6 Financial Risk Management

The IMF's Articles of Agreement call for adequate safeguards for the temporary use of its resources.[1] Risks stem from interactions with the membership in fulfillment of the IMF's mandate as a cooperative international organization that makes its general resources available temporarily to its members. The IMF has an extensive risk-management framework in place, including procedures to mitigate traditional financial risks as well as strategic and operational risks. The latter risks are addressed by a variety of processes, including surveillance reviews, lending policies and operations, capacity building, standards and codes of conduct for economic policies, the communications strategy, and others.

Financial risks are mitigated by a multilayered framework reflective of the IMF's unique financial structure. Key elements include the IMF's lending policies (program design and monitoring, conditionality and phasing, access policies as well as the exceptional access framework), investment guidelines, internal control structures, financial reporting, audit systems, and the IMF's preferred creditor status. The Fund also utilizes precautionary balances to absorb the impact of risks once they crystallize. In addition, the IMF conducts safeguards assessments of central banks to ensure that their governance and control systems, auditing, financial reporting, legal structures, and autonomy are adequate to maintain the integrity of operations and minimize the risk of any misuse of IMF resources.

This chapter provides an overview of the financial risk-management framework and control structure of the IMF. A detailed description of financial risk mitigation follows, covering credit, liquidity, income, and market risks (interest rate and exchange rate risk controls). The balance of the chapter details the IMF's strategy for handling overdue financial obligations, safeguards assessments of central banks, and the IMF's audit framework and financial reporting and risk-disclosure mechanisms.

6.1 Financial Risk: Sources and Mitigation Framework

The monetary character of the IMF and the need for its resources to revolve require that members with financial obligations to the institution repay them as they fall due so that resources can be made available to other members. The IMF faces a range of financial risks in fulfilling its mandate, relating to credit, liquidity, income, and market risk, and has developed a multilayered financial risk-mitigation framework (Box 6.1).

- **Credit risk** typically dominates, reflecting the IMF's core role as a provider of balance of payments support to members when other financing sources may not be readily available. Credit risk can fluctuate widely since the IMF does not target a particular level of lending or lending growth. Since lending needs may arise from global developments, IMF lending can be highly concentrated and subject to correlated

[1] Article I, paragraph V: "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

risks. While credit risk is inherent in the IMF's unique role, it employs a comprehensive set of measures to mitigate such risk and safeguard the resources members provide to the IMF.

- Related to credit risk is **liquidity risk**—the risk that the IMF's resources will be insufficient to meet members' financing needs and its own obligations. Members may make additional demands for credit and may also draw on their reserve tranche positions and draw suddenly and in large amounts from their precautionary arrangements. In addition, under the terms of the New Arrangements to Borrow (NAB) and borrowing agreements, lenders may encash their claims against the IMF if they face balance of payments difficulties.
- The IMF also faces **income risk**—the risk of a shortfall in the ratio of annual income to expenses. This risk has been significant in the past—for example, when lending fell to low levels during the mid-2000s, before the recent global financial crisis. There has been significant progress in implementing the IMF's new income model, which aims to mitigate this risk.
- The IMF does not face significant **market (exchange rate and interest rate) risk** in its lending and funding operations with members, since the same floating interest rate determines both the rate of charge payable to the IMF by borrowing members and the rate of remuneration paid by the IMF to creditor members. In addition, the IMF's balance sheet is denominated in SDRs. The IMF faces market risks on its investment portfolios, though these risks are contained by the adoption of relatively conservative strategies (see Chapter 5).
- The IMF also self-insures for certain risks (for example, to cover losses of a capital nature) and has strong internal controls to address **operational risks**.

The IMF works to mitigate credit risk in several ways, including through policies on access, limits on financing, and incentives to contain excessively long and heavy use of its resources. It also mitigates credit risk through program design and conditionality, safeguard assessments of central banks, post-program monitoring, measures to deal with misreporting, and an arrears strategy. Liquidity risk is managed through regular quota reviews, as well as maintaining a 20 percent liquidity cushion called the prudential balance, and implemented through the Forward Commitment Capacity and the Financial Transactions Plan[2] (see Chapter 2). In addition, the IMF may borrow temporarily to supplement quota resources. The IMF's new income model aims to mitigate income risk and fluctuations. Precautionary balances are an important element of this model, because they generate investment income for the IMF and are a critical part of the risk management framework. The sections that follow discuss these risk-mitigation factors in more detail.

6.1.1 Credit Risks

6.1.1.1 LENDING POLICIES

Credit risk refers to potential losses on credit outstanding due to the inability or unwillingness of member countries to make repurchases (that is, to repay credit extended to them). Credit risk is inherent in the IMF's unique role in the international monetary system given that the IMF has limited ability to diversify its loan portfolio and generally provides financing when other sources are not available to a member. In addition, the IMF's credit concentration is generally high due to the nature of its lending.

The IMF employs a comprehensive set of measures to mitigate credit risk. The primary tools for credit risk mitigation are the strength of IMF lending policies on access—phasing, program design, and conditionality—which are critical to ensuring that IMF financial support helps members resolve their balance of payments difficulties (see Chapter 2 for a more detailed discussion of the IMF's lending policies). These policies include assessments of members' capacity to implement adjustment policies and repay the IMF including the exceptional access policy for large commitments. This policy subjects potential users of Fund resources to a higher level of scrutiny, including review of compliance with substantive criteria and early involvement of the Executive Board including through a discussion of risks to the IMF if proposed access exceeds 145 percent of their quota annually or 435 percent cumulatively, net of scheduled repurchases.

Credit risks are also mitigated by the structure of charges and maturities, adequate junior cofinancing from other official lenders, and the IMF's preferred creditor status (Box 6.2). The IMF passes its low cost of funding to borrowers to assist with their adjustment but adds a level- and time-based surcharge premium to moderate large and/or prolonged use of resources and encourage prompt repayment when access to market financing is restored.

In addition, the IMF has systems in place to assess safeguard procedures at members' central banks and to address overdue financial obligations. In the event of arrears, the IMF has a financial strategy for addressing overdue obligations, including a burden-sharing mechanism (Box 6.3). This mechanism aims to cover income losses related to arrears charges (see Section 6.2); it can also contribute to the accumulation of precautionary balances (see Section 6.1.1.2).

Furthermore, the Fund normally employs a system of post-program monitoring with members that have substantial outstanding credit to the Fund but are no longer in a program relationship. Post-program monitoring enhances the Fund's ability to detect risks to the member's repayment capacity and thus safeguard the Fund's resources. In July 2016, the Executive Board adopted changes to the post-program monitoring framework to

[2] Guidelines for Quarterly Financial Transactions Plan: www.imf.org/external/np/tre/ftp/pdf/0408.pdf.

Table 6.1 Level of Precautionary Balances in the General Resources Account
(Billions of SDRs; as of April 30 each year)

	End of Financial Year								
	2008	2009	2010	2011	2012	2013	2014	2015	2016
Precautionary balances[1]	6.9	7.1	7.3	8.1	9.5	11.5	12.7	14.2	15.2
Reserves	5.8	5.9	6.1	6.9	8.3	10.3	11.5	13.0	14.0
General	3.5	3.5	3.5	4.0	4.9	6.1	7.6	9.0	9.5
Special	2.2	2.4	2.6	2.9	3.4	4.2	4.0	4.0	4.5
SCA-1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Memorandum items:									
Credit outstanding	5.9	20.4	41.2	65.5	94.2	90.2	81.2	55.2	47.8
Arrears[2]	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Principal	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Charges	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Precautionary balances to Credit outstanding	117.7	34.7	17.8	12.4	10.1	12.8	15.7	25.7	31.8

Source: Finance Department, International Monetary Fund.

Note: SCA = Special Contingent Account.

[1]Precautionary balances as of the end of FY2011 and for subsequent periods exclude pro ts from gold sales.

[2]Obligations to the GRA that are 6 months or more overdue. Excludes arrears in the Structural Adjustment Facility (SAF), Poverty Reduction and Growth (PRG) Trust, and the Trust Fund.

make it more risk based and focused. The Board established absolute-size thresholds that would trigger post-program monitoring set at SDR 1.5 billion for GRA credit and SDR 0.38 billion for PRGT credit, to help ensure adequate monitoring of large exposures to the Fund's resources.[3] As a backstop, a quota-based threshold of 200 percent of quota in outstanding Fund credit also applies. A post-program monitoring report is expected to be prepared once a year, based on a mission scheduled between annual Article IV consultations. The report should examine in depth the full range of risks to members' capacity to repay, with the analysis tailored to a country's specific circumstances.

6.1.1.2 PRECAUTIONARY BALANCES

Precautionary balances strengthen the IMF's balance sheet, help to ensure the value of members' reserve positions, and safeguard the IMF's financing mechanism (Box 6.4). IMF financial assistance can result in large exposures, and high credit concentration is a likely consequence of the IMF's mandate to respond to members' balance of payments needs. Precautionary balances address residual risks after applying other elements of the multilayered risk-management framework and protect the IMF's balance sheet in the event that it suffers losses as a result of credit or other financial risks (Box 6.1). This function is critical to protecting the value of members' reserve assets and promotes confidence that members' reserve positions are safe and liquid from a balance sheet perspective.

The IMF's precautionary balances consist of reserves held in the General and Special Reserves and the balance in the Special Contingent Account, or SCA-1 (Box 6.4).[4] Additions to reserves come through net income allocations determined annually by the Executive Board (including from surcharges), while the SCA-1 has been built up mainly by contributions from IMF debtors and creditors under the burden-sharing mechanism, which are potentially refundable. As of April 30, 2016, precautionary balances amounted to SDR 15.2 billion (Table 6.1).

6.1.1.3 REVIEW OF THE ADEQUACY OF PRECAUTIONARY BALANCES

The IMF conducts regular reviews of the adequacy of precautionary balances. At the 2002 review, a target for precautionary balances of SDR 10 billion was established. This figure took into account a number of considerations, including the possibility of imminent risk to the IMF's credit portfolio, the need to ensure continued compliance with International Financial Reporting Standards (IFRS), and the need to raise the IMF's reserve ratio closer to those of other international financial institutions. The IMF staff also considered it reasonable to double precautionary balances to at least 6 percent of the IMF's credit capacity. The

[3]These thresholds are calibrated to reflect the Fund's loss-absorption capacity and correspond to 10 percent of the minimum floor of precautionary balances for credit outstanding from the GRA, and to the end-December 2015 balance in the Reserve Account for credit outstanding from the PRGT, respectively.

[4]For analytical purposes the IMF's concept of precautionary balances does not include the portion of the Special Reserve attributed to the gold profits and invested in the endowment. As a legal matter, however, the Special Reserve forms part of the IMF's reserves and amounts attributed to gold sales profits may be used for the same purposes as other parts of the Special Reserve.

target was subsequently reaffirmed on three occasions (in 2004, 2006, and 2008).

During the 2008 review of precautionary balances, the Executive Directors asked the IMF staff to develop a more transparent and rules-based framework for reserve accumulation, with forward-looking elements to account for the volatility of IMF lending. They noted that this framework should cover how the reserves target would be set and adjusted over time, the modalities for accumulating reserves, and how reserves in excess of the target would be handled. The Directors emphasized that credit risk should be the primary consideration in assessing reserve adequacy under the new income model (see Chapter 5), since this model is expected to significantly mitigate the IMF's overall income risk. They also supported use of a variety of forward-looking indicators and further development of scenario analyses and stress tests.

In response to this request, the IMF staff proposed a new framework for assessing reserve adequacy in 2010. Under the framework, the target for precautionary balances would be broadly maintained within a range linked to developments in total credit outstanding. The framework consists of four main elements:

- **Reserve coverage ratio**: The reserve coverage ratio would be set within a range of 20 to 30 percent of a forward-looking measure of credit outstanding, subject to a minimum floor (see below). This proposal draws on approaches of other international financial institutions but seeks to adapt them to the specific circumstances of the IMF.
- **Forward-looking credit measure to anchor the range**: The credit measure used to determine the range would include a strong forward-looking element while also seeking to smooth some of the year-to-year volatility of credit movement. Specifically, it would comprise a 3-year average of credit outstanding covering the previous 12 months and projections for the next 2 years, taking into account scheduled disbursements and repayments under all approved nonprecautionary arrangements.
- **Treatment of precautionary arrangements**: The framework currently does not explicitly include commitments under precautionary arrangements in determination of the range, but allows for these commitments to be taken into account when the Executive Board decides where to set the target.
- **A minimum floor for the target**: The framework includes a minimum floor for precautionary balances to protect against an unexpected increase in credit risk and ensure a sustainable income position.

