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To: Members of the Executive Board

From: The Acting Secretary

Subject: **Safeguards Assessments—Semi-Annual Update**

Attached for the information of Executive Directors is the semi-annual update, for the period to June 30, 2002, on safeguards assessments. It is expected that this paper will be published on the Fund's external website.

Questions may be referred to Mr. Catsambas (ext. 34017) and Ms. Manno (ext. 38175) in TRE.

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INTERNATIONAL MONETARY FUND

Safeguards Assessments—Semi-Annual Update

Prepared by the Treasurer's Department

(In consultation with other Departments)

Approved by Eduard Brau

August 19, 2002

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I. INTRODUCTION

1. At the last review of the safeguards assessment program by the Executive Board, the staff committed to provide semi-annual summary reports covering the results of the program. As the first such report, this document summarizes the status of program work, the findings and results of assessments, and the implementation status of recommendations. Future update reports will be produced semi-annually, as of June 30 and December 31, and will focus primarily on the incremental activities during the six-month period since the previous semi-annual report.

II. THE SAFEGUARDS FRAMEWORK—A SUMMARY

2. On March 14, 2002 the Executive Board adopted, as a permanent feature, the policy of conducting **safeguards assessments of central banks**.¹ The specific objective of safeguards assessments is to provide reasonable assurance to the Fund 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. In particular, safeguards assessments review the adequacy of a central bank's ELRIC² framework, based on a review of documentation provided by the authorities, discussions with the external auditors and, if necessary, on-site assessments.

3. Safeguards assessments apply to all central banks of member countries with arrangements for use of Fund resources approved after June 30, 2000. Central banks of member countries with arrangements in effect prior to June 30, 2000 were subject to transitional assessments, under which only the adequacy of the external audit mechanism was evaluated.

4. At the last review, the Executive Board judged that "the policy has been widely accepted by central banks, and has helped improve their operations and accounting procedures while enhancing the Fund's reputation and credibility as a prudent lender."³ The staff's experience since then continues to support this overall conclusion.

¹ The Executive Board paper, *Safeguards Assessments—Review of Experience and Next Steps* EBS/02/27 (2/19/02), and the panel of experts' paper, *Safeguards Assessments—Review of Experience and Next Steps—Independent Review of the Safeguards Assessments Framework*, EBS/02/28 (2/19/02). These papers are published on the IMF website, without country-specific references.

² The five areas covered by the acronym **ELRIC** are: 1) **E**xternal audit mechanism, 2) **L**egal structure and independence, 3) **f**inancial **R**eporting, 4) **I**nternal audit mechanism, and 5) **s**ystem of internal **C**ontrols.

³ See *The Acting Chair's Summing Up on Safeguards Assessments—Review of Experience and Next Steps*, BUFF/02/43 (3/20/02, revised 4/1/02).

III. IMPLEMENTATION AND STATUS OF RECOMMENDATIONS

A. Progress in the Conduct of Safeguards Assessments

5. Since inception in July 2000, Fund staff has completed 56 safeguards assessments (see Annex), comprising 29 full assessments and 27 transitional assessments, and covering a total of 50 central banks (five central banks have been subject to both a transitional and a full assessment and one central bank has had two⁴ full assessments). The table below indicates the status of the work on safeguards assessments as of June 30, 2002 and provides the comparative figures reported in the Board paper as of February 8, 2002.

**Table 1. Status of Safeguards Assessments
as of February 2 and June 30, 2002**

Status of Assessment	Number As of 2/8/02 ^{1/}	Number As of 6/30/02	Percent As of 6/30/02
Total Assessments	69	79	100.0
of which: Full Assessments Completed	22	29	36.7
Transitional Assessments Completed	25	27	34.2
Assessments in Progress	18	22	27.8
Awaiting Documentation	4	1	1.3

^{1/} As reported in EBS/02/27. Please note that assessments for four countries have been reclassified from completed status to in-progress status as of 2/8/02 due to a streamlining of the safeguards reports from a two-stage process to a one-stage process. Assessments are now classified as being in progress until completion of the final safeguards report, and no interim report is issued.

6. Twenty two safeguards assessments were in progress, at various stages of completion, as of June 30, 2002. In addition, there are 15 assessments to be initiated based on area departments' most recent projections of potential forthcoming arrangements. This figure excludes member countries with a Staff Monitored Program (SMP), and with credit outstanding to the Fund, but no active arrangement. These member countries are not required to undergo a safeguards assessment, although they may voluntarily request an assessment, either under the SMP or in conjunction with an Article IV consultation. So far, no such request has been received.

7. Of the assessments in progress at June 30, 2002, three assessments have since been finalized, four assessments are in the report finalization stage⁵ and three assessments are

⁴ Central banks are subject to a full safeguards assessment in respect of every arrangement approved after June 30, 2000. Where a previous safeguards assessment has only recently been completed, the safeguards assessment for a new arrangement is based primarily on the previous assessment, i.e., the new safeguards assessment updates the findings and conclusions of the previous assessment.

