives of actions taken by the Fund after the fact of misreporting has been established, and they welcomed this opportunity to review relevant aspects of the Fund's legal framework governing misreporting of information to the Fund.

Directors also welcomed the opportunity to consider an approach to assessing the adequacy of member countries' framework of safeguards that could help, *ex ante*, to prevent the possible misuse of Fund resources and misreporting of information. In considering the

staff's proposals, Directors expressed their gratitude to the panel of six eminent outside experts, drawn from the private and public sectors, who had independently assessed these proposals. In light of these proposals, the Board has decided on a number of steps to strengthen key aspects of the Fund's framework for dealing with these issues.

Ex ante Safeguards

Directors generally concurred that the proposed two-stage approach to safeguards assessments could provide an appropriate mechanism to strengthen existing safeguards by assessing a central bank's compliance with a series of desirable practices, rules and regulations regarding internal control procedures, financial reporting, and audit mechanisms. Safeguards assessments of central banks have the objective of providing reasonable assurance to the Fund that the 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. However, Directors remarked that safeguards assessments would not prevent misuse of resources by a willful override of controls or manipulation of data. They noted the view of the panel of experts that safeguards assessments will greatly enhance the ability of central banks to improve their controls, efficiency, and effectiveness, as well as their view that the assessment framework addresses the protection of member shareholders' resources without threatening the cooperative nature of the Fund.

Directors generally endorsed the framework for the conduct of safeguards assessments and, in particular, the focus on member countries' central banks. They agreed that the safeguards framework would include an assessment of the accountability and transparency of foreign reserves management operations assumed by agencies outside the central bank, which is sometimes the case when the fiscal agent for the Fund is not the central bank. Some Directors, however, emphasized the importance of strengthening controls and financial reporting in the government sector, and took note, in this regard, especially of the need to strengthen the quality and reliability of fiscal data and of other information related to performance criteria used in Fund-supported programs. They noted management's intention to strengthen the approach to handling data in the Fund, to which I will refer later.

Directors endorsed the proposal that an important principle of the strengthened safeguards framework become a standard requirement for Fund financial support, namely, that central banks of member countries making use of Fund resources publish annual financial statements independently audited by auditors external to the central banks in accordance with internationally accepted audit standards. In noting their agreement with the staff proposal on external audits based on international quality standards, several Directors underscored the importance of sound risk and reserve management practices, including transactions on an arm's length basis with related parties. They also endorsed the general principle of basing benchmarks on the Fund's Code of Good Practices on Transparency in Monetary and Financial Policies.

A number of Directors noted that, although they agree in principle with the staff's proposals, country-specific circumstances would need to be taken into account in the conduct of safeguards assessments. In this context, Directors stressed the importance of technical

assistance in the implementation of recommendations arising from the safeguards assessments.

In the first stage of the assessment process, the authorities of a member seeking a new *Fund arrangement* would be expected to furnish the Fund with the documents listed in the attachment to this summing up as early as possible, and grant permission for Fund staff to hold discussions with their independent auditors. The staff would review this information to arrive at a preliminary judgment about the adequacy of the central bank's internal control systems, reporting, and internal and external audit mechanisms.

Directors supported the view that if, based on this information, the staff reaches the conclusion that the central bank's control, reporting, and auditing mechanisms appeared adequate for safeguarding Fund resources, no further steps would be undertaken. In other cases, and as a second stage, an on-site review would be undertaken by a multidisciplinary team prior to presentation of the arrangement for Board approval, or in any case no later than the first review.

On the modalities of this second stage, Directors considered that multidisciplinary teams were needed, including experts from central banks and private accounting firms. They generally concurred that the teams should be led by the staff to ensure consistency of the approach and to help achieve a continuous improvement of the assessment methodology. Directors emphasized the importance of confidentiality and the need for close monitoring and guidance of outside experts. They also recognized the confidential nature of safeguards assessment reports and, in this regard, generally agreed that the results of safeguards assessments be made available to the Executive Board in a summary form. At the same time, if requested by Board members, information referred to in the summary reports would be made more fully available by management to the Executive Board in an appropriate format and forum.

Directors considered that the introduction of safeguards assessments requires a differentiation between new and current users of Fund resources. For Fund arrangements approved after June 30, 2000, two requirements would be applied: (i) member countries' central banks would be subject to the two-stage assessment approach described above, with the expectation that in many cases the first stage would suffice, and (ii) as part of the safeguards, central banks would publish annual financial statements independently audited by auditors external to the central banks in accordance with internationally accepted audit standards.

