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Statement by Mr. Portugal and Mr. Tombini on Safeguard Assessments (Preliminary)
Executive Board Meeting 02/26
March 14, 2002

1. The safeguarding of the proper use of public resources should be a universal objective of all member countries, independently of the use of Fund money and of the presence of a safeguards assessment mechanism. An IMF safeguards assessment is not, however, the only or even the main instrument to achieve such objective. It is in the interest of every member to keep under periodic review, and to strengthen as needed, its systems of internal and external controls and auditing of the use of public funds in general, including those under the auspices of the central bank. This is a major objective of the countries in our constituency, some of which have already in place robust internal control and external auditing systems.

2. The staff correctly reminds us in paragraph 10 that "the focus of the evaluation is not on the development of international best practice, but on safeguarding IMF resources." Adherence to this principle should guide all future work on safeguards assessment. In reviewing the experience and assessing common vulnerabilities identified, however, the staff sometimes leaves the impression that the aim is not safeguarding of Fund resources, but indeed looking for the establishment of international best practices. This clearly goes beyond the limited objectives approved by the Board. Likewise, the paper leaves, in many instances, the impression that staff is aiming at a broader scope, namely assessing the safeguards of central bank resources in general, beyond what would be necessary to constitute reasonable assurances to safeguard the use of Fund resources. The safeguards assessment framework should not be converted either into an institutional capacity building exercise, which is a necessary but completely different activity, based on a voluntary decision of the member country to request Fund's technical assistance.

3. As the staff acknowledged, while safeguards assessments may inhibit the circumvention of controls, they cannot prevent it. The incidence of misreporting and misuse of Fund resources will not be precluded by the existence and by the strengthening of the safeguards assessment framework. An identified weakness certainly requires prompt remedial action by the part of the member country. This chair supports the transformation of recommendations in conditionality provided that they address key vulnerabilities that endanger Fund resources. On this account, we urge the staff to clarify what is meant by key vulnerabilities in paragraph 66, and based on the experience so far, to exemplify such occurrences.

4. The staff notes in Chapter III an increased awareness among central banks of the need for strong safeguards in the areas of external and internal auditing, financial reporting, and

internal controls, and suggests that this would be a result of the new mechanism of safeguards assessment. At the same time, there has been an increasing concern regarding its own controls by central banks in line with a widespread strengthening of prudential regulation and supervision of financial markets. To disentangle these two effects in order to be able to assess more accurately the value added by the Fund's new assessment framework is not a trivial task.

5. As the staff points out "an independent and high quality external audit of a central bank's financial statements is the most important control to ensure the reliability and completeness of the information contained in the financial statement." In this connection, the staff found that more than half of the transitional assessments concluded that the existing external audit mechanism was in full compliance with the safeguards framework. This is a very positive development that the staff expects to continue in the future.

6. In reviewing the assessment process, the staff identifies a series of weaknesses that would require remedial action. However, the question to be addressed is whether this framework has in fact reduced the probability of misuse of Fund resources. The evidence provided in the report is basically analytical, as the staff takes stock of the most common vulnerabilities identified and draws the potential implications of these vulnerabilities on the safeguarding of Fund resources. Given the infancy of the new framework, however, it is impossible to establish the causation between the framework and the prevention of misuse of Fund resources.

7. The panel of experts suggests that safeguards assessments have enhanced the IMF's reputation and credibility as a prudent lender. The staff adds that the initial findings have demonstrated the importance of staying vigilant in the areas covered by the safeguards assessment framework and proposes that the safeguards policy be adopted as a permanent feature of the IMF's operations. Despite the limited evidence of the contribution of this new framework to reducing the likelihood of misuse and misreporting, we are of the view that the safeguards assessment framework should be transformed into a permanent policy of the Fund. Moreover, we can support some of the recommendations made by staff with a view to refining the existing mechanism.

