IMF Publication

Safeguards Assessments - 2012 Update

INTERNATIONAL MONETARY FUND

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Safeguards Assessments – 2012 Update

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(In consultation with other departments)

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EXECUTIVE SUMMARY

The safeguards policy was introduced in 2000 to reduce the risks of misuse of Fund resources and misreporting of program monetary data to the Fund. It supports the Fund's approach to prudent lending and complements other safeguards such as program design, conditionality, and access limits, to name a few. Some 242 assessments of 92 central banks have been completed since 2000. Assessments are followed by a period of monitoring for as long as Fund credit is outstanding.

The safeguards policy continued to evolve in FY 2012. Building on the policy review in 2010, efforts were focused on updating practices for developments in financial sector governance, increased collaboration with relevant stakeholders, and wider dissemination of safeguards findings. In addition, FAD staff has commenced a pilot exercise to identify fiscal safeguards risks in budget financing cases at the state treasury level.

Safeguards activity in FY 2012 included fewer assessments, but more monitoring work than in FY 2011. A decrease in assessment activity reflected fewer programs approved by the Board in FY 2012. Internal and external collaboration continued to be important across all aspects of safeguards activity. Internal collaboration helped to meet ever more challenging deadlines for assessment completion due to high uncertainty in the likelihood and timing of programs under discussion with some member countries. Externally, staff was engaged in active dialog with central banks under monitoring and outreach activities, and with the accounting and auditing profession to help strengthen audit quality.

Safeguards findings in FY 2012 varied from overarching governance and policy matters to specific operational and capacity issues. In line with Executive Directors' request from the 2010 safeguards policy review, assessments focused on central banks' governance and included coverage of risk management practices. Major findings in FY 2012 included instances of ineffective oversight and impaired autonomy. Risk management was found to be a work in progress for the majority of the central banks assessed.

I. INTRODUCTION

1. **Safeguards assessments provide a diagnostic review of a central bank's governance and control frameworks** with a focus on their adequacy to protect Fund resources from misuse and to provide accurate program monetary data. Safeguards reports include a snapshot of governance practices in the central bank, identify vulnerabilities across five key areas, and propose recommendations to address them.[1] A cornerstone of the policy is the requirement that central banks publish financial statements that have been independently audited by external auditors in accordance with international standards.

2. **Assessments are typically carried out at or before the start of each program and should be completed before the first program review.** Assessments are 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). After assessments are completed, the status of recommendations and other safeguards developments are monitored for as long as credit is outstanding.

3. **A summary of the safeguards assessment is included in the program staff report** following the assessment. Subsequent staff reports update the Board on significant developments identified during the monitoring phase. Recommendations to address critical safeguards vulnerabilities may also be included in program measures.

4. **This paper updates the Board on safeguards activity in FY 2012.** It starts with a description of developments in implementing the policy (Section II) and proceeds with a review of activity in FY 2012 (Section III).

[1] The five areas that comprise the safeguards framework (known as ELRIC) are: (i) External audit; (ii) Legal structure and autonomy; (iii) financial Reporting; (iv) Internal audit; and (v) internal Controls.

Box 1. The Fund's Safeguards Assessments Policy—Applicability

The safeguards assessments policy applies to members seeking financing from the Fund, except for the Flexible Credit Line (FCL) arrangement and First Credit Tranche Purchases. The policy applies to new and successor arrangements, augmentations of access under existing arrangements, precautionary arrangements, and disbursements involving rapid and emergency assistance. 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 and emergency assistance instruments (i.e. RCF and RFI) or under a six-months Precautionary and Liquidity Line (PLL) arrangement requires a commitment to undergo a safeguards assessment, providing Fund staff with access to the central banks' most recently completed external audit reports and an authorization for Fund staff to hold discussions with the external auditors. The timing and modalities of the assessment for members with assistance under these instruments 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 the three regional central banks—Central Bank of West African States (BCEAO), Central Bank of Central African States (BEAC), and Eastern Caribbean Central Bank (ECCB)—a four year assessment cycle was established irrespective of the timing of the member countries' programs, because the member states concerned do not have a national central bank to which Fund disbursements can be made. Conversely, national central banks of the members of the euro area are assessed individually as they are separate legal entities that can receive Fund disbursements on behalf of the member concerned.

