INTERNATIONAL MONETARY FUND

Safeguards Assessments—2011 Update

Prepared by the Finance Department
(In consultation with other departments)

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EXECUTIVE SUMMARY

1. **Under the Fund's safeguards policy introduced in 2000, assessments of central banks are carried out for countries seeking financing from the IMF**. They are part of the Fund's approach to prudent lending and complement the Fund's other safeguards such as program design, conditionality, and access limits, to name a few. The assessments aim to provide reasonable assurance that governance and controls can protect Fund resources from misuse and guard against misreporting of monetary data used for program monitoring purposes.

2. **The Executive Board completed its third review of the safeguards policy in 2010 and endorsed key requirements in place since the policy's inception** including: (i) assessments are required for almost all IMF financing arrangements and must be completed before the first program review; (ii) the independently audited financial statements of the central bank must be publically available; and (iii) safeguards reports are confidential and shared only with the central bank and, with its permission, the World Bank if requested.

3. **The safeguards policy is evolving to ensure it keeps pace with both developments in financial sector governance and demands on the Fund**. As part of the policy review, Directors endorsed several enhancements including: (i) a sharper focus on governance principles such as transparency, autonomy, and accountability, and risk management; and (ii) increased collaboration with partners such as audit firms and wider dissemination of safeguards findings. In addition, the Board asked to be informed about fiscal safeguards risks when Fund resources were being used for budget financing. Implementation of these and other enhancements is underway.

4. **The number of assessments completed during FY 2011 remains above pre financial crisis levels** and activity is likely to continue at about this level into FY 2012.

I. Introduction

5. **This annual update paper focuses on progress in implementing the third safeguards policy review and summarizes the main safeguards activities during FY 2011**.[1] In doing so, the paper draws implications for the year ahead: assessment activity is likely to remain above pre financial crisis levels, with the intensity depending on the number of new cases. Implementation of the recommendations made during the third policy review will continue, with more work on informing the Board of fiscal safeguards risks at state treasuries and bolstering the focus on governance and risk management in central banks. The paper begins with a synopsis of the safeguards assessment process. Subsequent sections review steps taken to implement the main outcomes for the 2010 review of the safeguards policy, followed by a summary of assessment activity and findings in FY 2011.

II. The Safeguards Process

6. **A safeguards assessment is a diagnostic review of a central bank's governance and control framework.** An assessment is conducted for almost all countries that have financing arrangements with the IMF, and on a voluntary basis, for countries with staff monitored programs or policy support instruments (Box 1). Each assessment aims at providing reasonable assurance that the governance and control frameworks at central banks are adequate to protect Fund resources from misuse and to provide accurate program monetary data. They are conducted at central banks because these institutions are typically responsible for managing disbursements and reporting on monetary data used for program monitoring.

7. **Safeguards assessments are an integral part of the Fund's lending process and complement the Fund's other safeguards.** These include limits on access, program design and conditionality, measures to address misreporting, and post-program monitoring. Assessments also help to reduce reputational risk, for example if resources were diverted from the intended purposes of a country's economic program. The assessments are distinct from audits in that they entail high-level reviews of governance structures and control mechanisms rather than a verification of assets and detailed tests of controls that underpin a financial statement's audit.

8. **Safeguards assessments are typically carried out at or before the start of each program and should be completed before the first program review**. The work entails a review of the main governance and control mechanisms in place at the central bank, for example the structure of governing bodies and independent oversight of decisions and operations. A cornerstone of the policy is the publication of central bank financial statements that have been audited by external auditors in accordance with international standards. The

[1] Safeguards Assessments—Review of Experience and Review of the Safeguards Assessments Policy. An external panel assisted with the review: The Safeguards Policy—Independent Panel's Advisory Report.

legal underpinnings of the central bank are also reviewed as these are the basis of both the bank's governance structure and autonomy. To ensure consistency across countries, assessments utilize the "ELRIC" framework.[2]