8. One of the most controversial areas of the safeguards assessment framework relates to the role of the legal structure. The staff draws a series of implications from what are considered to be deficiencies of the legal structure. The room for confusion is large. In this respect, we share staff's concerns that the current operational approach may be too broad, and there is the need to refine the scope of the assessment of the legal structure to refocus it more narrowly on issues that may have a direct causal link to the prevention of misuse of Fund's resources and misreporting. The lack of *de jure* independence of a central bank, for instance, should not be interpreted as vulnerability regarding the safeguards on the use of Fund resources. Even in such a context, an existing legal structure can still provide the statutory assurances for protecting the public resources, safeguarding Fund resources. The potential for confusion in this area of the safeguards assessment should not be underestimated. We, therefore, propose that the area of legal structure, which is subject to

assessment by the Fund, be clearly and narrowly defined to encompass exclusively the legal structure pertaining to internal and external auditing and control and financial reporting.

9. We support the proposition of further developing the diagnostic tools to review the selection of external auditors and the audit rotation policies applied at central banks. As stated before, this chair is of the view that the external auditing area is the most relevant in the whole safeguards assessment framework. It is where the most effective progress can be made in a less intrusive manner, and without an overburden for the IMF staff and resources. Relying as much as possible in external evaluations of central bank's safeguarding policies towards the use of Fund resources and having the capacity to assess the quality of these external evaluators is, in our view, the most promising avenue going forward for developing a sound and cost-effective safeguards policy in the IMF. Along the lines of introducing operational refinements to the existing framework, we could support further development of tools to focus on controls over foreign reserve management and external reporting.

10. We share the staff's view that the existing two stages in the safeguards assessment process have created confusion among both country authorities and IMF staff. Nevertheless, we diverge from the staff that the solution is to consolidate the two-stage approach into one process. We still believe that for many members, the off-site stage (stage one) would be sufficient to properly assess the safeguarding of Fund resources. This appropriateness of a single stage is likely to increase as the Fund completes more assessments. We would submit, for instance, that for countries that have undergone the stage two assessment and that in the future request further financial assistance from the Fund, a one-stage off-sight assessment would be enough. It is useful, therefore, to retain the flexibility of the two-stage process. However, the circumstances that would trigger the stage two should be more flexibly defined. Currently, the staff engages in the stage two only if it cannot reach the conclusion that the existing safeguard mechanism appears adequate to safeguard the Fund's resources. This language may give the impression that the implementation of a stage two is linked to a deficient auditing, control and reporting mechanism. The reason could be, however, that the case is complex and the documentation not well understood to warrant a conclusion at the off-site phase. This language should, therefore, be clarified, but without losing the flexibility of the two-stage process. In this respect, it is also important that Fund staff should exhaust all means by an off-site assessment to the analysis of a member's safeguards structure, such as for instance further consultation with the authorities, before engaging in the second on-site stage. Any difficulties regarding logistic aspects should be promptly addressed by the Fund staff to avoid unnecessarily triggering a second stage.

11. We share staff's concern that a wider dissemination of safeguards reports could create disincentives for central banks to cooperate in providing valuable information to the Fund. We do not share, however, the view expressed by staff in paragraph 49 that public dissemination of matters of interest related to safeguards will aid in the establishment of central bank best practices in these areas. On this account, we recall that the objective here is not to foster best practices, rather to safeguard the use of Fund resources. Therefore, we do not see any grounds for changing the existing communication's policy regarding safeguards assessment.

12. We support the expansion of safeguards assessment to encompass the program's augmentations or Rights Accumulation Programs (RAP). We do not support, however, the contention in paragraph 53 that for "Staff Monitored Programs, central banks should be encouraged to voluntarily undergo a safeguards assessment." Staff-monitored programs do not involve commitment of resources and in some cases do not involve even the perspective of a future commitment, and, therefore, should not be the basis for any recommendation regarding safeguards assessment of Fund resources.

13. In face of the average time required to complete a safeguards assessment, which ranges from one to eight months, we are not too convinced by staff's proposition to retain the current deadline of completion by no later than the first program review. Perhaps a more realistic deadline would be advisable, without undermining the credibility and effectiveness of the mechanism.