Most Directors supported this framework at the 2010 review. They agreed to raise the medium-term target for precautionary balances to SDR 15 billion. They also generally supported setting a minimum floor for precautionary balances at SDR 10 billion, while highlighting the need to keep this under review. Consistent with the framework, the medium-term target was subsequently increased to SDR 20 billion at the time of the review in April 2012 (Table 6.1). At the most recent review in February 2016, Directors supported retaining the medium-term indicative target for precautionary balances of SDR 20 billion. The minimum floor for precautionary balances was raised to SDR 15 billion, a level deemed more consistent with maintaining a long-term sustainable income position and one that would provide a larger buffer to protect against unexpected increases in credit in a future environment of low-lending by the IMF.

6.1.2 Liquidity Risks

Liquidity risk is the risk that the IMF's resources may not be sufficient to meet the financing needs of members and its own obligations. The IMF must have adequate usable resources available to meet members' demand for IMF financing. While the IMF's resources are largely of a revolving nature, uncertainties in the timing and amount of credit extended to members during financial crises expose the IMF to liquidity risk. Moreover, the IMF must also stand ready to (1) meet, upon a member's representation of need, demands for a drawing of a member's reserve tranche position, which is part of the member's reserves, and (2) make drawings under borrowing agreements to fund encashment requests from lenders under bilateral borrowing agreements or the NAB in case of balance of payments need of the relevant creditor member.

The IMF's financial structure helps mitigate liquidity risk, but the volatility and uncertainty in the timing and size of members' needs for financing, as well as the potential demands from members to draw on their reserve tranche positions, require appropriate management of that liquidity risk. The IMF does not use market financing to cover unanticipated liquidity needs, but rather takes a multifaceted approach to ensure sufficient financial resources to cover its members' financing needs:

- The IMF's main measure of its capacity to make new GRA resources available to its members—the Forward Commitment Capacity (FCC)—is closely monitored by the Executive Board, management, and staff. The FCC equals uncommitted usable resources from quota and IMF borrowing, plus repurchases 1 year forward, minus repayment on borrowing 1 year forward, minus the prudential balance, minus undrawn balances under existing arrangements (Box 6.6). A modified FCC has been developed to take into account shorter-term availability of resources under the amended and expanded NAB—see Chapter 2. The maximum activation period within which the IMF can make commitments funded with NAB resources is 6 months.
- IMF lending is based on an exchange of assets. Members whose currencies are used in GRA lending operations are reviewed and approved by the Executive Board on a quarterly basis in the Financial Transactions Plan (FTP). In the FTP, the IMF staff specifies the amount of SDRs and selected

member currencies to be used in transfers and receipts expected to be conducted through the GRA during that period. The selection of members to participate in financing IMF lending transactions takes into account recent and prospective developments in balance of payments and reserves, trends in exchange rates, and the size and duration of external debt obligations. Use of the IMF's holdings of these currencies in lending operations results in FTP members receiving, in exchange, a liquid claim on the IMF (reserve tranche position) that earns interest based on the SDR interest rate.[5] The NAB employs a similar quarterly liquidity review called the Resource Mobilization Plan (RMP) (see Chapter 2).

- Longer-term resource needs are assessed in General Quota Reviews of the adequacy of members' quotas for meeting the demand for IMF financing that take place at least every 5 years. The methodology is not defined under the Articles, but the size of the IMF in terms of quota has been assessed historically against global economic indicators such as GDP, trade and capital flows, and estimates of members' needs (see Chapter 2).
- The IMF may borrow to supplement its quota resources. It has two standing borrowing arrangements—the NAB, which is the main backstop for quota resources, and the General Arrangements to Borrow (GAB), which can be used in limited cases. The IMF has also employed ad hoc bilateral borrowing with official lenders, and may borrow from the private markets, although it has never done so (see Chapter 2).
- The prudential balance is intended to safeguard the liquidity of creditors' claims and take account of the potential erosion of the IMF's resource base. The prudential ratio of 20 percent set by the IMF's Executive Board reflects historical experience and judgments on the indicative level of uncommitted usable resources that the IMF would normally not use to make financial commitments (see Box 6.6).
- Level- and time-based surcharges mitigate large and long use of IMF credit, supporting the revolving nature of IMF resources by providing an incentive to repurchase IMF credit when market access is regained.
- Commitment fees also help contain risks to the Fund's liquidity. The current upward sloping fee structure was introduced as part of the broader reforms to the GRA lending toolkit in 2009 with the aim of discouraging unnecessarily high precautionary access (see Box 5.3).
- Access limits are a further element of the Fund's risk management framework to help preserve Fund liquidity and the revolving character of Fund resources (see Access Policy Chapter 2).

6.1.3 Income Risk

The IMF also faces income risk—the risk of a shortfall in annual income relative to expenses. This risk has occurred at certain times in the past, including when lending fell to very low levels during the run-up to the global financial crisis. Chapter 5 explains how the IMF generates income to finance its administrative expenditures, highlighting the ways in which the IMF has adapted the financial structure in order to broaden its sources of income. The new income model is intended to mitigate income risk associated with decreased lending and is based on more diverse sources of revenue that are appropriate to support the IMF's mandated broad range of activities. In addition, precautionary balances—which also generate investment income—add further protection to the Fund's income. Other measures to mitigate income risk include changes in the margin on the basic rate of charge and surcharges as well as the burden-sharing mechanism.

6.1.3.1 INTEREST RATE RISK

Interest rate risk is the risk that the future cash flows will fluctuate because of changes in market interest rates. The IMF mitigates interest rate risk primarily by linking the rate of charge to the rate of remuneration. To minimize the effect of interest rate fluctuations on income, the IMF links the rate of charge directly to the SDR interest rate (and thus to the rate of remuneration, which has often been set at 100 percent of the SDR interest rate before burden-sharing adjustments).

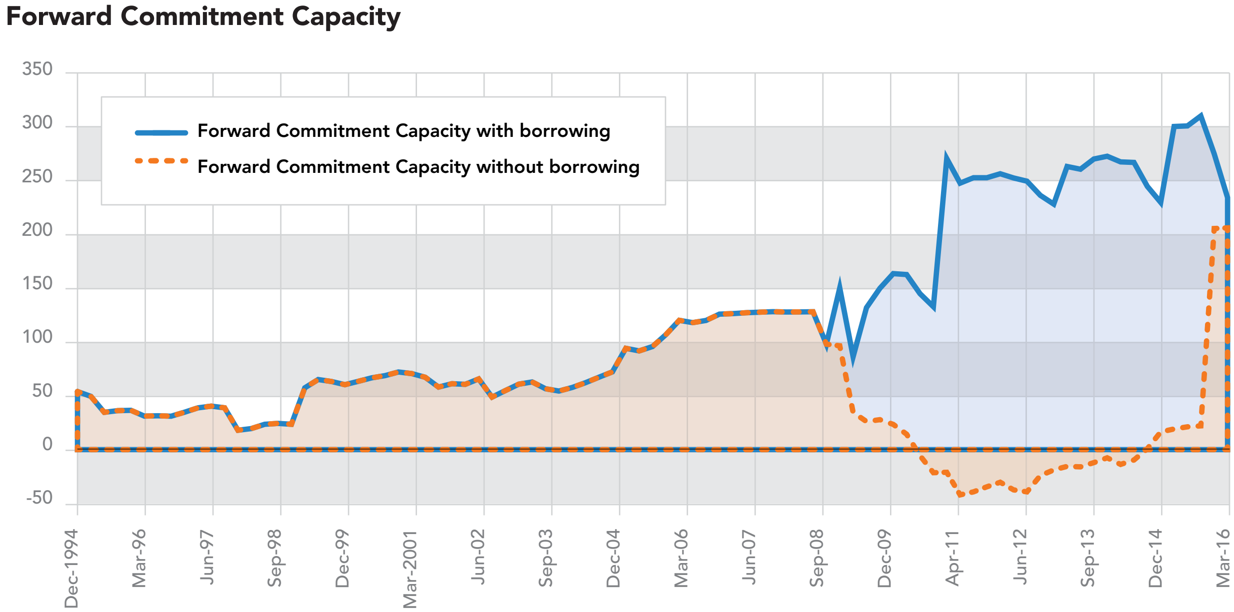
Interest rate risk related to bilateral borrowings, issued notes, and borrowings under the enlarged and amended NAB is limited since claims from drawings are currently remunerated at the SDR interest rate. The proceeds from borrowings are used to extend credit to member countries at the rate of charge, which is based on the SDR interest rate plus a margin, or to repay borrowings under bilateral borrowing agreements and the enlarged and amended NAB.

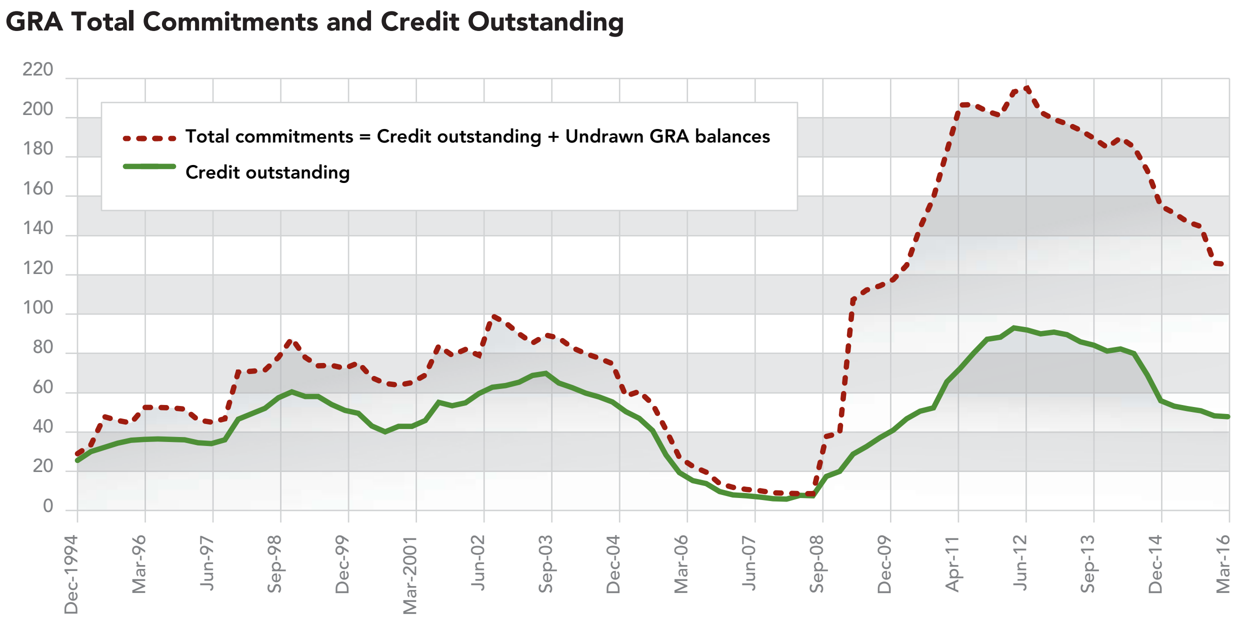
Interest rate risk on investments is limited by prudent limits on duration. In the case of the Fixed-Income Subaccount of the Investment Account, interest rate risk is controlled by the short duration of portfolios. In the case of trust assets, the duration of the investment portfolio is limited to a weighted average effective duration that does not exceed 3 years (see Chapter 5).

[5] IMF reserve positions, which are part of members' reserve assets, must be fully liquid and readily available for use if needed. Members' reserve positions at the IMF are the sum of the reserve tranche that reflects the reserve assets the member has provided to the IMF under its quota-based obligations and use of the member's currency in the IMF's lending operations, plus any indebtedness of the IMF in the GRA that is readily available to the member to meet balance of payments financing needs (see Chapter 2). The IMF's *Balance of Payments and International Investment Position Manual Sixth Edition* (BPM6) defines reserve assets as "those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate and for other resulted purposes…" To be readily available, reserve assets generally should be of high quality. (See BPM6, Chapter 6, paragraphs 6.64 and 6.70.)

Figure 6.1 **Forward Commitment Capacity: How the IMF Augments Quota Resources through Borrowing, December 1994–April 2016**

(Billions of SDRs)





Source: Finance Department, International Monetary Fund.
Note: GRA = General Resources Account.