Box 1. The Fund's Safeguards Policy—Applicability

The safeguards policy applies to members seeking financing from the Fund, except for the Flexible Credit Line (FCL) arrangement, First Credit Tranche Purchases, and disbursements under the Emergency Assistance for Natural Disasters. The policy applies to new and successor arrangements, augmentations of access under existing arrangements, precautionary arrangements, and disbursements involving Emergency Post-Conflict Assistance (EPCA). A member following a Rights Accumulation Program (RAP), where resources are being committed but no arrangement is in place, is also subject to a safeguards assessment. A member's request for assistance under the Rapid Credit Facility (RCF) requires a commitment to undergo a safeguards assessment and an authorization for Fund staff to have access to the central banks' most recently completed external audit reports and to hold discussions with the auditors. The timing and modalities of the assessment for members with assistance under the RCF are determined on a case-by-case basis; it is presumed, however, that the safeguards assessment would have been completed before Executive Board approval of any subsequent arrangement to which the Fund's safeguards policy applies.

For members of three regional central banks—Central Bank of West African Countries (BCEAO), Central Bank of Central African Countries (BEAC), and Eastern Caribbean Central Bank (ECCB)—a four year assessment cycle was established, irrespective of the timing of the member countries' programs. Central banks of the members of the euro area are assessed individually as the European Central Bank (ECB) is not considered a regional central bank for the safeguards purposes.

Safeguards assessments are not conducted for members with FCL arrangements, on the grounds that eligible countries have strong institutional arrangements in place. Instead, certain safeguards procedures are conducted. A member requesting an FCL arrangement is required to provide authorization for the central bank's auditors to hold discussions with Fund staff and for Fund staff to have access to the central bank's most recently completed external audit reports.

Voluntary assessments are encouraged for members that have a Policy Support Instrument (PSI) in place or those that are implementing a Staff Monitored Program (SMP).

9. **A summary of the safeguards assessment is included in the program staff report** following the assessment. This provides the Fund's Executive Directors with assurances on safeguards in place and a summary of key recommendations to bolster a bank's safeguards. This information is updated periodically based on *safeguards monitoring*, which entails tracking implementation of safeguards recommendations and a review of the annual statutory audit. The safeguards report itself, however, remains confidential because it can contain sensitive material, comments on secured physical areas in central banks, and information based on privileged discussions between external auditors and their client.

[2] The ELRIC acronym denotes the five pillars of safeguards assessment: **E**xternal audit, **L**egal framework, financial **R**eporting, **I**nternal audit, and internal **C**ontrols.

III. IMPLEMENTING THE 2010 POLICY REVIEW

10. **The Executive Board reviewed the safeguards policy in 2010, ten years after its adoption (Box 2)**. The review confirmed the continued effectiveness of the safeguards approach in helping mitigate the risks of misreporting and misuse of Fund resources, and maintaining the Fund's reputation as a prudent lender. The review also affirmed the existing policy requirement, including:

- Publication of central bank financial statements that have been independently audited by high-quality firms in accordance with international standards.
- The deadline of the first program review for completion of a safeguards assessment.
- The importance of continued cooperation by central banks and their external auditors for maintaining the effectiveness of the monitoring framework. In this context, it was agreed that instances of non-receipt of monitoring information be explicitly flagged in staff reports.
- The existing confidentiality of safeguards reports should be retained, but scope for wider dissemination of the safeguards findings should be pursued.

Box 2. Earlier Safeguards Policy Reviews

The safeguards policy was introduced in 2000 and has been reviewed in 2002, 2005 and 2010. An external panel of experts was involved in each review to provide an independent evaluation of the policy and propose recommendations for improvement.

The first review (2002) of the safeguards policy examined the experience of an initial experimental period following the approval of the pilot program in 2000. It focused on the main risks and trends in the central banks' safeguards frameworks evident from the initial findings and formulating the modalities of safeguards assessments as a permanent feature of the IMF's lending operations, based on the lessons learned during the initial period.

The 2005 review provided a comprehensive analysis of developments in central banks' safeguards frameworks, trends in safeguards recommendations and their impact on improving data quality and reducing the risks of misuse. The review acknowledged a shift from new assessments to update assessments and monitoring, introduced a broader scope of monitoring work, encouraged outreach to central banks, and provided modalities for sharing safeguards reports with the World Bank.

