

CHAPTER

4

Safeguards Assessments and Central Bank Legislation

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Central bank legal frameworks are essential for the proper functioning of a country's financial system.¹ Not only do they set the tone for the relationship between central bank and government (including the degree of independence of the former from the latter) but they also establish the oversight between the central bank and the banking system as well as certain mechanisms that prescribe the relationship of central banks with the international capital markets and international financial institutions. The issue of autonomy is critical to safeguarding resources of the International Monetary Fund (IMF), since a central bank that is independent in the implementation of monetary and exchange rate policies is far less likely to yield to pressures for the provision of credit to government at the behest of the Executive or be subject to interference in its day-to-day operations. Safeguards assessments are concerned with the latter; the question of independence of monetary policy is an issue addressed during policy discussions between IMF staff and country authorities.

Origin of the Safeguards Policy

The purpose of the safeguards policy, which was established in 2000, is to provide reasonable assurance to the IMF's management and Executive Board that adequate controls are in place at borrowing member central banks to reduce the risk of misuse of IMF resources and misreporting to the IMF. Safeguards assessments are conducted at central banks because they are the recipients of IMF disbursements,² and include an analysis and evaluation of central bank legislation with a view toward ensuring the operational autonomy of the central bank.

The impetus behind safeguards assessments came from several high-profile cases of misreporting and alleged misuse of IMF resources. In

1997–98, officials in the Russian Federation and Ukraine were implicated in scandals pointing to the misappropriation of IMF funds and misreporting to the IMF the level and nature of foreign exchange holdings. Although the IMF established the occurrence of misreporting, but not necessarily misuse of IMF resources, the revelation of these transgressions enhanced the awareness of the need for transparency and accountability in central bank operations. To this end, the IMF's Executive Board adopted the safeguards assessment framework on an experimental basis in March 2000. Two years later, the IMF's Executive Board reviewed the work performed under the safeguards policy and, deciding that it had yielded significant results and enhanced the IMF's reputation as a prudent lender, made the policy permanent.³

The Safeguards Framework

Safeguards assessments examine five key areas of a central bank's governance structure: (1) the external audit mechanism; (2) the legal structure and independence; (3) the financial reporting framework; (4) the internal audit mechanism; and (5) the system of internal controls. These five areas are represented by the acronym ELRIC.

The process of performing safeguards assessments begins with a review of documentation provided by the central bank authorities at the request of IMF staff. These documents typically include audited financial statements and management letters from the external auditor, organizational charts, internal audit reports, lists of correspondent banks, summaries of internal controls, and, importantly, legislation governing and affecting the central bank. This last item will certainly contain the founding law of the central bank (and its amendments), but may also include various financial sector laws (for example, banking system law, insurance law, monetary law) that may pertain to the central bank and its operations.

The review of documentation is generally accompanied by discussions with the external auditors of the central bank, if any, as well as with central bank officials as necessary. If the documentation is deemed sufficient to draw conclusions about the adequacy of a central bank's ELRIC framework, the staff issues a safeguards assessment report. If, on the other hand, further information is required, the documents are

insufficient, or the weaknesses identified are high-risk in nature, staff may perform an on-site assessment of the central bank to confirm or modify conclusions drawn from the documentation review. In all cases, a safeguards assessment report is issued when staff has gathered enough information. The report is circulated to relevant IMF departments, after which it is sent to the authorities for their official comments. These comments are included in a final report sent to management for approval. Once approved, recommendations arising from the safeguards assessment process may become part of program conditionality under a member's financial arrangement with the IMF.

The ELRIC framework has proved a useful tool for assessing the adequacy of a central bank's governance and control structures. However, it should be noted that none of the five ELRIC areas is exclusive of the others. Indeed, experience has shown that the legal structure and independence of the central bank underpins all of the other areas of the framework. Nevertheless, the findings and recommendations of safeguards assessment reports are broadly categorized by the ELRIC framework to facilitate use of safeguards reports. Therefore, before examining the role of the legal framework in safeguarding Fund resources, it may be useful to visit briefly each of the other ELRIC areas to provide background on what the safeguards policy requires.

External Audit

In the area of the external audit mechanism, the safeguards policy requires that central banks be audited by an independent external auditor that adheres to internationally recognized auditing standards. Specifically, the policy foresees the use of major accounting and auditing firms, or Supreme Audit Institutions, that perform high-quality, timely, and comprehensive financial audits of central banks. To achieve this objective, it is important that the audit organizations possess appropriate staff skills, proven methodologies, and recognizable quality assurance mechanisms. They should also not have any restriction placed on their scope or their access to central bank documentation, staff, and facilities. Most important, the auditors are required to issue an opinion on the central bank's financial statements. This opinion must be published along with the financial statement on a periodic basis. Auditors should be rotated

regularly to avoid (the appearance of) a breakdown in the independence or objectivity of the auditor.