Table 6.2 The IMF's Liquidity, 2010–16
(Billions of SDRs; as of April 30 each year)

	2010	2011	2012	2013	2014	2015	2016
End of Period							
Usable Resources[1]	314.2	423.4	396.4	397.3	408.7	435.7	430.3
Of Which: Available Borrowing to Finance Pre-NAB Commitments[2]	166.3	58.0	43.2				
Available Borrowing to Finance Pre/Post-NAB Commitments[2]		1.5	1.4				
Available under NAB Activations[3]		211.0	206.3	242.0	242.8	252.3	38.4
Less: Undrawn Balances under GRA Arrangements	76.3	115.9	121.6	108.0	113.3	99.1	77.6
Plus: Repurchases Due in Next 12 Months	1.9	3.3	13.7	20.4	16.9	8.9	2.2
Less: Repayments of Borrowing Due 1-Year Forward			1.1	5.4	8.3	4.5	2.6
Less: Prudential Balance	70.7	40.1	40.0	39.7	39.7	39.7	79.6
Equals: 1-Year Forward Commitment Capacity	**169.1**	**270.7**	**247.4**	**264.7**	**264.3**	**301.4**	**272.8**
Memorandum Items, End of Period:							
Flows During the Period							
New Commitments[4]	77.6	142.2	52.6	75.1	24.2	79.8	5.6
Purchases	21.1	26.6	32.2	10.6	11.7	12.0	4.7
Repurchases	0.3	2.3	3.6	14.6	20.6	38.0	12.1
Total Credit Lines under GAB/NAB	34.0	367.5	370.0	370.0	370.0	370.0	182.4
Quotas of Members in Financial Transactions Plan	179.9	198.7	198.4	198.3	198.3	198.3	396.6
GRA Credit Outstanding	41.2	65.5	94.2	90.2	81.2	55.2	47.8
Active Borrowing Agreements[5]	172.6	169.3	169.7				
Outstanding Borrowing by the IMF	6.4	19.7	40.0	45.5	47.3	36.8	47.8

Source: Finance Department, International Monetary Fund.

Note: Columns may not add up due to rounding.

[1]Usable resources consist of: (1) the IMF s holdings of the currencies of Financial Transactions Plan (FTP) members, (2) holdings of SDRs, and (3) unused amounts available under activated bilateral loan and note purchase agreements, and unused amounts available under the New Arrangements to Borrow/General Arrangements to Borrow (NAB/GAB) when these have been activated.

[2]Effective April 1, 2013, the Board approved termination of any further drawings under these Fund bilateral borrowing and note purchase agreements, which were concluded in 2009/2010 prior to activation of the NAB.

[3]Re ects activation of the enlarged NAB for successive 6-month periods since April 1, 2011, until February 25, 2016.

[4]Gross amounts of new commitments not netted for undrawn balances under expired/cancelled arrangements. Includes disbursements under Emergency Assistance.

[5]Total amount made available under active borrowing agreements, including amounts already disbursed: only available for pre-NAB purchases.

Due to its return objective, the investments of the Endowment Subaccount are exposed to a larger set of risks, including interest rate risk. The conservative and diversified nature of the Endowment Subaccount asset allocation ensures that these risks are limited and balanced. Its relatively small size also limits the impact of adverse market movements on the IMF's overall balance sheet.

Procedures are in place to periodically review the strategy of the Investment Account, including the adequacy of risk limits. Within the scope of the investment authority under the Articles, the Executive Board endorses the investment objective, strategic benchmark, and main risk control procedures for all IA investments through the adoption of the Rules and Regulations for the IA.[6] Formal agreements with managers and custodians bind them to act within the IMF's risk approach (see Chapter 5).

[6]The strategic benchmark was selected based on an analysis of historical returns and forward-looking assumptions, as well as on consultations with asset managers in the private sector, with international organizations, and certain central banks of IMF members.

6.1.3.2 EXCHANGE RATE RISK

Exchange rate risk is the exposure to the effects of fluctuations in foreign currency exchange rates on an entity's financial position and cash flows. The IMF has no exchange rate risk exposure on its holdings of members' currencies in the GRA since, under the Articles of Agreement, members are required to maintain the value of such holdings in terms of the SDR. Any depreciation/appreciation in a member's currency vis-à-vis the SDR gives rise to a currency valuation adjustment receivable or payable that must be settled by the member promptly after the end of the financial year or at other times as requested by the IMF or the member. The IMF has other assets and liabilities, such as trade receivables and payables, denominated in currencies other than SDRs and makes administrative payments largely in U.S. dollars, but the exchange rate risk exposure from these other assets and liabilities is limited.

Investments of the Fixed-Income Subaccount and the trusts are exposed to very limited exchange rate risk. The portfolios include securities—Bank for International Settlements (BIS) Medium-Term Instruments and government bonds—denominated in the constituent currencies of the SDR based on the weight of each currency in the SDR basket. However, because securities included in the portfolio change in value over time and generate cash flows, the weight of each currency in the portfolio differs slightly from the weights in the SDR basket, generating some residual exchange rate risk. This risk is mitigated by regular (at least monthly) rebalancing of the portfolio. Regarding the Endowment Subaccount, the impact of foreign exchange volatility is controlled through mandatory hedging of part of the assets back to the base currency, the U.S. dollar (see Chapter 5).

6.2 Overdue Financial Obligations

6.2.1 Overview

In its first four decades, the IMF's experience with member countries in making timely payments was generally satisfactory. However, beginning in the early 1980s, the number and amount of late payments increased significantly. Overdue obligations to the IMF rose from SDR 178 million at the end of 1984 to a peak of SDR 3.6 billion at the end of 1991 (Box 6.10). Although most delays were temporary and quickly corrected, the increase in protracted arrears (defined as overdue financial obligations of 6 months or more) raised serious concerns and highlighted the need for procedures to deal systematically with arrears (Box 6.7).

In the late 1980s and early 1990s, the IMF strengthened its procedures for dealing with overdue obligations with the aim of preventing the emergence of additional overdue financial obligations and eliminating existing ones. This culminated in the establishment of the Strengthened Cooperative Strategy on Overdue Financial Obligations in the early 1990s. The strengthened cooperative arrears strategy comprises three elements: (1) the prevention of arrears, (2) collaboration in clearing arrears, and (3) remedial measures against continuing arrears. To further encourage members in protracted arrears to cooperate, the IMF established a policy in mid-1999 on the de-escalation of remedial measures. This policy lifted some remedial measures if the member established a solid record of cooperation with the IMF on policies and payments.

The cooperative arrears strategy has been broadly successful in helping to resolve the cases of protracted arrears that existed at the end of the 1980s and preventing new cases of protracted arrears from emerging. Of the 11 cases of protracted arrears at the end of 1989, 8 were resolved by the mid-1990s; another case (Liberia) was resolved in 2008. Nine new cases of protracted arrears emerged since the establishment of the arrears strategy. As of the end of April 2016, only three cases of protracted arrears remained—Somalia, Sudan, and Zimbabwe (Table 6.3). Clearing these arrears is complicated by domestic conflict, international sanctions, or both. Sudan accounts for about three-quarters of the total (Table 6.4).

Reflecting success in resolving past cases of arrears and preventing the emergence of new cases, the level of overdue financial obligations to the IMF has declined sharply, from its peak of SDR 3.6 billion at the end of 1991 to SDR 1.3 billion at the end of April 2016 (Figure 6.2). In addition, as of end-April 2016, as a percent of credit outstanding, arrears were at their lowest level in 27 years (Figure 6.3). The largest share of the arrears to the IMF was to the GRA (87 percent), with the balance due to the Trust Fund, the Special Disbursement Account, and the Poverty Reduction and Growth Trust—overdue charges and interest accounted for about two-thirds of the total. On June 30 and July 13, 2015, Greece did not settle repurchase obligations falling due amounting to SDR 1,232 million and SDR 360 million, respectively. While the overdue financial obligations were outstanding, Greece was not permitted to receive any further Fund financing. Greece subsequently settled these overdue obligations on July 20, 2015.

6.2.2 Cooperative Strategy on Overdue Financial Obligations

The Strengthened Cooperative Strategy consists of three elements: (1) preventive measures to avoid new arrears from emerging, (2) intensified collaboration with members in arrears, and (3) remedial measures of increasing intensity to encourage members to cooperate with the IMF in seeking a solution to their arrears.

6.2.2.1 PREVENTION

The IMF's best safeguard against the emergence of arrears is the quality of IMF supported programs. In this context, the IMF places priority on (1) assisting members in designing strong and comprehensive economic programs; (2) carefully assessing the access of members to IMF financial support and the phasing of such support; (3) conducting an explicit assessment of a member's capacity and willingness to repay the IMF; and (4) ensuring adequate balance of payments financing during the IMF arrangement. The IMF also introduced the safeguards policy in 2000 to obtain reasonable assurance that central banks of member countries using IMF resources have appropriate control systems in place to manage the resources adequately and to provide reliable information. In addition, the IMF continues to emphasize the importance of remaining current with the IMF. In some cases, specific financial or administrative arrangements can be used to ensure timely repayments to the IMF, including through the advance purchase of SDRs to provide for the settlement of forthcoming obligations.

6.2.2.2 COLLABORATION

To normalize relations with the IMF, the collaborative element of the arrears strategy provides a framework for cooperating members in arrears to establish a strong track record of policy performance and payments to the IMF. Accordingly, members use their own financial resources, or support from creditors, in order to clear their arrears to the IMF and regain access to IMF financial support (see Section 6.2.3). In this context the IMF developed the Staff-Monitored Program (SMP) and Rights Accumulation

Table 6.3 History of Protracted Arrears to the IMF

Country	Period	Arrears		
		Duration (years)	SDR millions	Percent of Quota
Up to 1979				
Cuba	1959 64	5.0	. . .	. . .
Egypt	1966 68	2.0	. . .	. . .
Cambodia	Mar. 1975 Oct. 92	18.6	36.9	147.6
1980 89				
Nicaragua	Feb. 1983 Apr. 85	2.2	14.4	21.0
Guyana	Apr. 1983 Jun. 90	7.2	107.7	217.7
Chad	Jan. 1984 Nov. 94	10.8	4.1	13.4
Vietnam	Feb. 1984 Oct. 93	9.7	100.2	41.5
Sierra Leone	Nov. 1984 Sep. 86	1.8	25.1	43.3
Sudan	Jul. 1984 present	. . .	970.1[1]	571.7
Liberia	Dec. 1984 Mar. 2008	23.3	543.0	761.6
Tanzania	Mar. 1985 Jul. 86	1.3	22.9	21.4
Zambia	Apr. 1985 Jan. 86	0.8	115.1	42.6
Gambia, The	Jun. 1985 Jul. 86	1.1	10.6	62.0
Peru	Sep. 1985 Mar. 93	7.5	621.0	187.7
Jamaica	Apr. 1986 Jan. 87	0.8	50.0	34.4
Zambia	Apr. 1986 Dec. 95	9.7	830.2	307.1
Sierra Leone	Jan. 1987 Mar. 94	7.2	85.5	147.7
Somalia	Jul. 1987 present	. . .	236.8[1]	535.7
Honduras	Oct. 1987 Nov. 88	1.1	3.3	4.9
Panama	Dec. 1987 Feb. 92	4.2	180.9	177.0
Congo, Democratic Republic of the	Jun. 1988 May 89	0.9	115.4	39.6
Haiti	Oct. 1988 Sep. 89	0.9	9.2	20.9
Honduras	Nov. 1988 Jun. 90	1.6	27.5	40.6
1990 present				
Iraq	May. 1990 Sep. 2004	14.3	55.3	11.0
Dominican Republic	Aug. 1990 Apr. 91	0.7	24.3	21.6
Congo, Democratic Republic of the	Nov. 1990 Jun. 2002	11.6	403.6	138.8
Haiti	Nov. 1991 Dec. 94	3.1	24.8	40.9
Bosnia and Herzegovina	Sep. 1992 Dec. 95	3.3	25.1	20.7
Yugoslavia	Sep. 1992 Dec. 2000	8.3	101.1	21.6
Central African Republic	Jun. 1993 Mar. 94	0.8	1.6	3.8
Afghanistan	Nov. 1995 Feb. 2003	7.3	8.1	6.7
Zimbabwe	Feb. 2001 present	. . .	78.8[1,2]	11.1

Source: Finance Department, International Monetary Fund.

[1]As of April 30, 2016.

[2]Arrears to the Poverty Reduction and Growth Trust. Zimbabwe s arrears to the General Resources Account were cleared in February 2006.

