

**IMMEDIATE
ATTENTION**

SM/03/298

August 22, 2003

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, 2003, on safeguards assessments.

It is intended that this paper will be published on the Fund's external website. If no objections are received by **noon on Friday, August 29, 2003**, the paper will be posted.

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

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

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INTERNATIONAL MONETARY FUND

Safeguards Assessments—Semi-Annual Update

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In consultation with other Departments

Approved by Eduard Brau

August 21, 2003

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I. OVERVIEW

1. The safeguards assessment policy was reviewed by the Executive Board last year.¹ Since then, staff has prepared semi-annual summary reports on the activities and results of the program.² This third summary report provides an update on the status of program work, the results of assessments completed in the first six months of 2003, and the implementation status of recommendations as of June 30, 2003. Box 1 highlights the main features of the safeguards policy.

2. **Fourteen assessments were completed during the period December 31, 2002 to June 30, 2003.** Section II provides statistical information on the status of assessments and the implementation rates for safeguards assessment recommendations. Section III describes the results of safeguards assessments over the six month period ended June 30, 2003, including examples of specific findings. Section IV summarizes the outreach activities undertaken by staff to enhance communication and dissemination of information on the safeguards policy.

3. **The safeguards policy continues to yield positive results.** The results of assessments finalized in the six months since December 31, 2002 are broadly consistent with previous findings, although the extent of the identified weaknesses has narrowed. As reflected by the high implementation rate of safeguards recommendations, central banks remain receptive to the assessments and the proposed remedies for the mitigation of weaknesses.

II. STATISTICAL UPDATE

A. Status of Assessments

4. In the six month period December 31, 2002 to June 30, 2003, new assessments were finalized for 14 member countries, namely Bolivia, Colombia, Democratic Republic of Congo, Croatia, Eastern Caribbean Central Bank (for Dominica), Ecuador, Guyana, Jordan, Laos, Macedonia, Paraguay, Rwanda, Uganda and Uruguay. All of these assessments were completed by the deadline required under the safeguards policy, i.e., the first review by the Executive Board of the respective arrangement with the Fund.³

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 The second such report was issued in March 2003: *Safeguards Assessments—Semi-Annual Update* SM/03/88 (3/7/03).

³ An arrangement for use of Fund resources has not yet been approved for Paraguay.

Box 1. Safeguards Assessment Policy—A Summary¹

- *Policy approved by the Executive Board on March 14, 2002, following a two year experimental period.*
- *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 and Fund disbursements, are adequate to ensure the integrity of financial operations and reporting to the Fund.
- *Applicability of Safeguards Assessments*
 - central banks of members with arrangements for use of Fund resources approved after June 30, 2000;
 - transitional assessments of external audit mechanism only for member countries with arrangements in effect prior to June 30, 2000;
 - also to existing arrangements that are augmented, and member countries following a Rights Accumulation Program (RAP), where resources are being committed;
 - not applicable to emergency assistance, first credit tranche purchases and stand-alone CFFs;
 - voluntary for members with Staff Monitored Programs.
- *Scope of Policy – ELRIC of a Central Bank*
 - the **E**xternal audit mechanism;
 - the **L**egal structure and independence;
 - the **f**inancial **R**eporting framework;
 - the **I**nternal audit mechanism;
 - the **i**nternal **C**ontrols system.

¹ See also <http://www.imf.org/external/np/tre/safegrds/complete/index.asp>

5. Since inception of the safeguards policy staff has completed 79 safeguards assessments, comprising 52 full assessments and 27 transitional assessments (see Table 1 and the Annex). These assessments cover a total of 65 central banks, as twelve central banks have been subject to both a transitional and a full assessment, and two central banks have had two full assessments.⁴

⁴ Central banks are subject to a full safeguards assessment in respect of every arrangement approved after June 30, 2000. A safeguards assessment for a new arrangement will update the findings and conclusions of the previous assessment. To date, Albania and Brazil have had two assessments because new arrangements were approved.