Safeguards assessments are not conducted for members with FCL arrangements, on the grounds that qualifying countries have very 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).

II. Developments

5. The Executive Board reviewed the safeguards policy in 2010 and endorsed several areas for further work to ensure that the policy evolves along with developments in financial sector governance and demands on the Fund.[2] In this context, safeguards work in FY 2012 has been guided by a sharper focus on governance and risk management, strengthening collaboration with stakeholders, increasing dissemination of safeguards findings, and adapting safeguards procedures for budget financing.

[2] *Safeguards Assessments—Review of Experience,* and *Public Information Notice No. 10/113*. An external panel assisted with the review: *The Safeguards Policy—Independent Panel's Advisory Report*. The 2011 update paper focused on progress in implementing the 2010 policy review – see *Safeguards Assessments 2011 Update*.

A. Sharper Focus on Governance and Risk Management

6. **Safeguards assessments are organized around the well-recognized attributes of good governance** (Box 2). Safeguards reports and summaries of safeguards work in country staff reports now include a more explicit focus on governance attributes across the ELRIC framework in recognition of the fact that transparency, accountability, and autonomy are the foundation of a central bank's safeguards, and which can lessen the risk of high-level control overrides.

Box 2. Key Attributes of Good Governance

Key attributes of good governance reflected in the safeguards assessments cover:

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

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

- Autonomy, which enables 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 entails giving a high priority to observance of ethical standards and permit corrective action, including for mismanagement where appropriate.

7. **The sharper focus on governance has been particularly useful in evaluating the effectiveness of oversight bodies**. The central bank board and audit committee are key bodies for overseeing adherence to the principles of good governance. Both play a role in ensuring that central banks are accountable to the public for the effective management of risks at times of high uncertainty, such as the recent financial crisis, and transparently disclosing their policies and results. From the safeguards perspective, a particular area of focus has been the autonomy and effectiveness of audit committee oversight, for example, in ensuring implementation of measures to address vulnerabilities identified by external and internal auditors. Assessment work in this regard also includes the staff engaging with Audit Committee members to gain further insight on current issues or difficulties that may signal governance gaps or weakness at the central bank.

8. **Safeguards assessments apply a more structured approach to review central banks' risk management practices.** Assessments evaluate the extent to which: (i) clear risk-related roles have been established; (ii) critical risks have been identified; and (iii) appropriate capacity is in place to support risk management. Based on this evaluation, assessments may recommend measures to establish a roadmap for the central bank to develop an effective risk management function. While management of financial risks has long been an integral part of central bank reserve management activities, the development of an

integrated bank-wide risk management framework remains a work in progress for the majority of the central banks assessed during FY 2012.[3] However, as experience in this area is accumulated, integrated bank-wide risk management becomes an increasingly important element of central banks' governance frameworks.[4]

B. Collaboration with Stakeholders

9. **Staff continued to engage in outreach and communication**, through both traditional activities and new initiatives launched in response to the 2010 policy review. Principal activities by staff in FY 2012:

- **Two seminars on financial safeguards at central banks were attended by 62 participants from 53 countries' central banks.**[5] These seminars provide a forum for senior central bank staff to discuss their experiences in strengthening governance, external and internal audit mechanisms, financial reporting practices, and internal control systems.

- **Staff maintained high-level contact with the accounting and auditing profession.** This engagement with the accounting and auditing profession is aimed at strengthening audit quality at central banks. Work during FY 2012 included preparation of an event involving senior representatives of international audit firms in follow up to the 2011 workshop, participation by the international audit firms (as speakers) at the seminars, and the appointment of an IMF representative as an observer at the Consultative Advisory Group of the International Federation of Accountants (IFAC), which provides input on audit standard setting.