11. **As part of the review, Directors endorsed several areas for further work** to ensure that the policy evolves along with developments in financial sector governance and demands on the Fund. The paragraphs below summarize the recommendations and progress towards implementation.

12. **Updating the existing ELRIC framework through a sharper focus on governance and risk management.**

- The review recognized that the ELRIC framework has been evolving over the ten years of policy implementation and has proved effective as an organizing tool.

- Attributes of good governance (see Box 3) are captured in the ELRIC framework, but a more explicit treatment of these attributes would help focus assessments and bring out the importance of effective oversight and provide insight into possible risks of high level overrides of controls. The Executive Board broadly endorsed the staff proposals to sharpen the focus on governance and risk management in the ELRIC framework.

- In this connection, a governance chapeau is now being applied in all safeguards assessments. Much of the change is at the working level and evident mainly to central bank counterparts, rather than in safeguards outputs. However, the summaries of safeguards work in country staff reports have begun to take on a governance orientation and emphasize a central bank's adherence to governance principles. This practice is likely to expand in the future as appropriate.

Box 3. Key Attributes of Good Governance

Governance is an overarching theme of the ELRIC Framework. Governance has different meanings, depending on the context, but in the safeguards context is most closely associated with the good governance principles that are relevant for the structure of central bank entities. In this regard the governing framework of central banks can be guided by general principles of good governance, appropriately modified to fit the situation of central banks operating as autonomous agencies of the State.

The attributes of good governance are cross cutting elements of all ELRIC pillars, and can be found in the use of the framework to assess whether a central bank's auditing, financial reporting, internal control systems, and its legal structure and autonomy are adequate to ensure the integrity of operations and minimize the risk of misuse of resources or misreporting of data. In this regard, key attributes of good governance reflected in the ELRIC framework cover:

- Discipline, represented by senior management's commitment to observe and promote good governance;

- Transparency, which is necessary to facilitate effective communication to, and meaningful analysis and decision-making by, external parties;

- Autonomy, which is essential for the top decision-making body such as the Board to operate without risks of undue influence or conflicts of interest, and is achieved through the application of objective criteria for the composition of, appointments to, and removal from such bodies;

- Accountability, whereby decision-makers such as the Board, its committees, and top management have effective mechanisms in place to report to, and as necessary discuss their actions with, the Parliament; and

- Responsibility, which should entail giving a high priority to observance of ethical standards and permit corrective action, including for mismanagement where appropriate.

- Some central banks have adopted new risk management frameworks and separated risk management responsibilities from internal audit functions. Assessments review such frameworks in terms of their coverage of key risk areas and also more generally discuss risk management options with central banks that have not yet adopted them. It is important to note, however, that risk management is technically demanding and consequently its effective application is likely to be strongly affected by capacity constraints.

13. **Budget financing and framework agreements for servicing member obligations.**

- When IMF financing is used for budget purposes, the internal obligation for the servicing of loans logically falls on the ministry of finance (or other budget agency). To help safeguard the member's ability to repay the Fund, the 2010 policy review called for formal framework agreements in these cases between the central bank and the ministry of finance that would spell out repayment and servicing responsibilities. As part of these arrangements, the safeguards policy also requires that IMF resources be deposited at the central bank and controls over the release of these funds to the government be assessed.

- Since the review, such agreements are now part of the program commitments and are being finalized before the first program review, if not earlier.

14. **Budget financing and fiscal safeguards.**

- The expert panel assisting with the 2010 policy review observed that the increase in budget financing cases has come with a corresponding shift in the nature of risks to Fund resources. When Fund resources are provided to the government, the safeguards assessment does not provide the same level of assurance about minimizing the risk of misuse of resources or misreporting of program data. The panel recommended a circumscribed approach toward safeguarding Fund resources at the state treasury level where the greatest budgetary-related risks lie.

