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March 7, 2003

To: Members of the Executive Board

From: The Secretary

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

Attached for the **information** of Executive Directors is the semi-annual update, for the period to December 31, 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. M. Manno (ext. 38175) in TRE.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND
Safeguards Assessments—Semi-Annual Update

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In consultation with other Departments

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March 6, 2003

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I. OVERVIEW

1. At the last review of the safeguards assessment program by the Executive Board,¹ the staff committed to provide semi-annual summary reports covering the activities and results of the program. The first such report was issued in August 2002.² This document updates the status of program work since inception of the policy and provides information on activities during the six-months ended December 31, 2002. Box 1 highlights the main features of the safeguards policy.

2. As foreshadowed in the previous semi-annual update (SM/02/268), the focus of staff work under the program has been shifting towards the monitoring of safeguards recommendations, balanced against the need to continue to conduct safeguards assessments related to new use of Fund resources. Between June and December 2002, staff has made significant progress in verifying the status of implementation for the backlog of assessments conducted during 2000 and 2001, while at the same time completing eight new safeguards assessments. Section II provides statistical information on (i) the implementation rates for safeguards assessment recommendations, (ii) the status of assessments, and (iii) the findings of safeguards assessments.

3. Overall, staff continues to find that safeguards assessments and the resulting recommendations are well received by member countries. However, experience over the past six months also demonstrates that cooperation among individual countries can vary significantly. Section III provides specific examples of the achievements and challenges in the conduct of safeguards assessments, and Section IV summarizes the outreach activities undertaken by staff to enhance communication and dissemination of information on the safeguards policy.

¹ See *Safeguards Assessments—Review of Experience and Next Steps* EBS/02/27 (2/19/02); *Safeguards Assessments—Review of Experience and Next Steps—Independent Review of the Safeguards Assessment Framework*, EBS/02/28 (2/19/02); and *The Acting Chair's Summing Up on Safeguards Assessment—Review of Experience and Next Steps*, BUFF/02/43 (3/20/02, revised 4/1/02).

² *Safeguards Assessments—Semi-Annual Update* SM/02/268 (8/20/02).

Box 1. Safeguards Assessment Policy—A Summary

- *Approved by the Executive Board as a permanent policy on March 14, 2002.*
- *Objective of Safeguards Assessments*
 - 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.
- *Applicability of Safeguards Assessments*
 - central banks with arrangements for use of Fund resources approved after June 30, 2000;
 - transitional assessments of only external audit mechanism for member countries with arrangements in effect prior to June 30, 2000;
 - not applicable to emergency assistance, first credit tranche purchases and stand-alone CFFs;
 - voluntary for members with Staff Monitored Programs.
- *Scope of Policy - **ELRIC***
 - the **E**xternal audit mechanism;
 - the **L**egal structure and independence;
 - the financial **R**eporting framework;
 - the **I**nternal audit mechanism;
 - the internal **C**ontrols system.

II. STATISTICAL UPDATE

A. Implementation of Recommendations

4. Table 1 provides a summary of the status of recommendations made to remedy vulnerabilities with due dates on or before December 31, 2002 and with a breakdown of recommendations included or not under program conditionality and commitments under the Letter of Intent(LOI)/Memorandum of Economic and Financial Policies (MEFP).³

³ Remedial measures that address high risk to Fund resources are typically included under program conditionality. Program conditionality, as defined here, includes prior actions, structural performance criteria and structural benchmarks.

Table 1. Status of Safeguards Assessments Recommendations
(as of December 31, 2002)

	Number	Implementation Rate (Percent)
Total Recommendations with due dates on or before 12/31/2002	275	63.3
1. Recommendations with Formal Commitment from the Authorities	62	-
a. Under Program Conditionality	31	-
<i>of which: Implemented</i>	<i>(28)</i>	<i>90.3</i>
<i>Not Implemented</i>	<i>(3)</i>	-
b. LOI/MEFP Commitments	31	-
<i>of which: Implemented</i>	<i>(26)</i>	<i>83.9</i>
<i>Not Implemented</i>	<i>(5)</i>	-
2. Recommendations Not Under Program Conditionality or LOI/MEFP Commitments	213	-
<i>Of which: Implemented</i>	<i>(120)</i>	<i>56.3</i>
<i>Not Implemented</i>	<i>(93)</i>	-