- **Staff launched a project to develop a tool for central banks' self assessment.** A key challenge in this task is to find a balance between providing a detailed description of the ELRIC framework and avoiding a perception of a box-ticking exercise. A design that is being explored currently includes guidance (in the form of examples of good practices as well as common risks encountered in safeguards activity), followed by an opportunity for the central bank to provide a description of its own practices.

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[3] Out of 14 central banks assessed in FY 2012, two had advanced integrated risk-management functions, six were in process of implementation, and six were either at only an initial stage or had no risk-management function.

[4] Such framework incorporates financial, operational, reputational and strategy risks and establishes the strategic context and processes to make risk management an integral part of entity's operations.

[5] These seminars were held at regional training centers in Singapore (December, 2011) and Tunisia (April, 2012).

C. Dissemination of Safeguards Findings

10. **Safeguards assessment reports can be shared with the ECB and the World Bank, subject to the consent of the applicable central bank.** Safeguards reports are confidential IMF documents that may only be shared with other agencies in accordance with an 2005 Executive Board Decision. During FY 2012 the Executive Board approved the transmittal of safeguards reports to the ECB for the National Central Banks in the European System of Central Banks, in the cases where the Member State received financial assistance from the European Union and the Fund jointly. Staff provided safeguards assessment reports for six countries following an ECB request made in November 2011. During FY 2012 staff also shared reports for a further eight central banks with the World Bank. As in FY 2011, no central banks withheld their consent for reports to be shared with the respective requesting agency in FY 2012.

D. Budget Financing and Fiscal Safeguards

11. **A pilot exercise for identifying fiscal safeguards risks was initiated during FY 2012**. The existing safeguards mandate covers assessments of central banks because they are typically responsible for managing disbursements and reporting on monetary data used for program monitoring. Currently, when Fund resources are provided for direct budget financing safeguards assessments ensure that a framework agreement between the central bank and the ministry of finance is in place for servicing member obligations. Fiscal safeguards should also ensure that a designated bank account is stated in appropriate legislation, subject to the exclusive control by the ministry of finance, and solely used to make payments that have been authorized through budget appropriations or other legislation. To this extent, in early 2012, FAD staff commenced a pilot exercise that will assess the effectiveness and usefulness of different approaches to identifying fiscal safeguards risks at the state treasury level.[6] The exercise aims at covering about six large budget financing cases in FY 2013, and the first case is currently in progress.

12. **Separately, but in a related vein, safeguards assessments identified a few cases in FY 2012 where changes in the design of controls over fiscal outlays shifted risks from the central bank to the ministry of finance.** This occurred, for example, where country authorities were implementing Treasury Single Account (TSA) and/or Integrated Financial Management Information Systems (IFMIS), and transaction checking, verification, and reconciliation procedures previously performed in the central bank became a responsibility of the fiscal authorities. In this context, the risks of control override or collusion shift to the ministry of finance. In two cases, where TSA/IFMIS implementation was still underway,

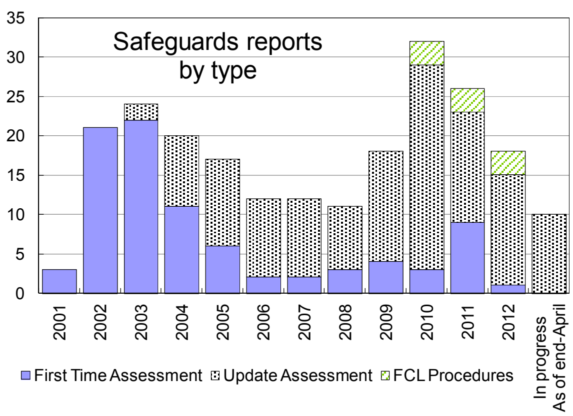
[6] Depending on the country's legal framework the term "state treasury" can be recognized as equivalent to the ministry of finance or central government payment authority.