**Table 1. Status of Safeguards Assessments
as of June 30, 2003 and December 31, 2002**
(cumulative since July 2000)

Status of Assessment	Number as of 12/31/02	Number as of 6/30/03	Percent as of 6/30/03
Assessments completed	65	79	100.0
of which: Full assessments	38	52	65.8
Transitional assessments	27	27	34.2
Assessments in progress	23	20	-

6. At end-June 2003, 20 safeguards assessments were in progress at various stages of completion. Of these, 4 assessments have since been finalized, and 2 are in the report finalization stage. The remaining 14 assessments, along with those required for any additional Fund arrangements that may be considered by the Executive Board, will comprise a significant part of the work program over the next six months.

B. Implementation of Recommendations

7. The recommendations of safeguards assessments are aimed at minimizing the risk of misreporting and misuse of IMF resources. For those remedial measures that address high risk to Fund resources and misreporting, the assessments typically *propose* recommendations under program conditionality or commitments under the Letter of Intent (LOI)/Memorandum of Economic and Financial Policies (MEFP).⁵ The determination of *actual* conditionality or commitments only becomes necessary when central banks have not already substantially implemented the safeguards measure by the time of the next review of the arrangement. Actual conditionality also takes account of the need to prioritize conditionality in the context of the entire Fund program with the member country.

8. Table 2 provides a summary of the status of recommendations to be implemented on or before June 30, 2003. Staff experience has shown it is important to analyze not only formal conditionality, but also LOI/MEFP commitments since both represent explicit pledges to implement the measures on the part of the member country. Table 2 distinguishes between recommendations with actual formal commitments under program conditionality or in the LOI/MEFP, and those without.

⁵ Program conditionality, as defined here, includes prior actions, structural performance criteria and structural benchmarks.

**Table 2. Implementation Rate of Safeguards Recommendations
(as of June 30, 2003)**

	Number	Implementation Rate (Percent)
1. Recommendations with formal commitment from the authorities	99	-
a. Under program conditionality	39	-
<i>of which: Implemented</i>	(35)	89.7
<i>Not Implemented</i>	(4)	-
b. LOI/MEFP commitments	60	-
<i>of which: Implemented</i>	(52)	86.7
<i>Not Implemented</i>	(8)	-
2. Recommendations not under program conditionality or LOI/MEFP commitments	253	-
<i>of which: Implemented</i>	(161)	63.6
<i>Not Implemented</i>	(92)	-
3. Total recommendations (1+2)	352	70.5

9. **The rate of implementation of safeguards recommendations continues to be relatively high, and improving.** The overall rate of implementation for all recommendations was 70.5 percent, representing a measurable increase over the 63.3 percent implementation rate as of December 31, 2002. This broadly reflects the improvement in the implementation rate for recommendations where no formal commitment from the authorities was sought, which improved to 63.6 percent from the 56 percent rate at December 31, 2002.

10. The implementation rate for measures proposed under program conditionality or commitments in the LOI/MEFP remained high at 88 percent. For the 12 measures that have not been implemented, substantial progress has been made on seven measures, while the remaining five measures relate to one country that has not satisfactorily implemented the recommendations and whose program is not currently on track.

11. The relatively high implementation rate for measures not included under program commitments (i.e., lower-priority recommendations), can be seen to reflect the general acceptance by country authorities of the findings of safeguards assessments. The timely implementation of approximately two-thirds of these recommendations, in the absence of a formal commitment, is indicative of the overall relevance of the findings to improving a central bank's framework of safeguards. The recommendations not yet implemented represent a range of situations including: (i) recommendations substantially, but not yet fully, implemented (41 percent); (ii) recommendations under programs that are not on track, which are more

difficult to monitor in the absence of a frequent dialogue with the authorities (12 percent); and (iii) recommendations for which the actions taken are not fully satisfactory (47 percent).

12. Staff seeks to resolve overdue recommendations in several ways, including: (i) communication with the authorities to clarify further actions needed for satisfactory implementation; (ii) the inclusion of a recommendation under conditionality or in the LOI/MEFP where it is considered critical to safeguarding Fund resources; and (iii) conducting a follow-up mission to reach further understandings on implementation.