5. Of the 275 recommendations with due dates on or before December 31, 2002 less than one quarter were included under program conditionality or letters of intent/MEFPs. Staff experience has shown it is important to analyze not only formal conditionality, but also LOI/MEFP commitments as both represent explicit pledges to implement the measures on the part of the member country. The overall rate of implementation for all recommendations was about 63 percent. As expected, the rate of implementation for measures in which the authorities have formally demonstrated ownership, either through commitments in the LOI/MEFP or under program conditionality, remained high. Measures included under conditionality have the highest rate of implementation at over 90 percent, followed by those for which formal commitment of the authorities has been obtained in the LOI/MEFP, which had an implementation rate of about 84 percent. Implementation of the remaining eight measures (three under formal conditionality and five under LOI/MEFP commitments) has been delayed due to slippages in the programs. In all but one case, the Executive Board has completed the review under the arrangement, notwithstanding the delay in implementation.

6. In contrast to those recommendations on which formal commitment to implement has been obtained, the measures not included under conditionality or LOI/MEFPs have a lower implementation rate of about 56 percent. The recommendations not yet implemented

represent a range of situations including: (i) lower-priority items which do not pose a continuing risk to Fund resources and were not included under conditionality; (ii) recommendations substantially, but not yet fully, complete; (iii) recommendations under non-active programs; and (iv) recommendations for which the authorities' actions have not fulfilled the requirements in the way the staff intended. Specific achievements in implementation, as well as challenges represented by recommendations not yet implemented, are further discussed in Section III.

B. Status of Assessments

7. Safeguards assessments have continued at a steady pace. As shown in Table 2 and the Annex, since inception of the safeguards policy in July 2000, Fund staff has completed 64 safeguards assessments, comprising 37 full assessments and 27 transitional assessments. These assessments covered a total of 56 central banks, as seven central banks have been subject to both a transitional and a full assessment and one central bank had two full assessments.⁴ Eight full assessments were completed in the six month period ended December 30, 2002: Argentina, Bangladesh, Bosnia & Herzegovina, Cape Verde, Guinea, Guatemala, Nepal and Sierra Leone. All of these assessments were completed by the deadline under the safeguards policy, namely the first review by the Executive Board of the respective arrangement with the Fund.⁵

**Table 2. Status of Safeguards Assessments
as of June 30, 2002 and December 31, 2002**
(cumulative since July 2000)

Status of Assessment	Number As of 6/30/02	Number As of 12/31/02	Percent As of 12/31/02
Assessments Completed	56	64	100.0
of which: Full Assessments Completed	29	37	57.8
Transitional Assessments Completed	27	27	42.2
Assessments in Progress	22	23	-

⁴ Central banks are subject to a full safeguards assessment in respect of every arrangement approved after June 30, 2000. If a previous safeguards assessment was completed, the safeguards assessment for a new arrangement updates the findings and conclusions of the previous assessment. To date, only Albania has had two full assessments.

⁵ Arrangements for use of Fund resources have not yet been approved for Bangladesh and Nepal.

8. Of the 37 full assessments completed, on-site assessments were conducted in 23 (or 62 percent) of the central banks. In the remaining 14 assessments, sufficient information was available through correspondence and communication with the authorities and the external auditors to form a final conclusion on safeguards without the need to verify the risks on-site. While on-site assessments incur incremental costs, experience to date suggests that assessments with on-site visits tend to be more effective, as measured by the rate and timeliness of reforms undertaken by central banks. The principal reasons behind this conclusion are: (i) significant outstanding issues or questions may not be easily resolved off-site because they require confirmation of procedures, observation of practices, and further review of detailed documents; (ii) on-site assessments afford the opportunity of an open dialogue with central bank representatives and in-depth meetings with multiple parties; and (iii) on-site assessments frequently overlap with area department missions and lead to an efficient collaboration between TRE and other Fund departments, especially in cases requiring measures under program conditionality.

9. At end-December 2002, 23 safeguards assessments were in progress at various stages of completion. Of these, four assessments have since been finalized,⁶ and four are in the report finalization stage.⁷ The remaining 15 assessments will comprise a significant part of the work program over the next six months.

C. Findings

10. Safeguards assessments are a diagnostic tool, whose primary purpose is to identify and remedy 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 3 provides a summary of the findings, including major and less significant deficiencies, of safeguards assessments as of December 31, 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 Congo (Democratic Republic of), Croatia, Paraguay and Uruguay.

⁷ Eastern Caribbean Central Bank, Lao (PDR), Uganda, and Vietnam.