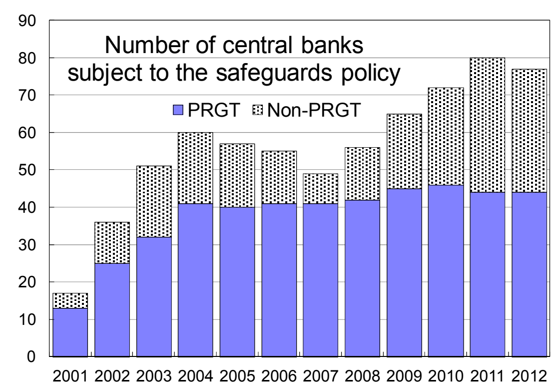
weaknesses in controls on the fiscal processing side were identified by external auditors and staff teams.. The staff collaborated with country teams and FAD to highlight these risks and to clarify that they fall beyond the application of the safeguards policy.

III. SAFEGUARDS ACTIVITY IN FY 2012

13. **Safeguards activity includes two major components: conducting assessments and thereafter ongoing monitoring** for as long as Fund credit remains outstanding. The intensity of assessment activity has varied during the history of the safeguards policy, peaking in tandem with member country demand for Fund financial assistance. At these times conducting assessments takes a greater share of staff time. Monitoring aims to track implementation of recommendations and to identify emerging vulnerabilities in a central bank's governance practices, based on a review of the statutory audit.

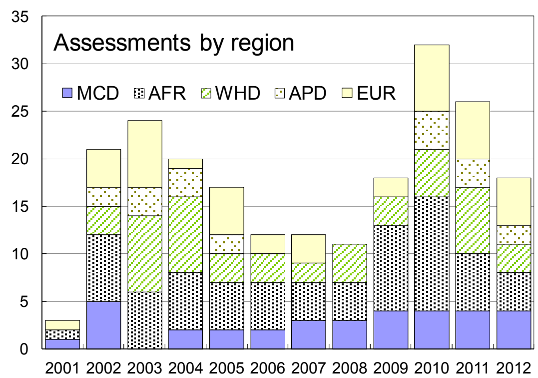
14. **FY 2012 was a year of uncertainty in terms of the timing of assessments.** Following a peak in activity during FY 2010–2011, there was a decrease in FY 2012 reflecting fewer programs approved by the Board. As a result, 15 assessments were completed in FY 2012 in comparison with 23 in FY 2011.[7] For some member countries the likelihood of programs under discussion has been uncertain throughout FY 2012 and in a few cases assessments could not be initiated until program discussions were at an advanced stage. In several other cases staff has been working on assessments that were either suspended because program discussions were put on hold (Egypt, Hungary), or not progressed due to the security conditions (Yemen). Eleven assessments were in progress at the end of FY 2012 in comparison with nine at the beginning of the year.

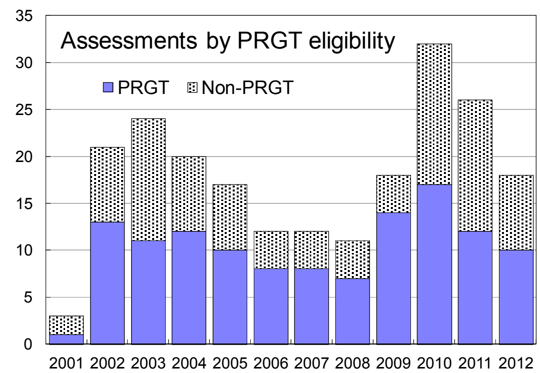




[7] Annex I lists those central banks that were assessed during FY 2012, along with those under assessment as at end-April 2012. As in FY 2011, three reports were prepared under the special procedures established for FCL arrangements.