III. RESULTS OF SAFEGUARDS ASSESSMENTS: DECEMBER 31, 2002 TO JUNE 30, 2003

13. **While the majority of assessments finalized in the six months since December 31, 2002 revealed some significant weaknesses**, three of the fourteen central banks assessed had no significant weaknesses in the ELRIC areas. In the other eleven countries, the most common deficiencies were broadly consistent with those found in earlier assessments and included: (i) poor controls over data reporting to the IMF, (ii) weak governance oversight, (iii) inadequate financial reporting framework or disclosures, (iv) ineffective external audit mechanisms, and (v) deficient internal audit mechanisms. In contrast to earlier assessments, there were no central banks with complete absence of an external audit function or nonexistence of an internal audit department.

14. As an *ex ante* framework, the safeguards policy typically identifies and seeks to correct general vulnerabilities that could potentially pose a risk to Fund resources either through misreporting or misuse. Examples of the general vulnerabilities revealed by the most recent assessments, together with the proposed remedy include:⁶

- nine central banks with **inadequate control procedures with respect to data reporting to the Fund** were expected to establish the necessary controls and/or conduct special audits;
- eight central banks **without an effective oversight organ for external and internal audits, and internal controls** were asked to improve or establish such a function;
- eight central banks **with weaknesses in their financial reporting framework** were asked to implement an internationally recognized framework, improve disclosures in the financial statements and/or prepare an IAS-compliant template;
- three central banks **without regular annual external audits** and four central banks with weaknesses in the external audit function were asked to contract annual external audits on a timely basis and improve the quality of the external audits, including through re-tender of the audit;

⁶ Conditionality or commitments were not proposed in all cases, depending on specific circumstances and the estimated timing of implementation.

- five central banks with **improvements needed in the internal audit function** were expected to conduct risk-focused audits, establish an appropriate mandate or improve staff qualifications;
- four central banks with **independence compromised by interference from government** were asked to remedy the situation through changes in the law or other agreements that clarify roles or functions;
- three central banks with **weaknesses in internal controls** were expected to implement various remedies ranging from improving controls in the trading room to establishing segregation of duties, to restructuring operations.

15. **Central banks have generally agreed with the overall assessment by staff and progress is underway in implementing the recommendations.** In most cases, a reasonable timeline for addressing the remedy extended beyond June 30, 2003; however, in some cases implementation has already occurred within the short period of time since the assessment. Implementation of the remaining recommendations within the timeframe agreed with the respective central banks will be monitored by staff until satisfactorily resolved.

16. The safeguards framework has also allowed staff to identify specific examples in the past six months where immediate steps have been taken to safeguard Fund resources or prevent possible misreporting:

- In two central banks, the **assessment identified inaccuracies in economic program data**. One case involved (i) incomplete reporting of the bank's swaps operations, and (ii) pledged foreign exchange deposits that were not freely and readily available. Prior to the first review of the arrangement the program data were corrected and the central bank committed to strengthening its data verification procedures. The other case involved the incorrect calculation of monetary aggregates using a stock-flow methodology and was immediately corrected.
- In another central bank, **immediate action was taken to address serious internal control weaknesses**. As a prior action under the arrangement, the bank established a separate BIS account to hold and manage IMF disbursements and subject them to specific *ex-ante* controls. The bank has also contracted special six-monthly audits of reserve data.
- In one central bank, the vulnerability related to **non-transparent financial reporting** was immediately addressed through publication of financial statements with a disclosure of deviations from IAS.

17. **The Executive Board review of a Fund-supported program has not yet been completed** for one country because understandings have not been reached with the central bank on compliance with the requirements of the safeguards policy, namely to publish annual financial statements independently audited by auditors external to the central bank in

accordance with internationally accepted standards.⁷ **The safeguards assessment of another central bank was not completed due to the unavailability of audit reports.** Several allegations have subsequently come to the attention of staff and there is an investigation by outside supervisory and law enforcement agencies into various aspects of the financial conduct of the central bank. The Executive Board review of the arrangement for this country is on hold.