Table 3. Main Findings of Safeguards Assessments
(as of December 31, 2002)

Findings in order of significance ¹	Number of Central Banks	Applicable number of assessments ³	Percent of Central Banks
	(1)	(2)	(3)=(1)/(2)
1. Non-existent or Deficient External Audit Mechanism ²	36	59	61
2. No, or Delayed, Publication of Audited Financial Statements ²	26	59	44
3. Poor Controls over Foreign Reserves and Data Reporting to the IMF	19	39	49
4. Inadequate Accounting Standards	32	39	82
5. Deficient Governance Oversight	28	39	72
6. Loopholes in Governing Legislation	17	39	44
7. Deficient Internal Audit	31	39	79
8. Inadequate Accounting for IMF Transactions	12	39	31

¹Categories of findings are identical to those reported in EBS/02/27. For countries with two assessments, the calculation is based on the most recent assessment. Findings are also included for three special cases where the assessment is substantially complete, but the final safeguards report has not yet been issued (Lao (PDR), Macedonia (FYR), and Vietnam).

²Because 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.

³The applicable number of assessments reconciles with the statistics in Table 2 as follows: 64 total assessments less 8 countries with two assessments (see Annex) plus three special cases=59; 37 full assessments less 1 country with two full assessments (Albania) plus three special cases=39.

11. Two and a half years into the safeguards assessment policy, assessments continue to reveal deficiencies in key areas of central banks. The five **most common deficiencies** are broadly the same as those found in the earlier review and update under the policy and include (in order from most to least common): (i) inadequate accounting standards, (ii) deficient internal audit mechanisms, (iii) deficient governance oversight, (iv) non-existent or deficient external audit mechanisms, and (v) poor controls over foreign reserves and data reporting to the IMF. In terms of these findings, some categories have a one-to-one correspondence to the ELRIC framework (i.e. “loopholes in governing legislation” is applicable only to the “L” category of ELRIC), while others transcend any one classification. For example, the category of “Deficient Governance Oversight” encompasses not only deficiencies in the legal governance structure, but also control deficiencies that result from the absence of an effective oversight body for the external or internal audit functions in the central bank. Furthermore, the specific findings included in each of the categories in Table 3 may not **individually** pose a risk to Fund resources; however, when considered together with other individual findings,

they could pose a risk. Annex II provides examples of some of the types of findings included in each of the categories in Table 3.

12. Of the eight assessments completed since June 2002, **significant weaknesses** in central bank safeguards were noted in seven of the assessments. In the case of these types of deficiencies, staff has proposed conditionality under the arrangement with the member. Examples of the deficiencies revealed by the assessments, together with the remedy and the type of conditionality proposed by staff are:

- two central banks with *no independent external audit* will be asked to appoint an independent external audit firm – (Proposed conditionality: Prior Action);
- six central banks *without an adequate financial reporting framework* will be asked to adopt and implement such a framework – (Proposed conditionality: Prior Action or Structural Benchmark);
- six central banks with *significant weaknesses related to reserves management* will be asked to implement various remedies ranging from conducting a special audit to developing reconciliation procedures and restructuring the reserve management function – (Proposed conditionality: Prior Action or Structural Benchmark);
- a central bank with *no functioning internal audit* will be asked to develop this function, with technical assistance from the Fund – (Proposed conditionality: Structural Benchmark).

13. Implementation of these recommendations within a timeframe agreed with the respective central banks will be monitored by staff until satisfactory implementation.

III. SAFEGUARDS—ACHIEVEMENTS AND CHALLENGES

14. The safeguards assessment work conducted to date has revealed both achievements of the policy and challenges that can arise in implementation of the recommendations. Central banks have generally been receptive to safeguards assessments and to the proposed remedies for the mitigation of weaknesses. Central banks have also been cooperative in providing their annual audited financial statements and related audit reports, as required under the policy. Moreover, there has been a positive trend since inception of the policy in the interest and knowledge of central bank management in safeguards assessments. This type of interest is signified by one particular case during the past six months, where the **central bank requested an on-site assessment** and seized the opportunity of the assessment to reinforce among its staff the importance of an effective control environment. In another central bank, the hiring of an external audit firm to supplement the work of the State Auditor resulted in **identification of additional vulnerabilities** and commitment by the central bank to undergo future audits in specialized areas of bank operations.