Financial Reporting Framework

As noted above, auditors are required to issue an opinion on the financial statements of the bank. To do this, however, they must understand the financial reporting framework on which the financial statements are based. Therefore, the safeguards assessment policy requires that central banks prepare financial statements in accordance with internationally recognized accounting standards, such as International Financial Reporting Standards (IFRS),⁴ U.S. Generally Accepted Accounting Principles (GAAP), or the accounting standards of the European System of Central Banks. These financial statements must be audited and published periodically. They must also contain appropriate disclosures about the accounting principles employed, including recognition and valuation policies, the risks facing the central bank, and its relations with government.

Internal Audit Mechanism

Internal audit has come to the fore due to the recent accounting and corporate governance scandals uncovered in the United States. In terms of safeguards assessments, each central bank should possess a functioning internal audit mechanism that provides independent assurance to the senior executive and board of directors of the central bank. This assurance should include controls over the production and authenticity of the financial statements. The internal audit function has moved away from its historical role as a simple compliance mechanism toward a risk-based assurance function that adds value to the organization. The Institute of Internal Auditors has issued guidelines for internal audit that serve as a benchmark for the assessment of a central bank's internal audit function under the safeguards policy.

System of Internal Controls

Although there is no defined benchmark for the assessment of internal controls at a central bank, safeguards assessments evaluate the overall internal controls system to ensure that appropriate controls are in

place in key areas related to the protection of IMF resources, that is, reserves management and data reporting. In particular, a central bank should have a general control structure that supports appropriate controls at three levels of the organization, namely, operational, managerial, and governance controls. In the area of reserves management, safeguards assessments seek to ensure that there is proper segregation of duties in the reserves management process among deal initiation, settlement, and accounting. Reserves management guidelines are also critical to ensure that the risks associated with managing a country's foreign exchange are understood and that dealers are held within limits established by the central bank's board of directors. Another area critical to safeguarding IMF resources relates to controls over data reported to the IMF. Safeguards assessments seek to ensure that a central bank's accounting data (which are audited by an independent third party) are able to be reconciled with data reported to the IMF for program purposes. Generally, these data include net international reserves, net domestic assets, and base money. The reconciliation of these two sets of data provides additional assurance that mitigates the risk of misreporting.

The Legal Framework

In many ways, the legal framework and autonomy of the central bank (the "L" of ELRIC) is both the most important and the most difficult area to assess. The legal framework within which the central bank operates underpins each of the aforementioned safeguards areas (i.e., ERIC) and has a direct impact on the ability of the central bank to safeguard resources, including IMF disbursements.

To evaluate this area, safeguards assessments draw on the expertise of the IMF's Legal Department to review the existing legislation for each member's central bank. Legal experts examine the laws for weaknesses in key areas related to safeguarding the IMF's resources. In particular, these key areas include

- Ensuring a proper governance structure for the central bank (for example, board of directors, monetary policy committee, governor, deputy governors);

- Preventing the undermining of central bank autonomy (for example, through the capricious removal of top management without due process of law);
- Defining the responsibility for owning and managing the foreign exchange reserves of the country;
- Detailing the modalities of central bank relations with the government, including, but not limited to, the terms of the provision of credit to government, the bank's profit distribution policy, and the roles of the central bank and government in policy decisions; and
- Providing for accounting and auditing mechanisms that meet international standards.

Safeguards assessments examine central bank and related legislation to ensure that there is no government interference with central bank operations that could undermine a central bank's autonomy and increase the risks to which it is exposed, particularly if agencies other than the central bank have responsibility for reserves management. To this end, safeguards assessments try to ensure that (1) the legal arrangements whereby the central bank extends credits, advances, or overdrafts to the government are adequate, and that the government has not interfered with the implementation of these regulations; and (2) for those agencies that share monetary authority with the central bank, the legal basis of their relationship to the central bank, their role as a monetary authority, and their responsibility for reserves management are transparent and explicit. Although other areas of central bank legislation (e.g., regulatory functions) may be more important to the overall stability of a country's financial system, only the above areas have direct relevance for safeguarding the IMF's resources.