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. Recent outreach activities include a one-week INS course on safeguards assessments. Three overseas deliveries of the course took place during the past six-months: at the Singapore Training Institute, the Joint Vienna Institute and the Joint Africa Institute. The course was attended by a total of 84 participants from 67 countries, about half of which had completed or were in the process of undergoing a safeguards assessment in their central bank. Other outreach activities have included staff contributions to publications on the management of reserve assets and on central bank accounting, and staff meetings with central bank delegations visiting Washington, DC.

⁷ In this case, staff and management made a determination not to present the program 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. Missions have been conducted on two separate occasions to further attempt to resolve the impasse.

Safeguards Assessments Completed as of June 30, 2003

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, 2003 are listed below:

Full Assessments			
Country	Date completed	Country	Date completed
Albania ¹	June 28, 2002	Kyrgyz Republic	January 18, 2002
Albania	March 15, 2001	Lao, PDR	April 8, 2003
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	Macedonia	April 24, 2003
BCEAO	March 4, 2002	Madagascar	November 12, 2001
BEAC	July 20, 2001	Malawi	July 12, 2001
Bolivia	June 27, 2003	Moldova	June 12, 2002
Bosnia and Herzegovina	October 28, 2002	Mongolia	March 4, 2002
Brazil	June 14, 2002	Nepal	September 3, 2002
Brazil ¹	September 16, 2002	Nicaragua	December 7, 2001
Bulgaria	June 12, 2002	Nigeria	November 28, 2001
Cape Verde	December 9, 2002	Pakistan	February 1, 2001
Colombia	May 14, 2003	Paraguay	January 31, 2003
Congo, D.R.	January 3, 2003	Peru	July 26, 2001
Croatia	January 3, 2003	Romania	May 13, 2002
ECCB	February 20, 2003	Rwanda	April 14, 2003
Ecuador	June 23, 2003	Sierra Leone	July 29, 2002
El Salvador	February 6, 2002	Sri Lanka	August 24, 2001
Ethiopia	September 6, 2001	Tajikistan	November 27, 2001
Georgia	January 24, 2002	Turkey	March 22, 2002
Guatemala	August 9, 2002	Serbia & Montenegro	November 29, 2001
Guinea	July 11, 2002	Uganda	April 13, 2003
Guyana	April 16, 2003	Uruguay	January 6, 2003
Jordan	June 27, 2003		
Kenya	January 30, 2001		
Transitional Assessments			
Country	Date completed	Country	Date completed
Argentina ²	March 7, 2001	Latvia ²	October 25, 2000
Bolivia ²	October 19, 2000	Lithuania ²	November 6, 2000
Bosnia/Herzegovina ²	April 12, 2001	Mauritania	April 9, 2002
Bulgaria ²	March 21, 2001	Mozambique	October 11, 2001
Cambodia	August 1, 2001	Panama	July 12, 2001
Colombia ²	May 28, 2001	Papua New Guinea	May 4, 2001
Djibouti	July 24, 2001	Romania ²	December 1, 2000
Estonia	December 13, 2000	São Tome & Príncipe	February 6, 2001
Ghana	October 31, 2001	Tanzania	April 3, 2001
Guyana ²	December 5, 2001	Turkey ²	August 21, 2001
Honduras	May 2, 2001	Ukraine	February 3, 2001
Indonesia	April 5, 2002	Uruguay ²	October 19, 2000
Jordan ²	May 22, 2001	Yemen	May 23, 2001
		Zambia	July 2, 2001

¹ Two assessments have been completed for Albania and Brazil in respect of two IMF arrangements since the inception of the safeguards policy.

² Both a transitional and a full assessment have been completed for Argentina, Bolivia, Bosnia and Herzegovina, Bulgaria, Colombia, Guyana, Jordan, Latvia, Lithuania, Romania, Turkey, and Uruguay.