

**IMMEDIATE
ATTENTION**

SM/04/281

August 10, 2004

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 on safeguards assessments for the period to June 30, 2004.

It is intended that this paper will be published on the Fund's external website. If no objections are received by **noon on Tuesday, August 17, 2004**, the paper will be posted.

Questions may be referred to Mr. Catsambas (ext. 34017) and Mr. Trines (ext. 35639) 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

Prepared by the Finance Department

(In consultation with other departments)

Approved by Eduard Brau

August 9, 2004

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I. OVERVIEW

1. Since the review of the safeguards assessment policy by the Executive Board in March 2002¹ staff has prepared semi-annual summary reports on the activities and results of the safeguards program.² This fifth summary report provides an update on the status of work, the results of assessments completed in the first half of 2004, and the implementation status of past recommendations as of June 30, 2004. A comprehensive review of the safeguards policy is scheduled to take place by March 2005 for Executive Board consideration. Box 1 highlights the main features of the safeguards policy.

2. 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, 2004, 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. **Nine safeguards assessments were completed during the period January 1 through June 30, 2004 and the findings were broadly consistent with those of earlier assessments.** As many central banks have a greater awareness of safeguards issues and, in many cases, have implemented recommendations resulting from earlier assessments, important improvements in central banks' control framework, especially in the external audit mechanisms, continue to be made. At the same time, safeguards assessments also continue to identify weaknesses. During the most recent six-month period, significant deficiencies with regard to foreign reserves management and reporting were identified in two instances.

4. **Monitoring by staff of recommendations made in the context of safeguards assessments shows consistently high implementation rates,** although the degree of implementation varies depending on whether or not the recommendations were included in program conditionality.

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 fourth such report was issued in March 2004 and covered the period July 1–December 31, 2003: *Safeguards Assessments—Semi-Annual Update* (SM/04/81, 03/09/04).

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;
 - 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 External audit mechanism;
 - the Legal structure and independence;
 - the financial **R**eporting framework;
 - the Internal audit mechanism;
 - the internal **C**ontrols system.

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

II. STATISTICAL UPDATE

A. Status of Assessments

5. **In the six-month period January 1 to June 30, 2004, assessments were completed for nine member countries**, namely Argentina, Belarus, Brazil, Burundi,³ Cambodia, The Gambia, Honduras, Mauritania, and Romania. The assessment for Belarus was conducted on a

³ In view of the constrained administrative and technical capacity in Burundi, a targeted assessment, focusing on the external audit, financial reporting and internal controls, was completed. A follow-up assessment will cover the remaining ELRIC areas.

voluntary basis, the first of its kind.⁴ The assessment for The Gambia was completed after considerable delays due to certain governance issues.

6. **Since inception of the safeguards policy, staff has completed 98 safeguards assessments** (see Annex). The number of assessments reflects 70 central banks, because 17 central banks have been subject to both a transitional and a regular assessment, and 11 central banks have had two or more assessments.⁵ Regional central banks (the Banque Centrale des Etats d'Afrique Centrale (BEAC), the Banque Centrale des Etats d'Afrique de l'Ouest (BCEAO) and the Eastern Caribbean Central Bank (ECCB)) are considered as one entity but each relate to a number of countries.

7. **At end-June 2004, 13 safeguards assessments were in progress at various stages of completion.** Of these, two assessments have since been completed and two more are in the report finalization stage. The remaining nine assessments (along with others required for additional Fund arrangements as yet unforeseen) will comprise a significant part of the safeguards work program over the next six months.

B. Implementation of Recommendations⁶

8. **The implementation rate for measures included under either program conditionality⁷ or as commitments in the LOI/MEFP remained high at about 91 percent on average for both categories** (Table 1). As in the past, the implementation rate for

⁴ The assessment was requested by the authorities in expectation of completion of discussions on a Staff Monitored Program (SMP). Subsequently, discussions on an SMP were suspended.