- Previous policy reviews considered that extending the safeguards mandate beyond the central bank was not practicable. In the 2010 review, Directors further noted that replicating the safeguards framework across the whole of government remained challenging. However, in view of the increasing number of budget financing cases, many Directors encouraged staff to highlight fiscal safeguards risks in staff reports involving budget financing, based on available sources such as fiscal ROSCs and PEFA reports, and a number of Directors encouraged exploration of a possible more ambitious approach to conduct parallel safeguards assessments at the level of the state treasuries.

- Staff has since been exploring alternative modalities to strengthen the coverage of fiscal safeguards risks where appropriate. An initial approach of relying solely on available information in fiscal ROSCs and PEFA reports requires some refinement to ensure sufficiently comprehensive and timely information. Staff is exploring options to strengthen this approach, including through use of a questionnaire to obtain the information necessary for identifying possible safeguards risks, and in particular any "red flags" that might indicate a need for further review. It is intended to assess the effectiveness and usefulness of this strengthened approach through a pilot exercise in which desk-based or field work would be used to (i) validate information received and (ii) prepare summary information for respective staff reports.

15. **Collaboration with stakeholders.**

- As in previous years, two seminars for central bankers were held in FY 2011, and a total of 52 participants attended. In line with the outcome of the 2010 policy review, new emphasis is being placed on governance principles and risk management.

- In response to a recommendation of the external panel for increased collaboration with stakeholders, staff engaged with senior representatives of international audit firms in a workshop sponsored by the International Federation of Accountants (IFAC) in February 2011 to explain the safeguards framework and explore ways in which international audit firms and the Fund could strengthen audit quality. The workshop was helpful in raising the profile of central bank audits with audit firms at a global level, and establishing improved communications channels going forward.

- The safeguards team has also conducted a series of seminars for other Fund staff to bolster awareness of the safeguards policy and its new directions.

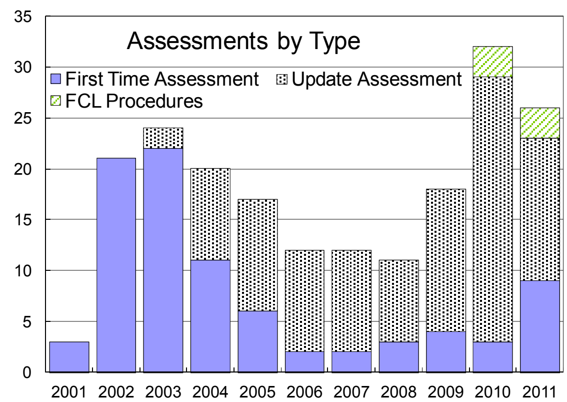
16. **Wider dissemination of safeguards findings**

- Arrangements are being established for sharing safeguards assessments reports with the European Central Bank (ECB). Appropriate procedures are being finalized in accordance with the 2005 Executive Board Decision, and staff expects to circulate shortly a paper for Executive Board endorsement on a lapse of time basis. This will see the sharing of safeguards assessment reports for the National Central Banks (NCBs) of those Member States whose currency is the euro, as well as other NCBs in the European System of Central Banks if their respective Member States are receiving financial assistance from the EU and the Fund jointly.

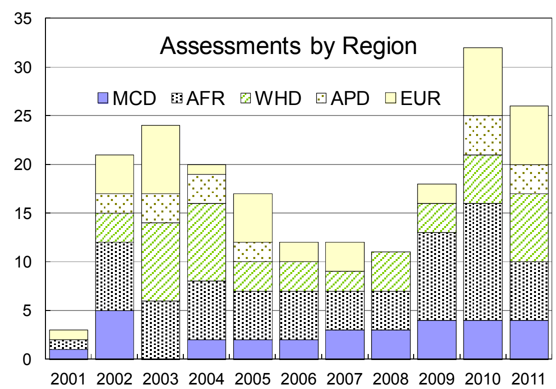
- Some central banks have commenced voluntarily sharing information on safeguards assessments in their annual reports, and also sought the staff's guidance on press releases concerning progress on safeguards matters.