For Fund arrangements in effect before June 30, 2000, Directors endorsed the view that, as a transitional arrangement to minimize resource costs, the two-stage assessment approach would not be applied. However, an important part of the safeguards framework would apply—the audit arrangements in place at central banks would be assessed to determine whether the central banks publish annual financial statements independently audited by auditors external to the central banks in accordance with internationally accepted audit standards. Members with possible disbursements subject to program reviews after September 30, 2000 would be required to furnish the Fund with the documents listed in

points (1) to (3) of the attachment three months before the first program review after September 30, 2000. The staff would review this information to assess the adequacy of the external audit arrangements and report its findings to management. Where improvements were deemed necessary, these and the authorities' response would be reported to the Board in the documentation for the first program review after September 30, 2000.

The resource implications of safeguards assessments would be kept under review and Directors noted management's intention to return to the Board should the resource requirements exceed those available under the Fund's current fiscal year 2001 budget proposals.

Most Directors expressed the view that safeguards assessments should be carried out on an experimental basis and that a review of the Fund's experience with this approach should be undertaken with the involvement of the outside panel of experts within 12-18 months.

Framework for Addressing Misreporting

Directors noted that, while the provision of information to the Fund must continue to be based fundamentally on trust, it should also be governed by a clear set of rules. Many Directors stressed that intentional and unintentional misreporting can have different implications, while others noted that in practice it was often very difficult to make a clear determination between the two. Directors also noted that the application of the rules governing cases of misreporting must take into account the vast differences in capabilities among the Fund's 182 member countries.

Directors considered that, while the Fund's existing legal framework provided a number of tools to address misreporting, many of these tools have not been applied to the full extent possible, and as a result the framework's coverage is to some extent incomplete and outdated. In this light, a number of Directors urged that these tools be applied more effectively. Directors also identified a number of steps that would broaden the applicability of the legal framework in various dimensions.

Some Directors also supported the idea of establishing an independent panel to investigate alleged cases of misreporting. However, a number of Directors were opposed to this idea, with some others observing that additional information, such as on the possible terms of reference and cost of such a panel, would be necessary before they could express a view.

The Misreporting Guidelines

Directors noted that the Misreporting Guidelines under the General Resources Account (GRA) and the Poverty Reduction and Growth Facility (PRGF) have generally been applied by the Fund only to data on performance criteria. Though such criteria are a key aspect of the Fund's ability to assess performance under programs, the Guidelines have generally not been applied to prior actions or to other important information that guides the

Board's decisions to approve arrangements, complete program reviews, or grant waivers. (This information includes, for example, reported initial levels of variables monitored as performance criteria and reported levels of these variables in cases in which waivers for nonobservance or of applicability are granted.) This implies that the Fund has no recourse under the Guidelines in cases in which misreporting of either prior actions or this other information occurs. Coverage of the Guidelines can be broadened within the existing framework of rules by including in such program-related decisions a clear statement of the prior actions and other essential information on the basis of which these decisions are being taken. Directors therefore supported the suggestion that prior actions and other essential information be brought within the scope of the Guidelines in this manner. This will require further consideration of some issues, including whether the approach should be selective or comprehensive, both with regard to country coverage and the set of prior actions included in a program. The staff will return to the Board with a paper elaborating on these issues. Meanwhile, the Fund has the option of including prior actions and other key information in its decisions in any case in which it deems this appropriate.

Directors also noted that the applicability of the Guidelines was constrained by the two-year limitation period. They therefore supported a lengthening of this limitation period, with many favoring an extension to cover the entire period during which relevant purchases or loans are due, and others favoring a more moderate extension.

In addition, Directors observed that the Guidelines at present apply only to Stand-By and Extended Arrangements and to the PRGF, but not to outright purchases in the credit tranches and the Compensatory Financing Facility (CFF). They supported extending the Guidelines to cover such outright purchases. Directors also noted that the treatment of misreporting in the context of assistance provided by the Fund under the Initiative for Heavily Indebted Poor Countries (HIPC) was an important issue that the Board would return to in the future.

Although there are some points of detail that remain to be worked out, the clear sense of the Board is that action is needed to strengthen all three aspects of the Guidelines: first, to apply them to prior actions and other essential information; second, to lengthen the two-year limitation period; and third, to apply them to outright purchases. The staff will return with a paper examining the remaining issues and make specific proposals for the Board's consideration.