Legal Findings to Date

The conduct of safeguards assessments has to date yielded interesting results. To begin with, IMF staff has noted that regardless of the strength of the underlying legal framework, there is always scope to circumvent the law. This is a truism among those in the legal profession. In

the case of safeguarding IMF resources, it has always been recognized that neither safeguards assessments nor the underlying controls can prevent the willful misuse of IMF resources or misreporting to the IMF. In the same way, a strong legal framework cannot hope to prevent intentional circumvention; it can, however, reduce the risk for such activity. Safeguards assessments have found that often, while the *de jure* framework is adequate, there may be *de facto* inadequacy of legal safeguards.

On the other hand, safeguards assessments have also found that occasional weaknesses in legal frameworks are compensated by *de facto* good governance or through operating regulations issued by banks' boards of directors. Nevertheless, safeguards assessments have revealed legal weaknesses in the areas of clarity of ownership of foreign exchange reserves and the potential for abuses in the appointment and dismissal of central bank officials. Safeguards assessments have also noted that many central bank laws do not contain provisions related to accounting and auditing of the institution, thereby leaving room for arbitrary policy decisions in these areas. Such decisions could result in weaknesses in the other ELRIC areas, namely the external audit mechanism and the financial reporting framework.

In several instances, safeguards assessments have noted that countries have multiple (and sometimes conflicting) laws governing central bank operations. Many countries have promulgated laws on central banks, as well as laws on monetary policy, the banking system, and other areas of the financial sector. The constitutions of some countries may contain clauses affecting the central bank and its relations with government. The multitude of laws affecting the central bank can have a marked effect on its ability to carry out its day-to-day operations, or on its ability to safeguard its resources in the most effective manner. For instance, in many cases, the constitution of the country may require that all state enterprises be audited by a government auditor. But this auditor may not have the capacity to effectively audit the central bank in accordance with minimum international standards (or those required by the IMF's safeguards policy). The central bank law may also require a government audit, but may not preclude an additional audit of the bank. In these cases, a solution would be to have a dual audit to fulfill the requirements of both the law and the IMF's safeguards assessment policy.

Safeguards Recommendations in the Legal Area

In general, when conducting safeguards assessments, IMF staff is reluctant to make recommendations regarding changes in the legal framework of a member's central bank. First, changing central bank legislation can be a lengthy process. Most of the safeguards assessments are linked to financial arrangements between the country and the IMF and have durations of one to three years; therefore, it may prove infeasible to require as part of program conditionality that a country change its central bank law under the auspices of the program. Second, changes to laws are politically difficult and sensitive. They require majorities—sometimes supermajorities—of legislators, as well as strong support from the executive. Third, and most important, recommending that a country revisit its central banking law(s) for the purposes of strengthening certain provisions may have unexpected (and undesired) side effects. Many central bank laws were adopted by previous governments and it may be imprudent to encourage legislatures to reexamine the law, thereby paving the way for possibly subjecting it to amendments reflecting political considerations. And experience has shown that certain legislators in each government are forever wont to rein in an overly independent central bank.

To avoid opening a Pandora's box—and to sidestep the other potential pitfalls—safeguards assessments refrain from recommending changes in the law in the near term, although they typically suggest desirable changes when an amendment of the law has been proposed on other grounds. Instead, safeguards assessments propose governance measures that aim to mitigate identified weaknesses in the legal framework. Such measures include resolutions adopted by the central bank's board of directors instituting an independent external audit for the bank, adopting internationally recognized accounting standards, or explicitly stating the autonomy of the central bank in the implementation of policy decisions.

Conclusion

Recommendations affecting the legal framework of the central bank—whether they are changes to the law or other measures designed to safeguard central bank resources—are but one aspect of the IMF's overall

approach to safeguarding its assets. Staff's proposals in the other ELRIC areas work to round out controls to reduce the risk of misuse of IMF resources or misreporting to the IMF. To date, the major weaknesses identified by safeguards assessments include the lack of an appropriate external audit, poor controls over data reported to the IMF, substandard accounting frameworks, and the absence of published financial statements. These weaknesses are in the process of being addressed through the implementation of recommendations made by IMF staff under the safeguards initiative. The legal component of a safeguards assessment is essential because it provides the legal foundation for all other areas of a central bank's control systems, and also sets the overall governance structure of the central bank.

Notes

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² Note, however, that in some cases, the central bank is not the fiscal agent of the government to the IMF, which means that some central banks do not record IMF accounts on their balance sheets.

³ See Press Release No. 02/19, *IMF Adopts Safeguards Assessments as a Permanent Policy*, issued April 5, 2002, <http://www.imf.org/external/np/sec/pr/2002/pr0219.htm>.

⁴ IFRS were previously called International Accounting Standards (IAS).