⁵ Argentina, Bangladesh, Nepal, and Uruguay.

either currently being completed or shortly to be completed through an on-site mission.⁶ The remaining twelve assessments in progress will comprise a significant part of the work program over the next six months. The pace of missions has been high—missions were conducted for 17 (or 59 percent) of the 29 full assessments completed as of June 30, 2002. In the other 12 cases, sufficient information was available through correspondence to form a conclusion on safeguards without the need to verify information on-site. However, an inherent risk exists that different conclusions may have been drawn from information that would have been brought to light during an on-site assessment. For this reason, an on-site visit is particularly useful for the initial assessment of a central bank, or for the subsequent assessment in cases where the initial assessment was conducted through correspondence.

8. On the other hand, on-site assessments incur incremental costs. It is estimated that staff costs for off-site and on-site assessments are broadly similar given the longer completion times and multiple iterations involved in an off-site assessment, balanced against the more efficient concentrated staffing of an on-site assessment. Therefore, the incremental costs of an on-site assessment consist of the direct travel costs, averaging close to \$40,000 per mission over the two-year period FY2001-FY2002. However, the direct cost of a mission is only one of several factors weighed in the decision to conduct an on-site assessment, as this determination is made on a case-by-case basis and with inter-departmental collaboration. Most importantly, experience to date has shown that on-site assessments tend to yield a greater probability of reforms being undertaken, increasing the overall effectiveness of the assessment. Some of the other qualitative considerations supporting an on-site assessment include: (i) significant outstanding issues or questions that cannot be resolved off-site, (ii) specific detailed data that is impractical to review off-site, (iii) the opportunity of an open dialogue with central bank representatives and in-depth meetings with multiple parties, and (iv) the timing of the approval of the arrangement and the related need for the timely and efficient completion of the assessment.

B. Findings and Issues

9. As a diagnostic tool, the primary purpose of safeguards assessments is to identify vulnerabilities in a central bank's safeguards that could lead to possible misreporting to the Fund or misuse of central bank resources, including Fund disbursements. Table 2 provides a summary of the findings of safeguards assessments as of June 30, 2002 for countries both with arrangements in effect prior to June 30, 2000 (transitional assessments) and for those with arrangements approved since that date.

⁶ Gambia, Macedonia, (FYR), and Vietnam.

Table 2. Main Findings of Safeguards Assessments

Findings ^{1/}	Number of Countries as of 6/30/02	Denominator ^{2/}	Percent of Assessments as of 6/30/02	Percent of Assessments as of 2/8/02 ^{3/}
1. Non-existent or Deficient External Audit Mechanism	33	54	61	67
2. No, or Delayed, Publication of Audited Financial Statements	22	54	41	41
3. Poor Controls over Foreign Reserves and Data Reporting to the IMF	16	32	50	54
4. Inadequate Accounting Standards	25	32	78	88
5. Deficient Governance Oversight	24	32	75	77
6. Loopholes in Governing Legislation	16	32	50	50
7. Deficient Internal Audit	27	32	84	88
8. Inadequate Accounting for IMF Transactions	10	32	31	35

^{1/} The categories of findings are identical to those defined and reported in EBS/02/27.

^{2/} Because transitional assessments are limited to determining the adequacy of the external audit mechanism of the central bank, only the first two categories are applicable to these assessments. For those countries with two assessments, the denominator includes deficiencies from the most recent assessment (Albania, Bulgaria, Latvia, Lithuania, Romania, and Turkey). The denominator also includes four assessments for which a preliminary report, including findings, was issued but the final report is not completed (Guinea, Lao PDR, Macedonia, (FYR), and Vietnam).

^{3/} As reported in EBS/02/27.

10. At the time of the last review by the Executive Board, the most common deficiencies, defined as those found in more than 50 percent of the assessments, included: (i) inadequate external audit mechanisms, (ii) poor controls over foreign reserves and data reporting to the IMF, (iii) inadequate accounting standards, (iv) non-existent or weak oversight by central bank Boards, and (v) deficient internal audit mechanisms. To date, the main deficiencies remain similar; however, the percentage of assessments with the relevant finding has decreased in all categories, based on completed assessments through June 30, 2002. While the number of additional assessments conducted between the two dates may be too small to draw firm conclusions, there seems to be some anecdotal evidence that reforms are now being undertaken by some central banks prior to the conduct of an assessment by the staff.

11. Nevertheless, several instances of significant weaknesses in central bank safeguards were encountered in the past few months. These included errors in recording and reporting of net international reserves (NIR), a key program monitoring criterion.⁷ In other cases, staff noted, *inter alia*, the lack of an external audit of the central bank, or a deficient audit by a state auditor.

⁷ However, none of these overstatements resulted in noncomplying purchases/disbursements under the Guidelines on Misreporting.