Obligations to Provide Information under Article VIII, Section 5

Directors noted that Article VIII, Section 5 permits the Fund to require members to provide information the Fund needs for its work, and stressed that it should be applied in a manner consistent with its relevance to the modern data needs of the institution. In particular, many Directors saw a need to update the set of data members are requested to report to the Fund pursuant to the Articles to correspond more closely to the evolving nature of the Fund's activities. These Directors noted in particular the importance of specifying that members be required to report data on fiscal accounts, the financial sector, and other subjects essential to the Fund, although they cautioned that the Fund's information requirements were certain to

evolve over time, and thus could not be specified once and for all. They also noted that the modalities for a possible broadening of the application of Article VIII, Section 5 would have to be carefully considered to take into account, inter alia, members' varying degrees of ability to provide data, the principle of uniformity of treatment, and the uses to which data are put. A few Directors thought that the staff's interpretation of the legal framework was too restrictive, and that any case in which a member provided inaccurate information should be regarded as misreporting. The staff will return with a paper discussing the modalities for a possible broadening of the application of Article VIII, Section 5, and of course the key question of what data sets members should be required to report, following the Board's discussion of the forthcoming paper on *Data Provision to the Fund*.

Remedial Measures in Cases of Misreporting

The existing framework for misreporting permits the Fund to respond to cases of misreporting as they arise, based on the circumstances of the case, including the seriousness of the misreporting. The available responses include an early repurchase expectation under the Guidelines, and for cases involving a breach under Article VIII, Section 5 a declaration of ineligibility to use the Fund's resources. Many Directors thought it would be useful for the Fund to formulate criteria that could be considered in determining the appropriate remedy to apply under various circumstances. Others cautioned, however, that such criteria could be difficult to specify and could place undue constraints on the Fund in dealing with the complexities and features of individual cases. The staff will give further thought to this and will return to the Board with further considerations.

It was generally agreed that the Fund should publicize cases of misreporting. Many Directors were of the view that this should be the normal expectation only in cases in which misreporting was determined to be intentional. In particular, they were concerned about the possible adverse effects such publicity could have on a member country, and cautioned against excessive use of publicity to punish members that misreport. However, as noted by many Directors, the question of intent is often not clear-cut. On balance, it was agreed that we would proceed to make relevant information public in each case after the Board has made its determination and with Board review of the text.

Data Handling in the Fund

Directors noted that the Fund's procedures for gathering and using information are generally among the institution's strengths, as the process of assembling information to form an overall assessment of the economic situation provides the opportunity to cross-check, question, and refine the information initially received. They also noted, however, that there are some areas in which the Fund's procedures could be made more effective, including by applying existing best practices more consistently throughout the institution. They therefore support the steps being taken by the staff in this regard. Directors noted in particular the staff's ongoing work to strengthen procedures for setting performance criteria by highlighting the most effective and comprehensive definitions of performance criteria with a view to providing models for new arrangements and ensuring that lessons from one country can be transferred to others; and the proposal to attach a detailed technical memorandum of

understanding (TMU) to all programs, defining all performance criteria, the data source for their measurement, and reporting intervals. Directors also welcomed the consideration being given by the staff to promote best practices in reserve management. With respect to strengthening countries' fiscal reporting capacity, Directors supported both a general effort to enhance the quality of fiscal data reporting and a more intensive effort in countries with evident weakness in the accuracy, coverage, or timeliness of fiscal data.

Finally, the Executive Board made clear the importance it attaches to the staff's efforts to ensure the accuracy of information it uses; to pursue the matter when data problems or anomalies arise; and to bring these difficulties to the attention of the Board.

LIST OF INFORMATION/DOCUMENTS TO OBTAIN FROM MEMBER COUNTRY CENTRAL BANKS

1. Copies of audited (or unaudited if no audit is performed) financial statements for the past three years, together with related audit reports.
2. Copies of all management letters issued by the external auditors in connection with their audit of the financial statements for the past three years.
3. Copies of all audit reports (including agreed-upon procedures engagements) issued by the external auditors during the past three years.
4. A description of the central bank's management structure, including the organizational reporting structure.
5. A description of the organizational structure and reporting lines of the internal audit department, including details of the senior management staff in the department and a summary of staff resources (experience and qualifications).
6. A summary of high-level internal controls in place for the banking, accounting, and foreign exchange departments of the central bank.
7. Listing of all reports issued by the internal audit department in the past three years and a summary description of findings. Potentially, copies of reports dealing with operational and financial controls during the same period.
8. Details of the full legal names of any subsidiaries of the central bank, and a description of their business and the nature of their relationship with the central bank. A listing of all correspondent banks.
9. A listing of all accounts held by government agencies with the central bank.
10. Copies of current legislation governing the central bank.