IV. Safeguards Activity in FY 2011

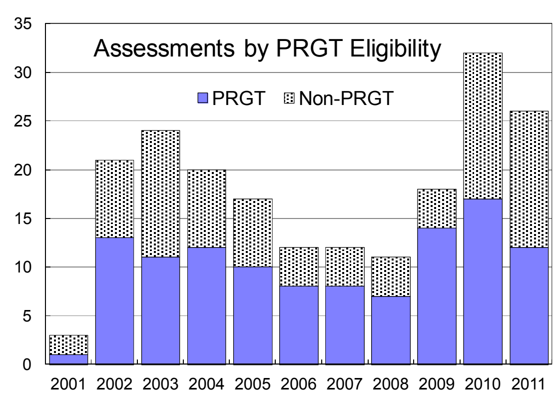
17. **Assessment activity remains well above pre-crisis levels**, mostly because of first time assessments in Europe and some Pacific islands. Due to the high level of program-triggered assessments, the staff was not able to accommodate in FY 2011 requests for the voluntary assessments by the countries having a PSI.



18. **Distribution of assessments by region became more even.** However, activity remained relatively low in APD and MCD.



19. **The share of non-PRGT-country assessments rose in 2010-2011** largely because of the new programs in Europe and the Western Hemisphere. Assessment cases are now roughly balanced between PRGT and non-PRGT eligible countries, a sharp contrast to the pre crisis period.

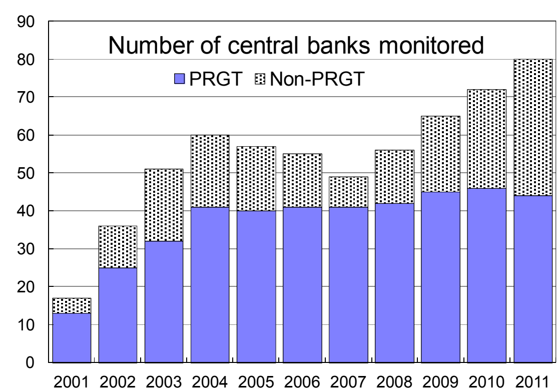


20. **As of end-April 2011, some 23 assessments had been completed, with a further 9 in progress** (Table 1). In addition, reports for FCL procedures (see Box 1) were issued for Colombia, Mexico, and Poland.

Table 1. Assessments Completed During FY 2011 and In Progress at End-April

Type of Activity	Assessments Completed	Assessments In Progress	Total
First-time assessments	Angola, Fiji, Greece, Ireland, Jamaica, Kosovo, Samoa, Solomon Islands, Yemen	Portugal	**10**
Update assessments	Armenia, Dominican Republic, El Salvador, Haiti, Honduras, Iraq, Lesotho, Malawi, Moldova, Seychelles, Sierra Leone, Tajikistan, Ukraine, Zambia	Afghanistan, Bangladesh, Georgia, Kenya, Kyrgyz Republic, Macedonia, Nepal, Romania	**22**
Total	**23**	**9**	

21. **Monitoring countries with outstanding credit continues to account for a significant part of safeguards activity.** This work includes follow up on safeguards recommendations and other developments in the central banks' governance, as well as contacts with their external auditors. In the medium term, the balance of safeguards work is likely to shift more toward monitoring, which is risk-based. As the number of new programs falls, the number of assessments will also decline, but monitoring activity will continue as long as credit is outstanding.



22. **However, a few monitoring cases require resources equivalent to or exceeding those for an assessment.** These high-profile cases can require almost daily interactions with central bank staff and external auditors, as well as within the Fund. Where required, monitoring staff visits are held and the Executive Board is kept informed of evolving risks and vulnerabilities.

A. The Euro Area Countries

23. **Safeguards assessments were undertaken in three euro area countries (Greece, Ireland, Portugal) during the period under review.** These assessments have a different

focus because their central banks are members of the Eurosystem and thus many aspects of their safeguards frameworks are harmonized and not under the direct control of the member bank. In addition, monetary policy decisions are taken at the ECB so that monetary data are not used in program monitoring and there is no need to assess misreporting risk for monetary data. The assessments are conducted because the Fund's resources are deposited at the National Central Banks (NCBs).