C. Monitoring of Safeguards Assessment Recommendations

12. **Monitoring of safeguards assessment recommendations formally commenced when the safeguards policy became permanent in March 2002.** Since then a monitoring system has been established and staff has begun to monitor the implementation of recommendations through multiple channels, including obtaining action plans from the central banks, receiving assistance from area and functional departments, and reviewing follow-up documentation received. In a few cases, monitoring through follow-up missions will be necessary to ascertain the level of implementation of critical recommendations, but the extent to which this approach is needed remains to be seen.

13. Staff has not yet been able to verify the status of implementation for the backlog of assessments conducted during 2000 and 2001. Within the next six months, staff plans to review the status of implementation of recommendations for each of the completed assessments and will report to the Board in the next update report. In the interim, staff's analysis has focused on those high-priority recommendations which became program conditionality for countries with active programs. Thirty four recommendations with implementation dates on or before June 30, 2002 were incorporated in program conditionality and 29 (nearly 85 percent) have been fully implemented. Implementation of the remaining five measures has been delayed by practical considerations, including increased lead times and the resolution of potential legal obstacles. In all cases, the Executive Board has either completed the review under the arrangement, notwithstanding the delay in implementation, or the review has yet to be presented to the Executive Board for completion. These measures, together with measures falling due in the next few months, will be closely monitored by staff and the results reported to the Executive Board in the next update report.

IV. SAFEGUARDS ASSESSMENT COORDINATION AND COMMUNICATION

14. The completion of 56 safeguards assessments in the Fund since June 2000 has broadened awareness of the safeguards assessment policy and its implications, both within the Fund and among member countries. Following the Executive Board's review of the safeguards policy in March 2002, staff has continued to intensify communication and coordination during the safeguards process. Since then, cooperation has been strengthened through the use of inter-departmental planning sessions for safeguards missions, greater overlap of safeguards missions with area department staff, and coordination of meetings with area departments when authorities visit headquarters.

15. Nonetheless, there are opportunities for further communication and dissemination of information on the safeguards policy. In April 2002, the Treasurer's Department provided information to central banks, international organizations, and accounting firms on the safeguards assessment policy. The Treasurer's Department is currently evaluating several options for a seminar or workshop for central bank officials on safeguards assessments and is continuing to explore other avenues of outreach. Also, staff is pursuing the possible establishment of an IMF Institute course on safeguards assessment.

Safeguards Assessments Completed as of June 30, 2002

Safeguards Assessments cover five key areas of control and governance within central banks, summarized by the acronym ELRIC: (i) the External audit mechanism; (ii) the Legal structure and independence; (iii) the financial Reporting framework; (iv) the Internal audit mechanism; and (v) the internal Controls system. Countries with arrangements in effect prior to June 30, 2000 were subject to a transitional assessment that evaluated only the external audit mechanism. Assessments completed as of June 30 are set out below:

Full Assessment		Transitional Assessment	
Country	Date completed	Country	Date completed
Albania 1/	June 28, 2002	Argentina	March 7, 2001
Albania	March 15, 2001	Bolivia	October 19, 2000
Armenia	February 19, 2002	Bosnia/Herzegovina	April 12, 2001
Azerbaijan	March 8, 2002	Bulgaria 1/	March 21, 2001
BCEAO	March 4, 2002	Cambodia	August 1, 2001
BEAC	July 20, 2001	Colombia	May 28, 2001
Brazil	June 14, 2002	Djibouti	July 24, 2001
Bulgaria	June 12, 2002	Estonia	December 13, 2000
El Salvador	February 6, 2002	Ghana	October 31, 2001
Ethiopia	September 6, 2001	Guyana	December 5, 2001
Georgia	January 24, 2002	Honduras	May 2, 2001
Kenya	January 30, 2001	Indonesia	April 5, 2002
Kyrgyz Republic	January 18, 2002	Jordan	May 22, 2001
Latvia	October 25, 2001	Latvia 1/	October 25, 2000
Lesotho	July 2, 2001	Lithuania 1/	November 6, 2000
Lithuania	December 10, 2001	Mauritania	April 9, 2002
Madagascar	November 12, 2001	Mozambique	October 11, 2001
Malawi	July 12, 2001	Panama	July 12, 2001
Moldova	June 12, 2002	Papua New Guinea	May 4, 2001
Mongolia	March 4, 2002	Romania 1/	December 1, 2000
Nicaragua	December 7, 2001	São Tome & Príncipe	February 6, 2001
Nigeria	November 28, 2001	Tanzania	April 3, 2001
Pakistan	February 1, 2001	Turkey 1/	August 21, 2001
Peru	July 26, 2001	Ukraine	January 30, 2001
Romania	May 13, 2002	Uruguay	October 19, 2000
Sri Lanka	August 24, 2001	Yemen	May 23, 2001
Tajikistan	November 21, 2001	Zambia	July 2, 2001
Turkey	March 22, 2002		
Yugoslavia	November 29, 2001		

1/ Two full assessments have been completed for Albania in respect of two IMF arrangements since the inception of the safeguards policy. Both a transitional and a full assessment have been completed for Bulgaria, Latvia, Lithuania, Romania and Turkey.