Table 6.4 Arrears to the IMF of Countries with Obligations Overdue by Six Months or More, by Type and Duration

(Millions of SDRs; as of April 30, 2016)

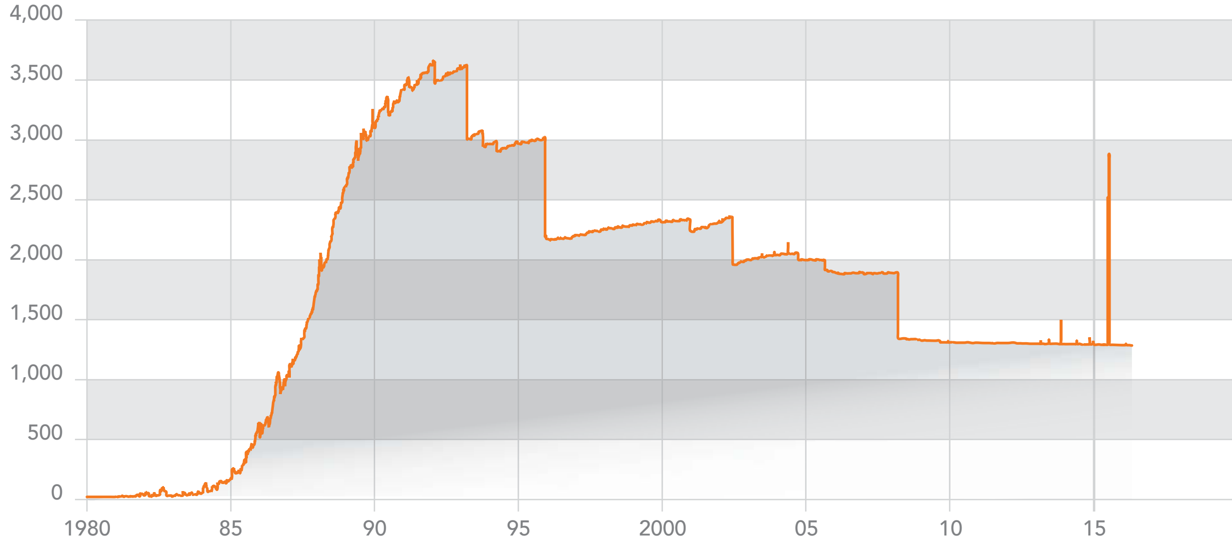
	By Type				By Duration		
	Total	General Department[1]	Trust Fund	PRGT	Less than 6 months	Over 6 months	3 years or more
Somalia	236.8	228.5	8.3		0.5	236.2	233.5
Sudan	970.1	887.7	82.4		1.1	969.1	963.7
Zimbabwe	78.8			78.8	0.0	78.8	78.6
Total	**1,285.7**	**1,116.2**	**90.7**	**78.8**	**1.6**	**1,284.1**	**1,275.7**

Source: Finance Department, International Monetary Fund.

Note: Numbers may not add up to totals due to rounding.

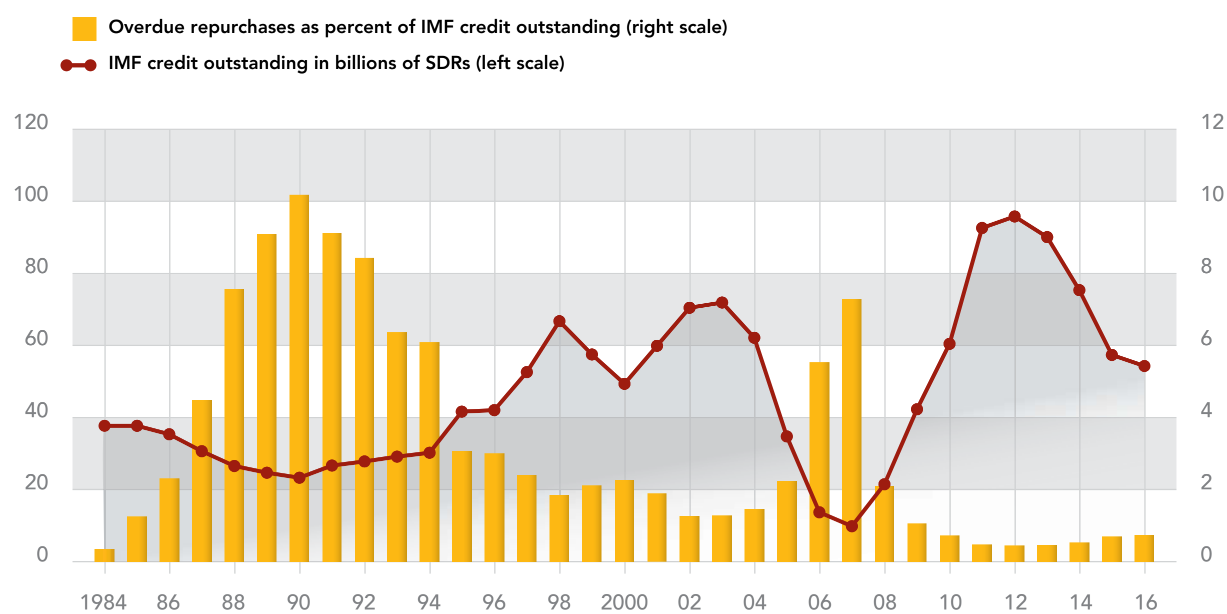
[1]Includes Structural Adjustment Facility.

Figure 6.2 Overdue Financial Obligations to the IMF, 1980–2016
(Millions of SDRs; as of April 30, 2016)



Source: Finance Department, International Monetary Fund.
Note: The sharp drops in arrears in 1993, 1995, 2002, and 2008 were largely attributable to arrears clearance by Peru, Zambia, Democratic Republic of the Congo, and Liberia, respectively.

Figure 6.3 IMF Credit Outstanding and Overdue Obligations, 1984–2016
(As of April 30, 2016)



Source: Finance Department, International Monetary Fund.

Program (RAP) to help members in arrears establish the required track record.[7]

THE RIGHTS ACCUMULATION PROGRAM

The rights approach was established in 1990 with eligibility limited to the 11 members in protracted arrears to the IMF at the end of 1989.[8] Under the RAP, a member in arrears may earn a "right"—that is, a claim toward a future disbursement from the IMF in a future arrangement. This future disbursement is conditioned on establishing a track record on policies and payments to the IMF in the context of an adjustment program monitored by the IMF, clearance of the member's overdue obligations, and approval of a successor arrangement by the IMF. The rights approach facilitated the clearance of arrears and normalization of financial relations with Peru (1993), Sierra Leone (1994), and Zambia (1995), and remains available to Somalia and Sudan.[9]

All RAPs involve upper credit tranche conditionality and require modified financing assurances.[10] Under these programs, members are expected to adopt and implement strong adjustment programs that establish a credible track record of policy implementation and help create conditions for sustained growth and substantial progress toward external viability. Such programs should adhere to the macroeconomic and structural policy standards associated with programs in the upper credit tranches and the PRGT. To support the member's adjustment efforts, adequate external financing is required for the program, including debt rescheduling and relief from bilateral and private creditors and new financing from various sources. Under the RAPs members are expected, at a minimum, to remain current with the IMF and the World Bank on obligations falling due during the period of the program. RAPs are normally 3 years in duration, although there is flexibility to tailor the length of the track record to the member's specific circumstances.[11]

STAFF-MONITORED PROGRAMS

Staff-Monitored Programs (SMPs) may be used in arrears cases if capacity constraints and/or insufficient financing assurances make it difficult for a member with protracted arrears to adopt and implement programs that meet the standards of upper credit tranche conditionality.[12] In such circumstances, informal staff monitoring has allowed the IMF staff to engage in intensive policy dialogue, helping establish or reestablish a track record on policies and payments to the IMF that can also be informative to creditors and donors as to the member's commitment to credible and sound policies. As regards payments to the IMF, it is expected that the member will make payments at least equal to newly maturing obligations. The arrears of Vietnam (1993), the Democratic Republic of the Congo (2002), and Liberia (2008) were cleared under this approach.

POST-CONFLICT CASES

In the late 1990s, the IMF's Executive Board noted the special challenges posed by large protracted arrears in postconflict countries. Noting that the IMF's arrears strategy had been effective in restoring relations with countries in a wide range of situations, the Executive Board in 1999 agreed to relax its call for payments as a test of cooperation, provided a member is judged cooperative on policies and provided all other multilateral creditors take at least comparable action.[13]

6.2.2.3 REMEDIAL MEASURES

Remedial measures are applied to member countries with overdue obligations to the IMF that are not actively cooperating with the IMF in seeking a solution to their arrears problem (Box 6.8). Since arrears to the Poverty Reduction and Growth Trust (PRGT) are not a breach of obligations under the IMF's Articles of Agreement, the Executive Board in August 2001 adopted a timetable of remedial measures for arrears to the PRGT. This timetable parallels to the extent possible the timetable of remedial measures for arrears to the General Resources Account (Box 6.9). Remedial measures are applied under an escalating time schedule. The timetable guides Executive Board consideration of remedial measures of increasing intensity, although the application of each particular step is considered in light of the individual circumstances of the member concerned.

A member's cooperation with the IMF is reviewed periodically. Once a member is declared ineligible to use the IMF's general

[7] Historically, IMF-Monitored Programs were also used to clear arrears. Like RAPs, such programs were expected to adhere to the macroeconomic and structural policy standards associated with programs in the upper credit tranches. The arrears of Guyana (1989) and Panama (1990) to the IMF were cleared through IMF-Monitored Programs.

[8] These were Cambodia, Guyana, Honduras, Liberia, Panama, Peru, Sierra Leone, Somalia, Sudan, Vietnam, and Zambia.

[9] To reassure lenders to the PRGT that they would be repaid for PRGT (formerly PRGF—Poverty Reduction and Growth Facility) loans made in connection with the encashment of rights under the RAP, the IMF in 1993 pledged to sell up to 3 million ounces of gold if it was determined that the PRGT Reserve Account, plus other available means of financing, were insufficient to meet payments due to creditors.

[10] Financing assurances were modified from the usual IMF arrangements in the sense that arrears to the IMF (and possibly to other multilateral institutions) could remain outstanding during the program period, although members are expected to make maximum efforts to reduce their overdue obligations to the IMF.

[11] The length of the RAPs of the three countries that have made use of the rights approach was 1½ years for Peru, 1¾ years for Sierra Leone, and 3 years for Zambia.

[12] A Staff-Monitored Program is an informal and flexible instrument for dialogue between the IMF staff and a member country on its economic policies and not necessarily specifically intended for arrears cases. Under a Staff-Monitored Program the country's targets and policies are monitored by the IMF staff; a Staff-Monitored Program is not supported by the use of the Fund's financial resources; nor is it subject to the endorsement of the Executive Board of the IMF.

[13] Similarly, flexibility would be applied with respect to payments to the Fund by members in protracted arrears that have been hit by a qualifying catastrophe or health disaster. In assessing such members' cooperation on payment under the de-escalation policy (Box 6.10), the IMF would exercise flexibility in accepting significantly reduced payments.

resources or, in the case of the PRGT, once the Executive Board has limited a member's use of such resources, the Board reviews the member's situation every year. In cases where civil conflict, the absence of a functioning government, or international sanctions prevent the IMF from making a judgment regarding a member's cooperation on policies and payments, the application of these measures is delayed or suspended until such a judgment can be reached.

A number of remedial measures have been applied against the countries that remain in protracted arrears to the IMF or PRGT. As of April 2016, Somalia and Sudan remained ineligible to use the general resources of the Fund. Zimbabwe was removed from the list of PRGT-eligible countries in September 2001. The June 2002 declaration of noncooperation and suspension of technical assistance (TA) also remains outstanding against Zimbabwe, though the suspension of TA was partially lifted in targeted areas in 2009, and further in 2012.

To further encourage members in protracted arrears to cooperate with the IMF in solving their arrears problems, the Executive Board in 1999 established understandings regarding the de-escalation of certain remedial measures (see Box 6.10). The de-escalation policy outlines the principles and the sequence of remedial measures withdrawal. The de-escalation process aims to encourage members in arrears to initiate economic reforms and establish a strong payment record with the IMF, culminating in the full clearance of arrears and restoration of access to the IMF's financial resources. Basic steps in the de-escalation process include: (1) a determination by the Executive Board that the member has begun to cooperate with the Fund; (2) the establishment of an evaluation period during which the member's commitment to resuming a normal relationship with the Fund would be assessed and the sustainability of the member's cooperation would be tested; and (3) the phased lifting of remedial measures including a declaration of noncooperation and measures under Article XXVI of the IMF's Articles of Agreement (for example, lifting of the suspension of voting rights). The de-escalation policy was applied for the first time in August 1999 in the case of Sudan and again to Liberia, in October 2006.