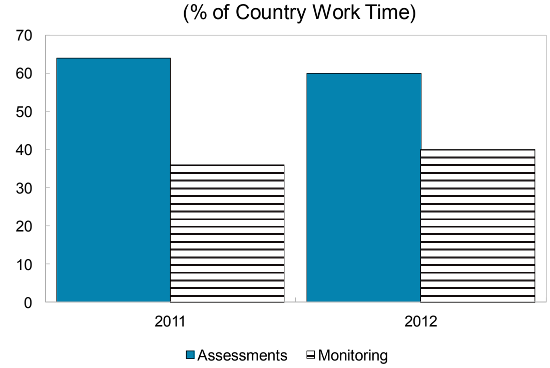
15. **The distribution of assessment activity across regions in FY 2012 differed significantly from that of pre-crisis years.** European countries accounted for the largest number of assessments (five), followed by African, and Middle East and Central Asia countries (four each). Another recent trend is a balance between PRGT and non-PRGT eligible countries assessed. However, in the group of all central banks currently subject to the safeguards policy, the balance remains weighted toward PRGT eligible countries (44 versus 33). This is due to the large number of PRGT eligible countries assessed in pre-crisis years which are currently being monitored, coupled with the longer duration of concessional lending repayment.[8]





16. **Monitoring accounted for 40 percent of the safeguards country work in FY 2012** (36 percent in FY 2011). Monitoring continues to be risk-based with the "high intensity monitoring" accounting for roughly half of all monitoring time.[9] Monitoring work during FY 2012 also included staff visits to BEAC and Tajikistan to follow up on the status of ongoing reforms across a number of safeguards related areas.

Assessments vs Monitoring
(% of Country Work Time)



Source: TRACES

17. **In the course of monitoring safeguards, staff maintains an active dialogue with central banks.** Staff assesses the effectiveness of implementation of safeguards

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[8] Central banks remain subject to safeguards monitoring for as long as Fund credit is outstanding.

[9] The risk-based methodology assigns monitoring intensities to central banks based on a number of criteria (see *Safeguards Assessments—Review of Experience*. Based on its assigned monitoring intensity each central bank is classified into one of four groups: High, Medium-High, Medium-Low, Low. In FY 2012, the "high intensity monitoring" group included 11 central banks.

recommendations as well as new developments in central banks' safeguards frameworks. In doing so, staff often reviews draft documents prepared by the central banks related to the implementation of recommendations.[10] Staff also draws attention to publicly available resources (such as auditing standards, the role and composition of audit committees, and accounting and financial reporting issues), which provide central banks with guidance on prevailing international practice in safeguards related areas.

18. **Ongoing collaboration with area departments remains an important part of safeguards activity.** Staff consults with the area department about significant risks and issues detected during the monitoring phase and appropriate responses.[11] Examples during FY 2012 included *inter alia* changes to the legislation undermining central bank autonomy, and central bank engagement in a new type of transaction that needed to be captured appropriately in program monetary data definitions. During FY 2012, staff also worked with area departments to flag instances of non-receipt of monitoring information in staff reports. Separately, regular follow up with area departments proved to be particularly beneficial in obtaining timely information from the authorities that facilitated the completion of assessments within the first review deadline for several new programs with short approval and review timelines.

19. **Activity in FY 2012 also continued to involve obtaining information on countries that may seek a Fund arrangement**, but are not currently subject to monitoring. Usually based on indications provided by area departments, this work involves marshalling publicly available information, such as the latest central bank audited financial statements, law, or other publications covering safeguards areas of interest. This helps to speed up the assessment process and, as necessary, alert the area department on significant requirements that may need to be addressed when a program is requested. Similarly, staff maintains an active dialogue with the area departments on developments in the countries that are currently subject to monitoring, especially those with arrangements expiring in FY 2013 (of which there are 21).

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[10] Typical documents include audit committee charters, policies for the selection and rotation of external auditors, and terms of reference for special audits of program monetary data.

[11] Implementation of safeguards recommendations sometimes requires building a central bank's capacity in the areas where Fund technical assistance can play an important role. Area departments, STA, and MCM establish strategies to ensure delivery of technical assistance to address priority safeguards recommendations. LEG provides further support in cases requiring comprehensive revision or amendment of the central bank law.