15. Central bank acceptance and implementation of recommendations that have a permanent impact on controls and operations are considered major achievements of the safeguards assessment policy. Selected examples of such measures to date include:

- **The reconciliation of economic data reported to the Fund with the underlying accounting records** of the central bank is now recognized as an essential control in the accuracy of data reported under Fund-supported programs⁸ and has become a permanent aspect of central bank operations in those central banks in which this control procedure did not previously exist;
- The importance of having an **independent external audit firm** conduct an audit in accordance with international standards has become widely accepted by central banks, even in geographic regions where other audit models were previously the norm;
- The **transparency and consistency of financial reporting** have been widely improved with the recognition by most central banks of the importance of adopting an internationally accepted reporting framework, and publication of the audited financial statements.

16. Despite the achievements to date, challenges remain. A few central banks initially resisted the safeguards assessment process or had not been receptive to adopting appropriate solutions to address identified vulnerabilities, although in the end virtually all have cooperated to a substantial degree. In one case, however, the Executive Board review of a Fund-supported program has not yet been completed due to lack of agreement with the central bank on the safeguards recommendations.⁹

17. Some challenges also exist with respect to implementation of recommendations. As a matter of policy, staff monitors the implementation of all recommendations made under a safeguards assessment, although high priority items are the main focus. The rationale for this approach is twofold: (i) some measures, if not implemented, may evolve to a higher priority level, especially if the delay in implementation is protracted, and (ii) it may be important that several measures, not individually considered high priority, be implemented concurrently or consecutively in order to effectively address a risk. As shown in Table 1, not all recommendations have been implemented as intended by the safeguards assessment and in

⁸ Fund staff monitoring the arrangement continue to review and analyze the economic data for discrepancies and compliance with the Technical Memorandum of Understanding, in addition to central banks reconciling the data with the accounting records as a basic control prior to submission to the Fund.

⁹ In this case, staff and management made a determination not to present the review to the Executive Board; the matter was discussed at an Informal Country Session where support for the requirements of the safeguards policy was voiced by most speakers.

some cases there are protracted delays in implementation. The approach by staff to resolve these matters has involved: (i) proposed stronger conditionality for the next review of the arrangement where implementation of the measure is considered critical, (ii) a proposal to incorporate a recommendation under conditionality or in the LOI/MEFP that was originally not included, and (iii) communication with the area department and the authorities to clarify the further actions needed for satisfactory implementation. In most cases, this approach is expected to resolve the issue, especially where the member country has an active arrangement and the opportunity exists to invoke stronger conditionality. Implementation of measures in member countries without an active arrangement tends to be more problematic as the opportunity for inclusion of the measure under conditionality is not available. Staff monitors these cases closely, even in the absence of a Fund-supported arrangement, but the probability of implementation within the original timeframe is often diminished.

IV. SAFEGUARDS ASSESSMENT OUTREACH

18. In the March 2002 review of the safeguards assessment policy, the Executive Board endorsed a continued focus on communication and coordination of matters of interest related to safeguards, both internally and external to the Fund. Staff has pursued, and will continue to pursue, opportunities for further communication and dissemination of information on the safeguards policy. Examples of initiatives undertaken in the past six months are as follows:

- The IMF Institute, in coordination with TRE, developed an INS course on safeguards assessments. The initial delivery of the course took place in Singapore in January 2003 and was very well received by 29 participants from 20 central banks. Courses are planned for the Joint Vienna Institute in March 2003 and the Joint Africa Institute in June 2003.
- A presentation on safeguards assessments was given at a seminar entitled “Risk Management for Central Bankers” held in Cambridge, England in September 2002, which was attended by 27 delegates from 18 central banks.
- Presentations on safeguards assessments have been given to several central bank delegations visiting Washington, DC.
- A number of external publications on the safeguards policy and central bank accounting have been completed.
- Safeguards assessments were one of several key topics discussed by staff in a meeting of Controllers of Multilateral Development Banks in December 2002.

19. These activities have confirmed a strong interest among central banks and the international community in safeguards-related issues. In March 2002, the Executive Board judged that “the [safeguards] 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.” The staff’s experience, both during the conduct of safeguards assessments and as a result of outreach activities, continues to support this overall conclusion.