24. **The safeguards teams applied the ELRIC methodology to the NCBs, taking into account their Eurosystem membership**. Thus, the assessments considered the existing harmonized policies and procedures for the Eurosystem operations and the external audit and financial reporting requirements governed by EU law. Other areas, such as NCB autonomy, governance structures, and non-Eurosystem operation, were reviewed taking into account national legal frameworks and control environments. As is standard in cases involving budget financing, the assessments ensured that a framework is in place to define respective roles and responsibilities for servicing of IMF lending between the central bank and government (see para 13 above).

25. **Vulnerabilities were limited and risks were in the lower end of the range in these cases.** The assessments found highly competent staff and modern systems. Nevertheless, the assessments identified areas for improvement. Recommendations were made to strengthen financial autonomy of the NCBs, which is especially important in the time of a financial crisis. A common recommendation related to definition of financial reporting and disclosure requirements for areas not addressed by the Eurosystem's harmonized accounting rules. In two cases, the assessments also noted a need to enhance independent oversight over central banks' controls and audit mechanisms.

B. Misreporting

26. **No cases of misreporting of program monetary data were identified during the year under review, compared with one case in 2010 (Ukraine).** Recommendations made by the safeguards assessments included measures to reduce the risk of misreporting of program monetary data (e.g. regular audits of program monetary data by internal or external auditors). Implementation of these measures mitigates risk but does not provide a guarantee of the data quality or elimination of misreporting.

C. Safeguards Findings and Recommendations

27. **Consistent with the conclusions in the 2010 policy review paper, safeguards recommendations are increasingly focused on strengthening existing practices** by implementing principles of good governance and ensuring effective functioning of safeguards frameworks. In assessments involving countries with GRA arrangements, the main findings have tended to concentrate on strengthening central bank autonomy and governance structures. However, in cases involving PRGT arrangements, attention has continued to focus on addressing significant capacity issues and deficiencies in operational controls.

28. **Statistics on safeguards recommendations implementation were mostly unaffected by the 2009 reforms to structural conditionality policies (Table 2a).** Implementation rates have remained high—above 95 percent—for recommendations that were linked to program measures (e.g., prior actions, benchmarks, LOI/MEFP commitments). At the same time, there is some indication that structural benchmarks were being used more parsimoniously after the reforms: the average number of recommendations per assessment that became structural conditions or benchmarks in 2010-11—the two complete years following the reform—was below the median for the pre-reform period. This change should be interpreted with caution because this indicator can be affected by various factors, such as the mix of new versus update assessments that are unrelated to the conditionality reform. Detailed statistics on the number of safeguards recommendations made in FY 2011 and FY 2010 are presented in Table 2b.

29. **Safeguards findings in FY 2011 reflected an increase in central bank exposure to the financial sector.** The recent financial crisis has seen several central banks provide liquidity assistance, for example, through lender of last resort facilities. Recommendations focused on lessening risks in such lending by establishing clear rules and independent oversight of the decision-making process, upgrading monitoring, and greater transparency of the resulting aggregate financial exposure. To protect central banks, the assessments have also recommended that predetermined recapitalization rules be established or clarified.

Table 2a. Implementation of Safeguards Recommendations (Cumulative)

	Implementation Rate (in %)	
	FY 2011	FY 2010[1]
1. Recommendations with formal commitment from the authorities	96.5	94.5
a. Under program conditionality	95.9	96.2
b. LOI/MEFP commitments	97.4	92.2
2. Other recommendations	73.9	73.3
3. Total recommendations (1 & 2)	77.9	77.1

[1] Implementation rate for FY 2010 is as of end-March 2010, which corresponds to the data reported in SM/10/128.

Table 2b. Number of Safeguards Recommendations Made (per financial year)

	Number of recommendations made	
	FY 2011	FY 2010
1. Recommendations with formal commitment from the authorities	15	14
a. Under program conditionality	14	7
b. LOI/MEFP commitments	1	7
2. Other recommendations	160	223
3. Total recommendations (1+2)	175	237