6.2.3 Arrears Clearance Modalities

A number of modalities allow members with overdue financial obligations to the IMF to clear their arrears, including using their own financial resources, grants from donors, or a bridge loan from key creditors. In the case of the latter, the IMF can assist the member in arranging for an intraday bridge loan from key creditors without interest, charge, or other cost. Following clearance of its arrears to the IMF and the Executive Board's approval of a new IMF financial arrangement, the member uses the proceeds of the first disbursement, made available on the same day as the arrears clearance, to settle the outstanding bridge loan. Historically, the bridge loan modality has been used in most arrears clearance. Most recently, Afghanistan (2003) used grant contributions from a group of creditors to clear its arrears to the IMF, Iraq (2004) used its own financial resources, and Liberia (2008) used an intraday bridge loan from another member.

6.2.4 Special Charges

The IMF levies special charges on overdue repurchases or repayments. For overdue obligations to the GRA, special charges apply only to arrears of less than 6 months duration.[14] The IMF currently sets the special rate of charge on overdue repurchases at zero. The special charge on overdue charges, levied for 6 months in the GRA, is set equal to the SDR interest rate.[15] Overdue repayments or interest to the PRGT are charged interest at the SDR interest rate instead of the usual concessional rates on PRGT loans.

Historically, the IMF accumulated reserves to protect against the risk of administrative deficits and capital loss. When overdue financial obligations became significant in the early 1980s, it affected the IMF's income. To avoid an overstatement of actual income, the Executive Board decided in March 1985 that charges due but not settled from members in arrears to the IMF for 6 months or more were to be reported as deferred, rather than current, income. Since that time, charges accrued from those members and not paid are excluded from income unless the member becomes current in paying its charges. Since May 1986, the financial consequences of overdue obligations to the IMF have, to the extent possible, been shared equally between debtor and creditor member countries through the burden-sharing mechanism (Box 6.3). When deferred charges are settled by members clearing protracted arrears, equivalent amounts are distributed to members that previously paid higher charges or received reduced remuneration.

To safeguard itself against potential losses resulting from the ultimate failure of members in protracted arrears to settle their financial obligations to the IMF, the First Special Contingent Account (SCA-1) was established in 1987 (Box 6.4). After an initial placement of SDR 26.5 million of excess income in that year, the additions to the SCA-1 have primarily been funded through burden-sharing adjustments to the rate of charge and the rate of remuneration. The IMF Executive Board suspended further accumulation in the SCA-1 effective November 2006, and in March 2008 refunded SDR 0.5 billion to contributors as part of a comprehensive financing package for debt relief for Liberia. Balances in the SCA-1 are refundable to the contributing creditor and debtor member countries when all overdue obligations have been settled, or earlier if the IMF so decides. As of April 30, 2016, the balance in the SCA-1 was SDR 1.2 billion.

[14] Special charges are limited to overdue repurchase obligation of less than 6 months. These charges may be an incentive to settle obligations, but there is concern that in the long term they may add to the problem of members' overdue obligations and further complicate eventual arrears clearance. The same considerations lie behind the decision not to levy any special charges on charges overdue for six months or longer.

[15] The short duration of the levy of special charges on overdue charges significantly reduces interest compounding on overdue obligations.

6.3 Safeguards Assessments of Central Banks

6.3.1 History and Objectives

The safeguards policy applies to members seeking financing from the IMF (Box 6.11). Its main objective is mitigation of the potential risk of misuse of resources and misreporting of monetary program data. The policy complements the IMF's other safeguards, which include limits on access, program design and conditionality, measures to address misreporting (Box 6.12), and post-program monitoring.

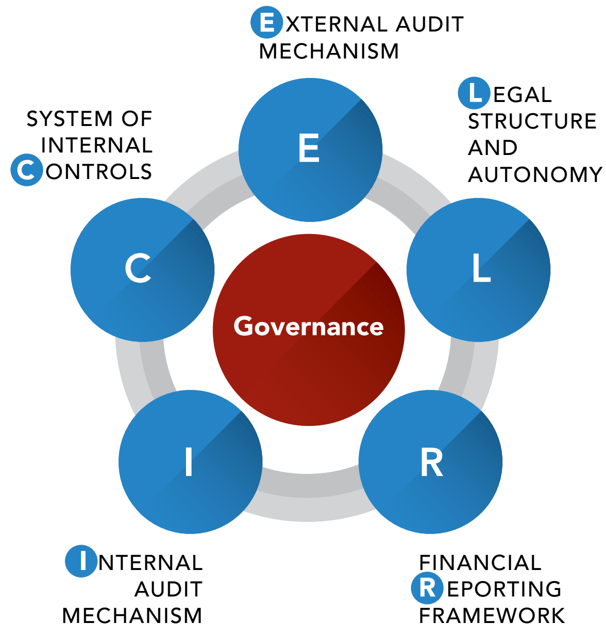
The specific objective of safeguards assessments is to provide reasonable assurances to the IMF that central banks of members using IMF resources have governance, control, reporting, and auditing systems in place to ensure the integrity of operations and to manage resources, including IMF disbursements. Assessments involve a diagnostic evaluation of these systems, followed by monitoring activities for as long as IMF credit is outstanding. A cornerstone of the safeguards policy is that central banks publish financial statements that have been independently audited by external auditors in accordance with international standards. Safeguards assessments are distinct from audits in that they entail high-level diagnostic reviews of the structures and mechanisms in place rather than a detailed test of transactions or verification of assets.

The safeguards policy was introduced in March 2000 and is subject to periodic reviews by the Executive Board, most recently concluded in October 2015.[16] The 2015 review, which involved consultations with various stakeholders and central banks, reaffirmed the importance of the safeguards assessment policy in helping to mitigate the risks of misreporting and misuse of IMF resources, and in maintaining the IMF's reputation as a prudent lender. It also noted that the safeguards process has helped central banks improve their control, audit, and reporting practices. Overall, the Executive Board found the framework for conducting safeguards assessments relevant and adequate and streamlined some applicability requirements (Box 6.11). Fiscal safeguards reviews of state treasuries were introduced as a new element to the safeguards policy for Fund arrangements that involve direct budget support (see Section 6.3.4).

6.3.2 Conceptual Framework: Governance and Controls

A safeguards assessment is a diagnostic review of a central bank's governance and control framework carried out by IMF staff. The assessments evaluate the adequacy of five key areas of control and governance within a central bank. These areas are denoted by the acronym ELRIC, and its pillars are explained below (Figure 6.4). Governance is an overarching principle of the ELRIC framework, and the assessments consider the following key attributes of good governance relevant to central banks:

Figure 6.4 Safeguards Analytical Framework and Governance Focus



Source: Finance Department, International Monetary Fund.

- *Discipline*, represented by senior management's commitment to promoting good governance.
- *Transparency*, necessary to facilitate effective communication to, and meaningful analysis and decision making by, third parties.
- *Autonomy*, which is essential for a top decision-making body—for example, a central bank board—to operate without risk of undue influence or conflict of interest.
- *Accountability*, under which decision makers have effective mechanisms for reporting to a designated public authority, such as the parliament.
- *Responsibility*, which entails high priority on ethical standards and corrective action, including for mismanagement where appropriate.

The five ELRIC pillars and main safeguards assessment objectives of each are:

- External Audit Mechanism: This mechanism encompasses the practices and procedures in place that enable an independent auditor to express an opinion on the financial statements' adherence to an established financial reporting

[16] The review included a discussion of an IMF staff paper and a report prepared by an independent panel of experts, which are available on the IMF's external website: www.imf.org/external/np/sec/pr/2015/pr15489.htm.

framework. Publication of a central bank's annual financial statements that are independently audited in accordance with international standards is a key requirement of the safeguards policy. The IMF assesses whether financial statements are audited annually in accordance with international standards and whether the audit recommendations are implemented. The assessment also looks at the process for the selection and rotation of external auditors, the quality of the audit, and the auditors' communication with governance bodies such as the central bank board and audit committee.

- **L**egal Structure and Autonomy: Government interference can undermine a central bank's autonomy and increase the risks associated with its operations. Assessments focus on laws and regulations affecting autonomy, transparency, and governance at the central bank, as well as actual practices in these areas. They also ascertain whether the legal framework supports the other four ELRIC pillars. Where IMF lending is provided as direct budget support, assessments look for a clear framework between the central bank and the government for servicing IMF lending so that their respective roles and obligations are transparent and well understood.
- Financial **R**eporting Framework: This framework encompasses the provision of financial information to both central bank management and to external parties. For such information to be useful, it must be relevant, reliable, timely, readily available, consistent in presentation over time, and based on internationally recognized standards. The IMF assesses whether central banks adhere to international good practices for transparent accounting and financial reporting. Consistency between published financial information and the underlying accounting data is closely reviewed because of the importance of monetary data reported under IMF programs.
- **I**nternal Audit Mechanism: The role of the internal audit is to evaluate the effectiveness of risk management, control, and governance processes within a central bank. The IMF assesses whether internal audit has sufficient capacity and organizational independence to fulfill this mandate and also reviews its compliance with international standards.
- System of Internal **C**ontrols: Sound governance practices and policies and procedures are necessary to safeguard a central bank's assets and manage its risks. The IMF assesses whether the control systems provide reasonable assurance that potential risks to the bank's operations are being continuously assessed and mitigated. The focus is on oversight by the bank's board and audit committee; the controls in foreign exchange management, accounting, banking, currency and vault operations; and the reporting of monetary program data to the IMF.

The ELRIC framework is derived from the Organisation for Economic Co-operation and Development's Principles of Corporate Governance and the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies. It employs International Financial Reporting Standards, International Standards on Auditing, professional standards promulgated by the Institute of Internal Auditors, and the IMF's data dissemination standards as benchmarks.

6.3.3 Modalities

The IMF Finance Department takes the lead in implementing the safeguards assessments policy. Assessments are based on a review of documentation provided by the authorities and discussions with the external auditors. Assessments may involve a visit to the central bank, as necessary. The main output of a safeguards assessment is a confidential report that establishes time-bound recommendations to address key vulnerabilities in a central bank's safeguards framework. The recommended remedial measures are discussed with central bank officials and may be incorporated in the member's program of reforms.

All members subject to safeguards assessment continue to be monitored under the safeguards policy for as long as they have credit outstanding to the IMF.[17] The monitoring procedures focus on the implementation of safeguards recommendations and identification of new and emerging risks, including through an annual review of audited financial statements and management letters prepared by external auditors.

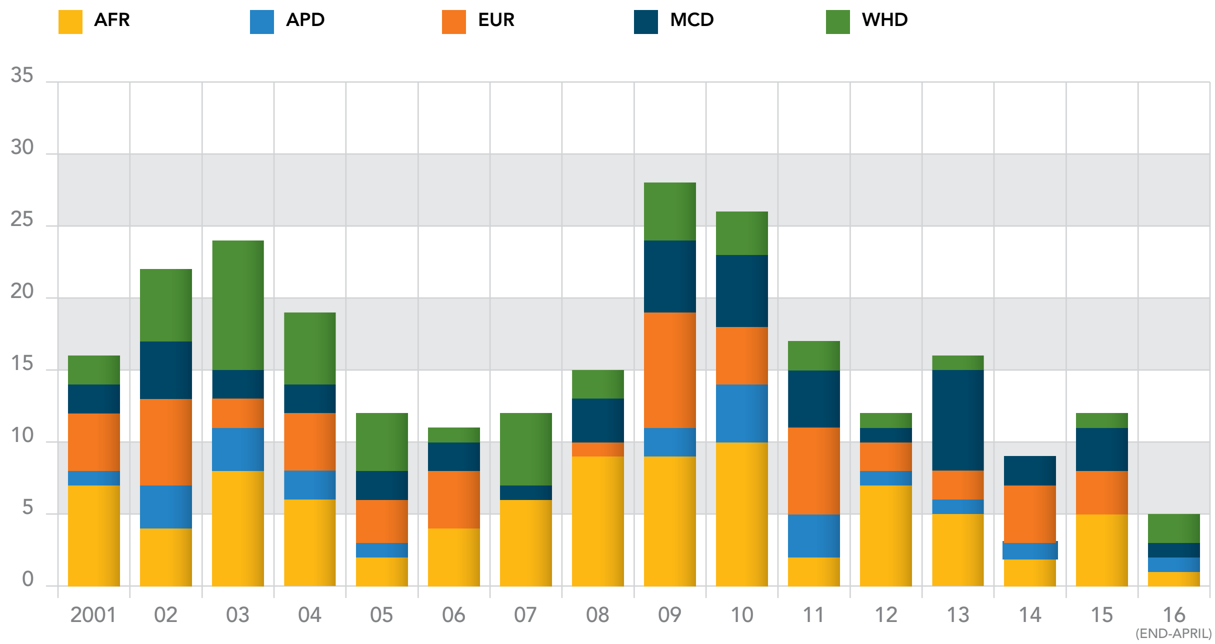
Confidentiality requirements limit the circulation of safeguards reports. This is because the primary focus of safeguards assessments is to provide due diligence input for IMF internal decision making. IMF staff members have access to sensitive information, including external auditor management letters and secured physical areas at central banks, when they are conducting the assessments.