A. Safeguards Findings and Recommendations

20. **Safeguards issues identified in the central banks assessed in FY 2012 varied from overarching governance and policy matters to specific operational and capacity issues.** Main findings are summarized below.

Governance and Policy Matters

21. **Independent oversight has been found ineffective in five assessments.**[12] In some cases this was due to temporary reasons, such as board vacancies not being filled or the board not having met for a long period of time. Recommendations to restore oversight were tailored to specific circumstances, which in one case saw immediate action by the government to appoint new Board members. In other cases oversight was not provided for institutionally and the assessments recommended changes to relevant legislation.

22. **Significant impairment of financial autonomy was also identified.** Five assessments identified issues including lending to government in excess of limits established by the central bank law, recapitalization needs not being addressed, and central bank involvement in quasi-fiscal activities. Vulnerabilities in central bank autonomy are especially difficult to address since *de jure* improvements are not always *de facto* implemented. Substantive changes may involve reshaping institutional and operational structures over several years. In the interim, assessments propose practical short-term steps to mitigate risks to the Fund, for example signing a memorandum of understanding with the government regarding the timing and extent of recapitalization of the central bank.

Specific Operational and Capacity Issues

23. **Assessments detected deficiencies in central banks' accounting, auditing and controls frameworks.** While the continued trend of adoption of international standards for financial reporting and auditing by the central banks remains evident, instances of poor quality accounting and auditing practices were identified. Some assessments found capacity constraints undermining central banks' control frameworks. Specific examples in FY 2012 included:

- ***Departures from International Standards on Auditing*** in conducting the external audits of two central banks. In both cases, the audit was performed by a local accounting firm with limited capacity to conduct the audit and without affiliation to an internationally experienced audit firm.

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[12] In four more cases recommendations were provided to strengthen audit committee effectiveness, including by appointing an advisor to the audit committee with experience in accounting and auditing.

- ***Non-existent or ineffective internal audit functions*** in two cases (different from those above). In the absence of a well grounded independent review of controls by internal audit, the ability of the respective boards to properly exercise oversight of management and financial controls was restricted.

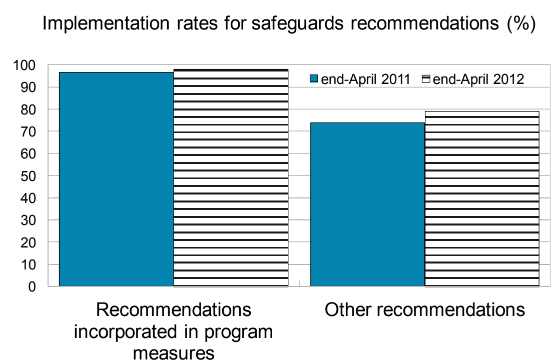
- ***Inadequate transparency*** in two instances, where the central banks used an outdated financial reporting framework and did not publish a full set of audited financial statements.

- ***Deficiencies in internal controls*** in four central banks, including in the areas of foreign reserves and cash management.

24. **The respective recommendations were focused on building capacity,** including through hiring qualified personnel, providing appropriate training and engaging consultants or peer review by another central bank.[13] In the area of external audit the assessments recommended contracting external audit firms with experience in auditing central banks or large financial institutions.

Recommendations

25. **Implementation rates for safeguards recommendations demonstrate continued central bank commitment to improve their governance and controls.** During assessments, staff discusses with the authorities proposed recommendations to ensure they are feasible and effectively tailored to specific circumstances to address corresponding governance risks. This helps to achieve central banks' ownership of changes which is key to effective implementation.