⁵ Central banks are subject to a safeguards assessment in respect of every arrangement approved after June 30, 2000. For those countries that had a Fund arrangement as of June 30, 2000, a compressed assessment of only the central bank's external audit function was completed. These are known as "transitional" assessments. A safeguards assessment for a new arrangement updates the findings of the previous assessment, updates the status of past recommendations, and may suggest new remedies. To date, Albania, Argentina, Kenya, Lesotho, Malawi, Mongolia, Nicaragua, Romania, Sri Lanka, and Tajikistan have had two assessments. Brazil has had three assessments, of which the third was with respect to an augmentation. In addition to the 98 assessments completed, a partial (Stage One) assessment for one central bank (Vietnam) was completed in 2001. Finalization of a subsequent full assessment for this central bank was delayed due to extensive consultations with the authorities, and the arrangement eventually lapsed before the assessment was completed.

⁶ Information on the implementation of recommendations was, in most cases, provided by central banks, sometimes supplemented by information gathered by area departments.

⁷ Program conditionality includes prior actions, structural performance criteria, and structural benchmarks and is limited to issues highly relevant to safeguarding the use of Fund resources. Measures covered under program conditionality have mainly focused on achieving adequate external audits, ascertaining international reserve data and control over foreign reserve operations, and achieving reliable data reporting to the IMF.

recommendations formally included in Fund-supported programs is higher than for other recommendations, demonstrating that well-targeted conditionality has been successful in strengthening central banks' safeguards. For the 11 measures formally included in Fund-supported programs that had not yet been implemented, substantial progress has been made on most.

9. **The average implementation rate for measures *not* included under program commitments increased slightly from 72 to about 74 percent in the first half of 2004 compared to the second half of 2003, although results continue to vary from country to country.** In most cases where recommendations remain pending, efforts are continuing; close to 60 percent of the 102 measures not implemented by end-June 2004 have been outstanding for less than six months and most are at an advanced stage of implementation or have been

Table 1. Implementation Rate of Safeguards Recommendations¹
(as of June 30, 2004)

	Number	Implementation Rate (Percent)
Recommendations with formal commitment from the authorities	120	-
a. Under program conditionality ²	53	-
<i>of which: Implemented</i>	(48)	90.6
<i>Not Implemented</i>	(5)	-
b. LOI/MEFP commitments	67	-
<i>of which: Implemented</i>	(61)	91.0
<i>Not Implemented</i>	(6)	-
Recommendations not under program conditionality or LOI/MEFP commitments	385	-
<i>of which: Implemented</i>	(283)	73.5
<i>Not Implemented</i>	(102)	-
3. Total recommendations (1+2)	505	77.6

¹Excludes recommendations for which the suggested implementation date is later than June 30, 2004 or later and recommendations which are not monitored.

²Includes 11 prior actions (all implemented), 13 structural performance criteria (11 implemented), and 29 structural benchmarks (26 implemented).

partially implemented. In addition, about 20 percent of the measures not yet implemented are expected to be superseded by new recommendations made in the context of subsequent and already initiated assessments, which include alternative measures to overcome legal obstacles raised by the authorities. For the remaining 20 percent of recommendations not yet implemented, several of which have been pending in excess of 12 months, more intensive

follow-up, including possible monitoring missions, will be required to ascertain the true progress or the nature of impediments to their implementation.

III. FINDINGS OF SAFEGUARDS ASSESSMENTS: JANUARY 1 TO JUNE 30, 2004

10. **The nature of the findings of the nine assessments completed since January 1, 2004 is broadly in line with earlier findings.** Progress in the strengthening of central banks' safeguards frameworks was noticed in several of the assessments completed since January 1, 2004; for example, only minor recommendations were made in two assessed central banks. At the same time, one central bank was found to have a severely deficient external audit mechanism and in another case, the legal framework needed substantial strengthening. In two central banks, severe weaknesses in foreign reserves management and reporting were identified. The most common other weaknesses identified in the recent assessments included: (i) insufficient controls over data reporting to the Fund, (ii) inadequate financial reporting frameworks or disclosures, (iii) ineffective internal audit mechanisms, and (iv) weak governance or oversight functions. Examples of the vulnerabilities revealed by the most recent assessments and proposed remedies included the following:

- Two central banks had **severely inadequate controls over foreign reserves management and reporting**. Recommendations entailed special audits of the foreign reserves and satisfactory resolution of weaknesses before further disbursements of Fund resources. In four other cases with **inadequate control procedures with respect to data reporting to the Fund**, recommendations entailed establishing formal internal procedures for reconciling accounting data with data reported to the Fund. In the two cases where special audits were recommended, it was additionally proposed that the data reported to the Fund be audited by the external auditor for each program test date.
- One central bank **lacked an external audit mechanism** and in two central banks the **external audit mechanism was inadequate**. In the first case, an external audit was to be introduced, and in another it was recommended to replace the current audit firm, because it did not meet international standards in its audit practices. In the third case, it was suggested to involve audit firm staff from outside the country in the audit process.
- Four central banks required various degrees of **improvements in the internal audit function**, and proposed remedies included the introduction of mechanisms to follow-up on past audit recommendations, strengthening of the overall internal audit function, or expanding the coverage of internal audit activities.
- Three central banks had **ineffective oversight of external and internal audits and internal controls** and were advised to improve their current mechanism or to establish such oversight functions. In two cases, the central banks were advised to commission external reviews of critical internal control processes (e.g., with regard to reserves management).

- Four central banks did not **publish audited financial statements** and recommendations were made to address this weakness, while in one other case the deadline for publication was tightened.
- To address **weaknesses in financial reporting**, in three cases recommendations were made to introduce an internationally recognized accounting framework, such as International Financial Reporting Standards (IFRS).

11. **In their official responses, as provided for under the safeguards policy, most of the central banks were in general agreement with the safeguards findings and have been making progress in implementing the recommendations.** One of the nine central banks covered in this report did not formally agree to implement the recommendations, but, nevertheless, appears to be taking steps to address most of the identified vulnerabilities. In most countries for which assessments were completed in the first half of 2004, proposed timelines for addressing the identified vulnerabilities extended beyond June 30, 2004, but in several of these cases, measures are being implemented well in advance of the deadlines.

12. **As noted on earlier occasions, there is clear evidence that the safeguards policy has contributed to the strengthening of central banks' safeguards frameworks.** The range of weaknesses identified during safeguards assessments has been narrowing as central banks undergo follow-up assessments and have already addressed vulnerabilities observed earlier. In two cases involving follow-up assessments, no significant weaknesses were identified. As expected, the most severe vulnerabilities identified during the period under review involved central banks that had not been assessed previously. In general, measures to strengthen the external and internal audit functions of central banks (which imply structural improvements in the safeguards framework) are expected to have long-term positive effects, because they enable central banks to assess their overall system of controls on a regular basis and take corrective measures as necessary.

IV. SAFEGUARDS ASSESSMENTS OUTREACH

13. **Outreach activities to communicate and disseminate information related to safeguards continued, in particular through training.** In May 2004, some 30 central bank officials from member countries in Asia attended a one-week course on safeguards assessments to familiarize them with the concepts and methodology followed by Fund staff in the implementation of the safeguards policy. The course was organized jointly by the Joint IMF-Singapore Regional Training Institute and the Finance Department as part of a periodic series of training courses on this subject. To date, a total of 142 central bank officials from 87 countries have attended IMF Institute courses on safeguards assessments. Staff also provided several briefings on the safeguards assessment policy for central bank delegations visiting Washington, D.C. In general, as a result of both the outreach activities and the assessments themselves, staff has noted that there is a greater awareness among central bank staff of the benefits of a strong safeguards framework both with respect to central banks' day-to-day operations and in their relations with the Fund.