The Executive Board is informed of the main findings and recommendations of individual member safeguards assessments through summaries in country reports.[18] Safeguards reports may be shared with authorized international agencies on a confidential basis and with the consent of the central bank in question. The authorized agencies comprise (1) the World Bank, in conjunction with the due diligence process associated with its lending operations, and (2) the European Central Bank, for the national central banks in the European System of Central Banks, if countries in the Eurosystem receive joint financial assistance from the European Union and the IMF.

[17] Under streamlining measures introduced in 2015, once a member's outstanding credit falls below the threshold for post-program monitoring, the monitoring intensity is limited to a desk review of the annual external audit results, that is, the financial statements and management letters of the member's central bank.

[18] The safeguards paragraph covers at a minimum: any instances of misuse or misreporting; any significant recommendations on legislative amendments that involve parties external to the central bank; problems in obtaining access to data; and deviations from commitments relating to safeguards recommendations. Bi-annual activity reports are prepared and are available on the IMF's website at www.imf.org/external/ns/cs.aspx?id=156.

Figure 6.5 Safeguards Assessments by Region



Source: Finance Department, International Monetary Fund.
Note: Data presented by calendar year. Safeguards assessments completed to date: www.imf.org/external/np/tre/safegrds/complete/index.aspx.
AFR = Africa; APD = Asia and the Pacific; EUR = Europe; MCD = Middle East and Central Asia; WHD = Western Hemisphere.

6.3.4 Safeguard Risks beyond Central Banks

In recent years, instances and volume of direct budget financing with IMF resources provided directly to the government have increased. The safeguards policy requires that IMF disbursements be deposited and maintained at a specific government account at the central bank, pending their use for budget support. Furthermore, the policy also requires that an appropriate framework between the central bank and the state treasury be in place to ensure timely servicing of the member's financial obligations to the IMF.

During the 2010 review of the safeguards policy, the Executive Board recognized that replicating safeguards assessments across the entire government remained challenging; however, the Board encouraged IMF staff to highlight fiscal safeguards risks in staff reports on IMF-supported programs involving direct budget support. In 2013, based on a pilot exercise, staff proposed a risk-based approach to evaluating fiscal safeguards risks in Fund arrangements and developed an evaluation framework that draws from the existing diagnostics tools and assessments of members' public financial management systems. This approach was endorsed as a new element of the safeguards assessment during the 2015 policy review. Accordingly, fiscal safeguards reviews of state treasuries should be conducted for all IMF arrangements where a member requests exceptional access to IMF resources, with an expectation that a significant proportion (at least 25 percent) of the funds will be directed to financing the state budget.[19]

6.4 Audit Framework

The IMF has in place a comprehensive audit framework. This framework comprises complementary, yet distinct, roles of the external audit, internal audit, and external audit committee functions. Each of these audit elements follows the relevant internationally recognized, professional standards, including consideration of risk management, the control environment, and the IMF financial results reported in the audited financial statements. The IMF's audit arrangements follow international best practices.

The External Audit Committee (EAC) oversees the IMF's external and internal audit functions. The EAC is independent of management, staff, and the Executive Board and is not involved in IMF financial operations or policy decisions. In accordance with best practices (1) the terms of reference of the EAC are

[19] Operational modalities, applicability and reporting requirements for fiscal safeguards reviews are outlined in *Safeguards Assessments: Review of Experience*, September 23, 2015.

approved by the Executive Board, (2) individual EAC members are selected by the Board through a comprehensive selection process and are appointed by the Managing Director, and (3) the EAC includes members with accounting and risk management expertise. Members of the EAC meet with management, IMF staff, and external auditors throughout the year and receive all key financial reports and Board documents. The EAC briefs the Executive Board twice a year.

The IMF's external auditors are selected by the Executive Board through a competitive process and are appointed by the Managing Director. The audit firm conducts an annual audit of the financial statements of the IMF, including the trust accounts, other administered accounts, and the accounts related to the Staff Retirement Plan, in accordance with International Standards on Auditing. The audit firm examines internal controls over financial reporting and provides an opinion on whether the financial statements are free of material misstatement. The report of the external audit firm accompanies the financial statements and is transmitted for consideration by the Board of Governors through the Managing Director and the Executive Board. To safeguard the independence of the external audit firm, the Executive Board has adopted several policies on auditor independence including requirements for mandatory rotation of the audit firm after 10 years and mandatory partner and manager rotation. In May 2015, the Executive Board decided to modify the Fund's policy on restrictions on the external audit firm to provide consulting services. The new policy includes a list of prohibited consulting services and a cap on consulting fees.

The Office of Internal Audit and Inspection (OIA) provides, among other things, independent and objective examinations and reviews of the effectiveness of the risk management, control, and governance processes of the IMF. The OIA is operationally independent of the IMF's activities and forms part of, and reports directly to, the Office of the Managing Director, and functionally to the EAC. The scope of activities of internal audit differs from those of external audit, which provides an independent assessment of the effectiveness of internal controls. The OIA may also provide analysis and advice to IMF management, review business processes, conduct internal investigations, and help support external audit activities. The office follows internationally accepted standards for the practice of internal audit as promulgated by the Institute of Internal Auditors.

6.5 Financial Reporting and Risk Disclosure

As required by International Financial Reporting Standards (IFRS), the IMF discloses its financial risk-management policies in its audited financial statements (Box 6.5). The external audit firm and the External Audit Committee review and assess the adequacy of these statements at least annually to ensure that the information disclosed enables the public to evaluate the nature and extent of financial risks arising from the IMF's activities (Box 6.13). The IMF staff continuously monitors IFRS developments to ensure compliance with new and revised standards, including those affecting the assessment of risks, financial instruments, and related disclosures.

In the interest of transparency, the IMF also provides extensive information to the public on the Finances pages of the IMF website.[20] Current and historical data on all aspects of IMF lending and borrowing are available, on both an aggregate and a country-specific basis. In addition, the portal provides a gateway to comprehensive information on the financial structure, terms, and operations of the institution.

[20] See www.imf.org/external/fin.htm.

Box 6.1 Financial Risks Management in the IMF

Financial Risk	Risk-Management Measures
Credit Risk	
The risk that a borrower could fail to meet its financial obligations to the IMF	Lending policies (for example, conditionality, access limits, charges and maturities, exceptional access framework) The IMF s preferred creditor status Safeguards assessments Arrears strategy Burden-sharing mechanism Financing by other official lenders in parallel to Fund financing Post-program monitoring Precautionary balances
Liquidity Risk	
The risk that available resources will be insufficient to meet the financing needs of members and the IMF s own obligations	Monitoring of Forward Commitment Capacity (continuous) Financial Transactions Plans (quarterly) Liquidity reviews (semiannually) General quota reviews (at least every 5 years) Bilateral borrowing and note purchase agreements, New Arrangements to Borrow, and General Arrangements to Borrow Precautionary balances
Income Risk	
The risk that the IMF s annual income may be insufficient to cover its annual expenditures	Margin on the basic rate of charge Surcharges Burden-sharing mechanism Investment Account and investment mandate Precautionary balances
Interest Rate Risk	
The risk that future cash flows will fluctuate because of changes in market interest rates	The IMF does not incur interest rate risk on credit because it uses a floating market interest rate (SDR interest rate) to determine its charge and remuneration rates. The interest rate risk of the Fixed-Income Subaccount is controlled by the short duration of portfolio (a mix of 0 3 years and 0 5 years). The Endowment Subaccount is exposed to higher interest risk given the longer duration (7½ 8 years) of its strategic asset allocation approved by the Executive Board in early 2013.
Exchange Rate Risk	
The risk associated with the effects of fluctuations in foreign currency exchange rates on the IMF s financial position and cash flows	The IMF has no exposure on its holdings of members currency, the credit it extends, or its borrowing, which are all denominated in SDRs, the IMF s unit of account. Members are required to maintain the SDR value of the IMF s holdings in their currency. The exchange rate risk on the IMF s Fixed Income Subaccount is managed by investing in financial instruments denominated in SDRs or in constituent currencies with a view to matching currency weights in the SDR basket. The IMF s Endowment Subaccount is subject to some exchange risk vis-ˆ -vis the SDR, which is the unit of account of the IMF. For performance measurement, the U.S. dollar is the reference currency. To limit exchange rate risk in the Endowment Subaccount, fixed-income investments denominated in developed market currencies are hedged back to the U.S. dollar. The relatively small size of the portfolio limits the overall impact to the IMF s balance sheet.
Operational Risk in Financial Matters	
The risk of loss as a result of errors or omissions, process failures, inadequate controls, human error, and/or failures in underlying support systems	Internal control procedures and processes Executive Board approved investment guidelines and benchmarks for external asset managers Audit arrangements: independent external audit, oversight of controls and financial processes by an independent external audit committee, and an internal audit function Precautionary balances

Source: Finance Department, International Monetary Fund.

Box 6.2 The IMF's Preferred Creditor Status

The IMF's preferred creditor status reflects the critical creditors' willingness to exclude the IMF from sovereign debt restructurings. The IMF's preferred creditor status is attributable to: (1) the recognition by both the creditor community and sovereign debtors that it is in their interest and that of the international community at large to exclude the IMF from the debt restructuring process, and (2) the IMF's legal limitation to restructure its claims on its members under its Articles of Agreement.

The concept of the IMF's preferred creditor status originates in the Paris Club, where official bilateral creditors have been willing to exclude the IMF from the restructuring process. This treatment reflects the public good nature of IMF financing, as it is provided in the context of a program designed to assist the member in resolving its balance of payments problems and regaining medium-term external viability while ensuring adequate safeguards for the Fund without resorting to measures that are destructive to national or international prosperity (such as arrears). The forbearance exercised by creditors is of a voluntary nature; unsecured creditors have not legally subordinated their claims to those of the IMF.[1] With some exceptions, the preferred creditor status has generally also been accepted by private creditors, as the public good aspects of IMF financing normally also inure to their benefit.

[1] In 1988, the IMFC urged all members, within the limits of their laws, to treat the IMF as a preferred creditor. See paragraph 12, Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options, 2009.

Box 6.3 The Burden-Sharing Mechanism: Capacity and Implications for Arrears

The burden-sharing mechanism seeks to ensure that the Fund's cash flow from its lending operations is not negatively impacted by members' failure to settle financial obligations to the Fund. Since its establishment in 1986, the burden-sharing mechanism has compensated the IMF for any unpaid charges ("deferred charges") of members in arrears, which offsets the impact of unpaid charges on IMF income, and helped in generating precautionary balances against possible credit default. This has proved essential to continued compliance with International Financial Reporting Standards (IFRS) given the IMF's limited ability under the IMF Articles of Agreement to make specific loan-loss provisions. The IMF's creditor and debtor members contribute equally to covering the amount of unpaid charges, which is achieved through increases in the rate of charge paid by debtor members and reductions in the rate of remuneration to creditor members.

Under burden sharing, temporary financing in equal amounts is obtained from debtor and creditor members by increasing the rate of charge and reducing the rate of remuneration, respectively, to (1) cover shortfalls in the IMF's regular income from deferred charges and (2) accumulate precautionary balances against possible credit default in a contingent account, the Special Contingent Account (SCA-1). No burden-sharing adjustment is made on interest paid on borrowed resources. The SCA-1 is also viewed from an accounting perspective as offering protection against the risk of loss resulting from the ultimate failure of a member to repay its overdue charges and principal should a member in arrears withdraw from the IMF (or if the IMF is liquidated). A breakdown in the mechanism for unpaid charges would have implications for the IMF's continued compliance with IFRS.