26. **Assessments seek to maintain a balance between addressing all identified weaknesses and focusing on areas of immediate importance.** Including too many recommendations risks dissipating central bank resources, both human and financial, which are often limited. On average, assessments in FY 2012 included 3 priority and 8 total recommendations, unchanged from FY 2011. Fewer (six) recommendations were

[13] In two cases the assessments recommended outsourcing or co-sourcing an internal audit function for an initial period.

incorporated in program measures (FY 2011: 15), largely reflecting the lower level of first-time assessments in FY 2012.[14]

B. Central Bank Balance Sheet Risks

27. **Difficulties in the banking sectors of some countries have seen increased emergency lending assistance by their central banks to commercial banks.** Emergency lending results in significant exposures on the central banks' balance sheets that can threaten financial autonomy in the event that losses are incurred. In cases where central banks provided emergency liquidity support or were expected to do so shortly, the assessments reviewed the legal and regulatory frameworks for such lending and proposed recommendations to protect central bank's financial autonomy.[15]

28. **The financial crisis has increased the focus on the information central banks disclose in their financial statements.** The crisis has highlighted the interconnectedness that exists between the state of the economy and several key financial risk exposures such as credit, liquidity and market risk. Several assessments noted limited transparency regarding risk exposures and risk management practices in the central banks concerned and recommended reviewing respective disclosures.

29. **The increased balance sheet risks can also warrant stronger rules for ensuring the adequacy of central bank capital.** Accordingly, safeguards assessments have proposed recommendations to strengthen *de jure* financial autonomy by reviewing rules for: (i) the establishment of adequate financial buffers (i.e. capital and reserves); (ii) recapitalization requirements in cases of depleted capital; and (iii) profit distribution to the government.

C. Misreporting

30. **In conducting safeguards assessments, staff evaluates risks that monetary program data reported to the Fund could be inaccurate.**[16] Key indicators in this regard include a poor quality of accounting records or inappropriate design of compilation procedures (for example when off-balance sheet accounts are not reviewed to identify possible encumbrances). Staff also reviews mitigating controls, such as an independent

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[14] Of the six, three involved prior actions and three structural benchmarks.

[15] Key elements from the safeguards perspective include that: (i) liquidity is provided only to solvent banks; (ii) lending is short term and subject to provision of collateral meeting strict predefined requirements; (iii) the decision making process is transparent and ensures equal treatment of all applicants; (iv) legislation provides adequate treatment of possible losses related to emergency liquidity lending; and (v) emergency liquidity operations are subject to internal audits.

[16] Program fiscal data misreporting also may be covered under the fiscal safeguards approach, if adopted.

review of the adequacy and correctness of the data compilation process.[17] If the safeguards team finds weaknesses, recommendations are proposed. In FY 2012 key recommendations in this area included: (i) periodic audits of monetary data compilation procedures by external or internal auditors; (ii) automation of monetary data compilation procedures; and (iii) clarification of program definitions related to the treatment of certain types of assets and liabilities.

31. **No cases of program monetary data misreporting have been identified since FY 2010.** Safeguards outreach and collaboration with central banks and area departments since the safeguards policy was introduced have helped to raise awareness of data reporting controls. This, in combination with safeguards recommendations, has contributed to reducing the risk of misreporting. However, as is always the case, while the safeguards policy can reduce risk, it does not eliminate it.

[17] In FY 2012 audits of monetary data compilation procedures by external or internal auditors were performed for 77 percent of the program countries, where such data were included in the program criteria. Such audits not only provide ex-post assurance over the data reported, but also improve ex-ante controls over the compilation procedures by identifying areas for improvement.

Annex I: Assessments Completed During FY 2012 and In Progress at End-April

Type of Activity	Assessments Completed	Assessments In Progress	Total
First-time assessments	Portugal		**1**
Update assessments	Afghanistan, Bangladesh, Djibouti, ECCB, Georgia, Guinea, Kenya (2), Kyrgyz Republic, Liberia, Macedonia, Nepal, Romania, Serbia	Burundi, Egypt, The Gambia, Greece, Hungary, Jamaica, Kosovo, Sao Tome and Principe, Solomon Islands, Tanzania, Yemen	**25**
Total	**15**	**11**	