**Safeguards Assessments Completed
as of June 30, 2004¹**

Total Assessments: 71			
Country	Date completed	Country	Date completed
Albania	March 15, 2001	Kenya	October 21, 2003
Albania	June 28, 2002	Kyrgyz Republic	January 18, 2002
Argentina	September 5, 2002	Lao, PDR	April 8, 2003
Argentina	February 10, 2004	Latvia	October 25, 2001
Armenia	February 19, 2002	Lesotho	July 2, 2001
Azerbaijan	March 8, 2002	Lesotho	July 24, 2003
Bangladesh	September 20, 2002	Lithuania	December 10, 2001
BCEAO	March 4, 2002	Macedonia	April 24, 2003
BEAC	July 20, 2001	Madagascar	November 12, 2001
Belarus	April 6, 2004	Malawi	July 12, 2001
Bolivia	June 27, 2003	Malawi	July 24, 2003
Bosnia & Herzegovina	October 28, 2002	Mauritania	May 21, 2004
Brazil	June 14, 2002	Moldova	June 12, 2002
Brazil	September 16, 2002	Mongolia	March 4, 2002
Brazil	March 25, 2004	Mongolia	November 25, 2003
Bulgaria	June 12, 2002	Nepal	September 3, 2002
Burundi	June 22, 2004	Nicaragua	December 7, 2001
Cambodia	March 24, 2004	Nicaragua	August 29, 2003
Cape Verde	December 9, 2002	Nigeria	November 28, 2001
Colombia	May 14, 2003	Pakistan	February 1, 2001
Congo, D.R.	January 3, 2003	Paraguay	January 31, 2003
Croatia	January 3, 2003	Peru	July 26, 2001
Dominican Republic	December 4, 2003	Romania	May 13, 2002
ECCB	February 20, 2003	Romania	June 17, 2004
Ecuador	June 23, 2003	Rwanda	April 14, 2003
El Salvador	February 6, 2002	Sierra Leone	July 29, 2002
Ethiopia	September 6, 2001	Sri Lanka	August 24, 2001
Gambia, The	February 3, 2004	Sri Lanka	July 30, 2003
Georgia	January 24, 2002	Tajikistan	November 27, 2001
Ghana	October 15, 2003	Tajikistan	July 23, 2003
Guatemala	August 9, 2002	Tanzania	December 5, 2003
Guinea	July 11, 2002	Turkey	March 22, 2002
Guyana	April 16, 2003	Serbia & Montenegro	November 29, 2001
Honduras	February 17, 2004	Uganda	April 13, 2003
Jordan	June 27, 2003	Uruguay	January 6, 2003
Kenya	January 30, 2001		

**Safeguards Assessments Completed
as of June 30, 2004¹ (Continued)**

Total Transitional Assessments: 27			
Country	Date completed	Country	Date completed
Argentina	March 7, 2001	Lithuania	November 6, 2000
Bolivia	October 19, 2000	Mauritania	April 9, 2002
Bosnia & Herzegovina	April 12, 2001	Mozambique	October 11, 2001
Bulgaria	March 21, 2001	Panama	July 12, 2001
Cambodia	August 1, 2001	Papua New Guinea	May 4, 2001
Colombia	May 28, 2001	Romania	December 1, 2000
Djibouti	July 24, 2001	São Tome & Príncipe	February 6, 2001
Estonia	December 13, 2000	Tanzania	April 3, 2001
Ghana	October 31, 2001	Turkey	August 21, 2001
Guyana	December 5, 2001	Ukraine	February 3, 2001
Honduras	May 2, 2001	Uruguay	October 19, 2000
Indonesia	April 5, 2002	Yemen	May 23, 2001
Jordan	May 22, 2001	Zambia	July 2, 2001
Latvia	October 25, 2000		

¹ Countries with arrangements in effect prior to June 30, 2000 were subject to a transitional assessment that evaluated only the external audit mechanism. Subsequently, full assessments were required for each new arrangement with the Fund. As a result, some central banks have undergone more than one assessment. In addition to the 98 completed assessments, one partial assessment (Vietnam, 2001) was completed under the original procedures of the safeguards policy. Finalization of a subsequent full assessment for this central bank was delayed due to extensive consultations with the authorities, and the arrangement eventually lapsed before the assessment was completed.