Safeguards Assessments Completed as of December 31, 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 December 31, 2002 are listed below:

Full Assessments			
Country	Date completed	Country	Date completed
Albania ¹	June 28, 2002	Kyrgyz Republic	January 18, 2002
Argentina	September 5, 2002	Latvia	October 25, 2001
Armenia	February 19, 2002	Lesotho	July 2, 2001
Azerbaijan	March 8, 2002	Lithuania	December 10, 2001
Bangladesh	September 20, 2002	Madagascar	November 12, 2001
BCEAO	March 4, 2002	Malawi	July 12, 2001
BEAC	July 20, 2001	Moldova	June 12, 2002
Bosnia and Herzegovina	October 28, 2002	Mongolia	March 4, 2002
Brazil	June 14, 2002	Nepal	September 3, 2002
Bulgaria	June 12, 2002	Nicaragua	December 7, 2001
Cape Verde	December 9, 2002	Nigeria	November 28, 2001
El Salvador	February 6, 2002	Pakistan	February 1, 2001
Ethiopia	September 6, 2001	Peru	July 26, 2001
Georgia	January 24, 2002	Romania	May 13, 2002
Guatemala	August 9, 2002	Sierra Leone	July 29, 2002
Guinea	July 11, 2002	Sri Lanka	August 24, 2001
Kenya	January 30, 2001	Tajikistan	November 27, 2001
		Turkey	March 22, 2002
		Yugoslavia	November 29, 2001
Transitional Assessments			
Country	Date completed	Country	Date completed
Argentina ¹	March 7, 2001	Latvia ¹	October 25, 2000
Bolivia	October 19, 2000	Lithuania ¹	November 6, 2000
Bosnia/Herzegovina ¹	April 12, 2001	Mauritania	April 9, 2002
Bulgaria ¹	March 21, 2001	Mozambique	October 11, 2001
Cambodia	August 1, 2001	Panama	July 12, 2001
Colombia	May 28, 2001	Papua New Guinea	May 4, 2001
Djibouti	July 24, 2001	Romania ¹	December 1, 2000
Estonia	December 13, 2000	São Tome & Príncipe	February 6, 2001
Ghana	October 31, 2001	Tanzania	April 3, 2001
Guyana	December 5, 2001	Turkey ¹	August 21, 2001
Honduras	May 2, 2001	Ukraine	February 3, 2001
Indonesia	April 5, 2002	Uruguay	October 19, 2000
Jordan	May 22, 2001	Yemen	May 23, 2001
		Zambia	July 2, 2001

¹ Two full assessments have been completed for Albania in respect of two IMF arrangements since the inception of the safeguards policy; the earlier one was completed in March 2001. Both a transitional and a full assessment have been completed for Argentina, Bosnia and Herzegovina, Bulgaria, Latvia, Lithuania, Romania and Turkey.

Safeguards Assessments –Examples of Findings

Non-existent or Deficient External Audit Mechanism:

- (i) non-adherence to auditing standards;
- (ii) insufficient experience or qualifications of external auditors;
- (iii) inadequate or only non-financial (operational or compliance) audits conducted by a State Auditor or equivalent.

No, or Delayed, Publication of Audited Financial Statements:

- (i) non-publication of complete set of financial statements;
- (ii) non-publication of the audit report;
- (iii) delays of at least a year in publication of the financial statements.

Poor controls over Foreign Reserves and Data Reporting to the Fund:

- (i) non-reconciliation of audited foreign reserves balances to net foreign asset data reported to the Fund;
- (ii) inaccurate or incomplete record keeping;
- (iii) inadequate procedures to ensure the accurate valuation of foreign reserves.

Inadequate Accounting Standards:

- (i) absence of a benchmark framework;
- (ii) inadequate explanatory notes;
- (iii) inappropriate accounting treatment of certain balances.

Deficient Governance Oversight:

- (i) over-reliance on Governor for decision-making and oversight;
- (ii) lack of monitoring and follow-up of internal and external audit recommendations by management;
- (iii) absence of an audit committee or equivalent oversight body.

Loopholes in Governing Legislation:

- (i) lack of clarity in statutory provisions governing ownership and management of reserves;
- (ii) weaknesses in the legal provisions related to appointment or dismissal of central bank officials;
- (iii) weaknesses in the legal provisions related to the financial reporting framework or external audit.

Deficient Internal Audit:

- (i) insufficient expertise or qualifications;
- (ii) lack of independence from operational activities;
- (iii) narrow scope of work.

Inadequate Accounting for IMF Transactions:

- (i) no disclosure of liability to the IMF;
- (ii) non-revaluation of IMF accounts;
- (iii) late payments to the IMF resulting from internal control deficiencies.