Limits on the Capacity of the Mechanism: The total capacity of the burden-sharing mechanism to cover unpaid charges is the sum of the maximum feasible reduction in remuneration expenses and the maximum feasible increase in income from charges:

- Article V, Section 9 (a), of the Articles of Agreement states that the rate of remuneration may be no less than four-fifths (80 percent) of the SDR interest rate, which limits the maximum reduction in remuneration expenses to[1]

  0.2 * SDR Interest Rate * Remunerated Reserve Tranche Positions.

- In the absence of arrears, the maximum burden-sharing capacity would simply be twice the above amount, because debtors and creditors contribute equally. But when the amount of credit in arrears increases, the debtor base contributing to burden sharing is reduced, so the capacity of the burden-sharing mechanism declines.[2]

The overall burden-sharing capacity depends on the following factors:

- **Outstanding credit:** The reserve tranche positions move in tandem with credit fluctuations when credit outstanding is financed fully from quota resources. Therefore, as credit rises, the base for higher charges and the base for lower remuneration both increase, which increases the burden-sharing capacity.

- **Borrowing by the IMF:** Creditor positions arising from IMF borrowing under bilateral loan or note purchase agreements, the New Arrangements to Borrow (NAB), or the General Arrangements to Borrow (GAB) do not increase burden-sharing capacity, as no burden-sharing adjustment is made to the interest paid to creditors on borrowed resources. Therefore, as the share of borrowed resources financing credit outstanding rises (and the share of quota declines), the burden-sharing capacity declines.

- **SDR interest rate:** At a higher nominal SDR interest rate, the rate of remuneration can be reduced by a larger amount in terms of basis points, which increases the burden-sharing capacity in nominal terms, although there may also be an increase in unpaid charges.

- **Share of credit in arrears:** As noted, a higher share of credit in arrears shrinks the base of debtors making burden-sharing contributions and thus reduces the burden-sharing capacity.

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[1] Decision No. 12189-(00/45), dated April 28, 2000, set the current floor for remuneration at 85 percent of the SDR interest rate. Changes in the rate of remuneration require approval by 70 percent of the Executive Board.

[2] For example, given that debtors initially account for half of the total base on which burden sharing can be collected, the capacity of the burden-sharing mechanism would decline by one-quarter if one-half of total outstanding credit went into arrears.

Box 6.4 Composition of the IMF's Precautionary Balances

The IMF's precautionary balances comprise retained earnings (the Fund's General and Special reserves) that are not linked to the gold profits from the recent limited gold sales, and the Special Contingent Account (SCA-1). Reserves are available to absorb financial losses, including credit or income losses.

Special Reserve: This account was established in 1957. The Executive Board decided in 1957 that any administrative losses would first be charged against the Special Reserve. The Special Reserve is therefore the first line of defense against income losses.[1] Under the IMF's Articles of Agreement, no distribution can be made from the Special Reserve.

General Reserve: The General Reserve is available for absorbing capital losses or meeting administrative losses, as well as for making distributions. Distributions of the General Reserve are to be made to all members in proportion to their quota, and require an Executive Board decision adopted by a 70 percent majority of the total voting power.

Special Contingent Account (SCA-1): This account was set up in 1987 with the specific purpose of protecting the IMF against the risk of a loss resulting from the ultimate failure of a member to repay its overdue charges and principal obligation in the General Resources Account. The SCA-1 has primarily been funded through burden-sharing contributions generated equally from debtors and creditors through adjustments to the rates of charge and remuneration, respectively.[2] SCA-1 accumulations were suspended effective November 1, 2006. The accumulated balances in the SCA-1 are to be distributed to contributing members when there are no outstanding overdue obligations or such earlier time as the Fund decides.[3] The decision to distribute SCA-1 balances requires a 70 percent majority of the total voting power.

[1] This decision has been applied whenever the IMF has suffered a loss, covering some SDR 342 million in losses—that is, FY1972–77 (SDR 103 million), FY1985 (SDR 30 million), and FY2007–08 (SDR 209 million).

[2] In FY1987, the SCA-1 was initially funded by SDR 26.5 million from General Resources Account income exceeding the target for the financial year. During FY1998–2000, an annual amount equal to 5 percent of reserves was placed to the SCA-1, and in FY2001–06, annual amounts of SDR 94 million representing the income effect on the fund from the receipt of gold, rather than currencies, in the repurchases associated with off-market gold transactions in 1999/2000.

[3] In March 2008, a partial distribution of SDR 0.5 billion from the SCA-1 account was made in the context of Liberia's debt relief and arrears clearance.

Box 6.5 Financial Reporting of Credit Losses under International Financial Reporting Standards

Although neither the Articles of Agreement nor the By-laws or Rules and Regulations require the adherence to a specific accounting standard, the IMF prepares its annual financial statements in accordance with International Financial Reporting Standards (IFRS). IFRS require that financial assets be measured and reported on the balance sheet at amortized cost or fair (market) value. For example, on the IMF's balance sheet, loan receivables (IMF credit) are carried at their amortized cost—that is, as outstanding principal obligations—while investments are carried at their fair value.[1]

When an asset's carrying value exceeds the realizable value, adjustments are required to reflect such assets at the recoverable or realizable amount. Under current provisions, entities must assess at the end of each reporting period whether there is objective evidence that assets carried at amortized cost are impaired. Under this *incurred loss model*, a loss event could be a default or delinquency in interest or principal payments. The adjustment is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows. The reduction in the value of an asset is normally charged against income and either the asset values on the balance sheet are reduced directly by an equivalent amount or an allowance account is established. At the IMF, such charges against income would need to be weighed against the burden sharing for deferred charges and the amounts in the Special Contingent Account (SCA-1), which protects the IMF against the risk of loss resulting from the ultimate failure of a member to pay its overdue charges or principal obligations to the Fund.[2]

New accounting rules, effective in FY2019, will require the impairment analysis to be performed under an *expected loss model*, which is more forward-looking than the current incurred loss model. Under this model, a loss event would no longer need to occur before an impairment loss is recognized. The guiding principle of the expected loss model is that an entity should calculate its annual impairment loss, if any, to reflect the pattern of deterioration or improvement in the credit risk of the underlying asset since the initial recognition. The loss allowance should be updated for changes in those expected credit losses at the end of each reporting period to reflect changes in credit risk since the initial recognition. For financial institutions that routinely incur credit losses as part of doing business, the expected loss model would likely result in earlier recognition of credit losses compared with the current incurred loss model. The impact of the introduction of the expected loss model on the Fund's financial reporting is currently under consideration.

General prudent financial and accounting practices necessitate that an adequate level of reserves (generated by shareholder capital contributions or by retention of earnings) be maintained, in addition to the specific provisions for value impairment, to ensure the viability and continued operation of an entity and provide protection against general business risk.

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[1] The IFRS accounting treatment is based on the economic substance of the IMF's lending arrangements and not the legal form of the underlying transactions, which involve the purchase and repurchase of currencies.

[2] If the capacity of burden sharing for deferred charges could not absorb the full amount of delinquent interest payments under IFRS, the IMF's income statement for the reporting period could no longer recognize income for the interest not covered by burden sharing. To comply with IFRS, further charges against income would be needed to account for reduction in the carrying value of the loan receivable after assessment of the protection provided by SCA-1 balances. If such a situation arose, the Executive Board of the IMF would need to decide how to proceed in light of the limitations under the Articles of Agreement to write off claims resulting from Fund credit and its policy on provisioning (when the issue of provisioning for loan losses was last discussed, the Executive Board rejected general and special provisioning).

Box 6.6 The Forward Commitment Capacity

The forward commitment capacity (FCC) measures the IMF's capacity to make new financial resources available to members from the General Resources Account for the forthcoming 12-month period taking into account resources available. Under the expanded and amended New Arrangements to Borrow (NAB), however, the maximum activation period within which the IMF may make commitments funded with NAB resources is 6 months. Therefore, the 1-year FCC has been modified to allow the inclusion of these shorter-duration NAB resources within the FCC concept. Figure 6.1 depicts the FCC since the mid-1990s, noting the importance of borrowing to maintain IMF lending capacity particularly after the 2008 global financial crisis, when the demand for IMF resources reached historical highs. Table 6.2 illustrates the calculation of the FCC.

The modified FCC takes full account of resources available under the NAB during a currently effective NAB activation period and is calculated as follows:

The FCC is defined as the IMF's stock of usable resources minus undrawn balances under existing arrangements, plus projected repurchases during the coming 12 months, minus repayments of borrowing 1 year forward, minus a prudential balance intended to safeguard the liquidity of creditors' claims and to take into account any erosion of the IMF's resource base.

Usable resources consist of (1) IMF holdings of the currencies of members deemed by the Executive Board to have a sufficiently strong balance of payments and reserve position for inclusion in the Financial Transactions Plan (FTP) for the financing of IMF operations and transactions; (2) IMF holdings of SDRs; and (3) unused amounts available under currently active bilateral loan and note purchase agreements, and unused amounts available under the NAB or the General Arrangements to Borrow (GAB) when these have been activated.

The prudential balance is calculated as 20 percent of the quotas of members included in the FTP, and amounts available under active bilateral loan and note purchase agreements. In determining maximum possible NAB activation amount for a given period, a 20 percent prudential buffer is also taken into account.

Box 6.7 Overdue Financial Obligations to the IMF

Overdue financial obligations to the IMF are a breach of a member's obligations under the IMF's Articles of the Agreement and have important implications for the IMF and the member concerned.[1] Specifically, significant and protracted overdue obligations

- damage the member country, in part through deterioration of its financial relationship with other creditors;
- impose a financial cost on the rest of the IMF's membership;
- impair the IMF's capacity to assist its members; and
- impair the IMF's ability to carry out its broader responsibilities in the international financial system.

Countries fail to honor payment obligations to the IMF for complex reasons, which vary from case to case. Broadly, failure may be a consequence of unsustainable economic policies, exogenous shocks, or political developments (for example, conflicts and/or international sanctions).

[1] Overdue obligations to the GRA and SDR departments constitute breaches of obligations under the Articles of Agreement, but not overdue obligations to the PRGT.

Box 6.8 Overdue Financial Obligations to the General Department and the SDR Department: Timetable of Remedial Measures

Time after Emergence of Arrears	Action
Immediately	The IMF staff urges the member to make the payment promptly; this communication is followed up through the office of the appropriate Executive Director. The member is not permitted any use of the IMF s resources nor is any request for the use of IMF resources placed before the Executive Board until the arrears are cleared.
2 weeks	Management sends a communication to the Governor for the member stressing the seriousness of the failure to meet obligations and urging full and prompt settlement.
1 month	The Managing Director notifies the Executive Board that an obligation is overdue.
6 weeks	The Managing Director notifies the member that unless the overdue obligations are settled promptly a complaint will be issued to the Executive Board. The Managing Director consults with and recommends to the Executive Board that a communication concerning the member s situation be sent to selected IMF Governors or to all IMF Governors in the event that the member has not improved its cooperation.
2 months	A complaint regarding the member s overdue obligations is issued by the Managing Director to the Executive Board.
3 months	The complaint is given substantive consideration by the Executive Board. The Board has usually decided to limit the member s use of the IMF s general resources and, if overdue SDR obligations are involved, suspend its right to use SDRs.
6 12 months	The Executive Board reviews its decision on limitation within 3 months, with the possibility of a second review if warranted. Depending on the Executive Board s assessment of the specific circumstances and of the efforts being made by the member to fulfill its obligations to the Fund, a declaration of ineligibility is considered to take effect within 12 months after the emergence of arrears. Communications are sent to all IMF Governors and the heads of selected international financial institutions regarding the member s continued failure to fulfill its financial obligations to the IMF. This step coincides with consideration of the declaration of ineligibility.
Up to 15 months	A declaration of noncooperation is considered within 3 months of the dispatch of the preceding communications. Technical assistance to the member is suspended unless the Executive Board decides otherwise.
Up to 18 months	A decision on suspension of voting and representation rights is considered within 3 months of the declaration of noncooperation.
Up to 24 months	The procedure on compulsory withdrawal is initiated within 6 months of the decision on suspension.

Source: Finance Department, International Monetary Fund.

Box 6.9 Overdue Financial Obligations to the Poverty Reduction and Growth Trust: Timetable of Remedial Measures

Time after Emergence of Arrears	Action
Immediately	The IMF staff sends a cable urging the member to make the payment promptly; this communication is followed up through the office of the appropriate Executive Director. The member s access to IMF resources, including Trust resources, is suspended.
2 weeks	Management sends a communication to the Governor for the member stressing the seriousness of the failure to meet obligations to the Trust and urging full and prompt settlement.
1 month	The Managing Director notifies the Executive Board that an obligation is overdue, and informs the Executive Board of the nature and level of arrears and the steps being taken to secure payment.
6 weeks	The Managing Director notifies the member that unless the overdue obligations are settled, a report concerning the arrears to the Trust will be issued to the Executive Board within 2 weeks. The Managing Director consults with and recommends to the Executive Board that a communication concerning the member s situation be sent to selected IMF Governors or to all IMF Governors.
2 months	A report is issued by the Managing Director to the Executive Board. The report requests that the Executive Board limit the member s use of PRGT resources.
3 months	The report is given substantive consideration by the Executive Board. A factual statement noting the existence and amount of arrears is posted on the member s country-specific page on the IMF s external website. This statement also indicates that the member s access to Fund resources, including Trust resources, has been and will remain suspended for as long as such arrears remain outstanding. A press release is issued following the Executive Board s decision to limit the member s use of PRG Trust resources. A similar press release will be issued following a decision to lift such limitation.
6 months	The Executive Board reviews the situation of the member and may remove the member from the list of PRGT-eligible countries. Reinstatement of the member to the list will require a new decision of the Executive Board. A press release is issued following the Executive Board s decision to remove a member from the list of PRGT-eligible countries. A similar press release will be issued when the member is reinstated on the list.
12 months	A declaration of noncooperation with the PRGT may be issued. The decision as to whether to issue such a declaration would be based on an assessment of the member s performance in the settlement of its arrears to the Trust and of its efforts, in consultation with the IMF, to follow appropriate policies for the settlement of its arrears. The Executive Board may at any time terminate the declaration of noncooperation in view of the member s progress in the implementation of adjustment policies and its cooperation with the IMF in the discharge of its financial obligations. Upon a declaration of noncooperation, the IMF could decide to suspend the provision of technical assistance. Technical assistance to the member may also be limited if the Managing Director judges that was not contributing adequately to the resolution of the problems associated with the arrears to the Trust. The IMF shall issue a press release upon the declaration of noncooperation and upon termination of the declaration.

Source: Finance Department, International Monetary Fund.

Box 6.10 Policy of De-escalation of Remedial Measures

In July 1999, the IMF Executive Board established understandings regarding the de-escalation of certain remedial measures to further strengthen incentives for members in protracted arrears to cooperate with the IMF, with the ultimate objective of full clearance of arrears and the restoration of access to IMF resources.

Initiation of de-escalation. The starting point for de-escalation is a determination by the Board that a member has credibly begun, or adequately strengthened, its cooperation with the Fund. This would be evidenced by a sustained track record of performance regarding economic policies and payments to the Fund, with prospects for its continuation.[1] With regard to policies, there should be reasonable assurance that the member's satisfactory policies were likely to be sustained. As regards payments to the Fund, it would be expected that the member has been making substantial payments for a sustained period, at least equivalent to maturing obligations.

Evaluation period. Once a determination has been made that the member has credibly begun to cooperate with the Fund, it would be desirable to establish an evaluation period to assess the member's commitment to resuming a normal relationship with the Fund and to test whether the member's cooperation is sustainable. At the outset of the evaluation period, it would be open to the Board to formulate a program of actions and measures that a member would be expected to implement before the lifting of remedial measures would be considered, and to specify the beginning and approximate length of the evaluation period. During the evaluation period, the Board would not proceed, nor recommend proceeding, to the next remedial measure, provided that the member's performance with respect to policies and payments to the Fund remained satisfactory. Moreover, it would be expected that the member's cooperation on policies and payments would strengthen progressively as a basis for reversal of remedial measures.

Modalities. From a legal and practical point of view, until such time as the member cleared its overdue obligations to the Fund in full, it would be appropriate to lift only a declaration of noncooperation and a suspension of voting rights, as opposed to other remedial measures in the timetable. As a general principle, the time period between the starting point and the lifting of a remedial measure would be set in proportion to the severity of the measure to be lifted. A case-by-case approach would be appropriate, with cooperation assessed in the context of a staff-monitored or other program. In the case in which a member's voting and related rights had been suspended, an evaluation period of about two years' duration would be considered as a guideline before the Board would consider lifting (by a 70 percent majority of the total voting power) the suspension of the member's voting and related rights in the IMF. Depending on the circumstances of the case, a somewhat longer or shorter evaluation period could be appropriate. Successful implementation of about one year of the evaluation period would be required before the Board would consider the lifting of a declaration of noncooperation (by a simple majority vote), although the period could be shortened in cases in which performance warranted. The resumption of technical assistance and restoration of a resident representative to the country at an early stage could, in some cases, be highly beneficial in strengthening cooperation.

Following the removal of one or more remedial measures, if a member subsequently failed to sustain its cooperation with the Fund, remedial measures could be introduced again at a more accelerated pace than that called for under the timetable of remedial measures, taking into account the sequencing of measures required by the Fund's Articles.

Application. The IMF's de-escalation policy on arrears has been applied to Sudan and Liberia. In light of Sudan's satisfactory performance on policies and payments to the IMF, the IMF Executive Board decided to lift the declaration of noncooperation on August 27, 1999, and to restore Sudan's voting and related rights on August 1, 2000. In the context of the latter, the outstanding complaint with respect to compulsory withdrawal was reformulated as a complaint with respect to the suspension of voting rights on August 23, 2000. In the case of Liberia, a declaration of noncooperation was issued on March 30, 1990. On October 2, 2006, the Fund initiated a process of de-escalation of the remedial measures that had been applied to Liberia. On the basis of Liberia's improved cooperation with the IMF, the Executive Board lifted the declaration of noncooperation and also decided to lift the suspension of Liberia's voting and related rights, following a period of satisfactory performance of 12 months.

[1] The de-escalation policy allows for flexibility for members in a post-conflict situation and for members that have been hit by a qualifying catastrophic disaster, as defined by the Catastrophe Containment and Relief Trust.

Box 6.11 The IMF's Safeguards Assessments Policy

The safeguards assessments policy applies to members seeking financial arrangements with the IMF, with the exception of Flexible Credit Line (FCL) arrangements. The policy applies to new and successor arrangements, and arrangements treated as precautionary. Safeguards assessments do not apply to financing extended through first credit tranche purchases. While assessments focus on central banks, IMF arrangements that involve budget financing include safeguards procedures to ensure that an appropriate framework between the central bank and the state treasury is in place for timely servicing of the member's financial obligations to the Fund. In October 2015, a requirement for fiscal safeguards reviews of state treasuries was introduced for members requesting exceptional access and, where upon approval of the arrangement, at least 25 percent of IMF funds are expected to be used for direct budget support. Under the streamlining measures introduced in 2015, successor arrangements where an assessment was completed within 18 months prior to approval of the successor arrangement do not require updated assessments. In addition, no assessments are needed for augmentations of existing arrangements, or if a central bank has a strong track record and had an assessment completed within the past four years.

Safeguards assessment requirements also apply to disbursements involving liquidity and emergency assistance under the Rapid Credit Facility (RCF), Rapid Financing Instrument (RFI), and a 6-month Precautionary and Liquidity Line (PLL). A member's request for assistance under these arrangements requires commitment to a safeguards assessment, IMF staff access to the central bank's most recently completed external audit reports, and authorization for IMF staff to hold discussions with the central bank's external auditors. The timing and modalities of the assessment for such arrangements are determined on a case-by-case basis, but typically the assessment must be completed before Executive Board approval of any subsequent arrangement to which the IMF's safeguards policy applies.

For members of currency unions with no autonomous national central banks, a periodic assessment cycle was established, irrespective of the timing of the member countries' programs. Accordingly, the Central Bank of West African Countries (BCEAO), the Central Bank of Central African Countries (BEAC), and the Eastern Caribbean Central Bank (ECCB) are assessed every 4 years.

Safeguards assessments are not conducted for members with FCL arrangements, on the grounds that qualifying countries have strong institutional arrangements in place. However, limited safeguards procedures, focused on a review of the most recent external audit results of the central bank, including discussions with their auditors, are conducted.

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).

Box 6.12 Misreporting Framework

Background and Applicability

The term misreporting is used broadly to cover situations in which a member provides incorrect/inaccurate information to the IMF. The IMF needs reliable information for every aspect of its work, and it is particularly important in ensuring that its resources are used for their intended purposes.

The IMF has developed guidelines that govern misreporting in the context of a member's provision of information under an IMF-supported economic program. The guidelines apply whenever a member makes a purchase or receives a disbursement from the IMF on the basis of information that conditions applicable to that purchase or disbursement were met but that information later turns out to be inaccurate. The guidelines stipulate that the IMF must take action within 4 years of such purchase or disbursement.

Misreporting provisions may also apply under the Policy Support Instrument (PSI) and in the context of Heavily Indebted Poor Countries (HIPC) Initiative assistance. The PSI misreporting framework is simplified compared to the procedures applicable in the context of the use of Fund resources and includes a 3-year limitation period from the PSI approval or review completion, compared with 4 years for arrangements supported by GRA or PRGT resources. Misreporting can also arise under the IMF's Articles of Agreement in the context of the general obligation of all members, regardless of whether they have used IMF resources, to give the IMF timely and accurately relevant economic information. Article VIII, Section 5 specifies members' continuing obligation to give the IMF, to the extent of the member's ability, the information it deems necessary for its activities. Taken together these misreporting provisions of the IMF's Articles, policies, and guidelines comprise the IMF's misreporting framework.

Procedures and Remedies

If evidence indicates that misreporting may have occurred, the Managing Director consults with the member and submits a report to the Executive Board, together with a recommended course of action to be taken by the Board.

Under the misreporting guidelines, a member found to have obtained use of IMF resources on the basis of information on the observance of condition(s) applicable to a purchase or disbursement that proved to be incorrect is deemed to have made a noncomplying purchase or disbursement. The member is required to repurchase its currency or repay the IMF, normally within 30 days, unless the Executive Board grants a waiver for the nonobservance of such condition(s). Waivers may be granted for minor or temporary deviations or if the member has taken additional policy measures appropriate to achievement of the objectives of the economic program.

Under a PSI, which does not involve use of IMF resources, the Executive Board's decision on a finding of misreporting and any impact on past assessments under the member's PSI are published.

Under the specified conditions, the amount of HIPC Initiative debt relief is adjusted if the debt sustainability analysis that determined the amount of assistance committed turns out to have been based on incorrect information. Further, interim assistance disbursed to the HIPC Initiative Umbrella Account that has not yet been used to service debt obligations could be returned to the Poverty Reduction and Growth–Heavily Indebted Poor Countries (PRG-HIPC) Trust if such assistance was approved on the basis of inaccurate information about the member's track record of performance.

A member found to have breached Article VIII, Section 5 may be subject to remedial measures, including possible declaration of ineligibility for IMF resources. In determining whether a member has breached its obligations under Article VIII, Section 5, the Executive Board must take into account the member's capacity to provide the relevant information.

De Minimis Cases

The misreporting framework allows for special and simplified procedures in de minimis cases. Deviations from a performance criterion or other condition are considered to be de minimis if they are so small as to be trivial that they have no impact on the assessment of program performance. Noncomplying purchases and disbursements arising from such cases call for the granting of a "waiver for nonobservance" and are exempt from general publication requirements.

Publication of Misreporting Cases

After the Executive Board has made its determination about misreporting, the IMF makes public relevant information for each case of misreporting. Publication is automatic, but reviewed by the Executive Board.

Box 6.13 The IMF's External Audit Arrangements

The authority for the IMF's external audit function is derived from Article XII, Section 7(a) of the Articles of Agreement, which requires the IMF to publish an annual report containing an audited statement of its accounts, and the By-Laws, Rules, and Regulations, which set out procedures for the conduct and oversight of the audit.

The current external audit arrangements consist of the External Audit Committee (EAC) and the external audit firm. The EAC has general oversight of the external audit function.

The EAC is composed of three individuals selected by the Executive Board—as recommended by the Audit Selection Committee—and appointed by the Managing Director. The EAC is otherwise independent of IMF management.

Each committee member serves for a period of 3 years. The members' terms are staggered so that there is overlap and continuity; one reappointment is permitted.

The members must be citizens of different member countries, and at least one must be a national of one of the six members with the largest quotas. As a matter of practice, the audit selection committees have been following the principle of regional rotation.

EAC members are selected based on relevant professional qualifications and experience. They must possess the qualifications required to carry out the oversight of the annual audit, including accounting and/or related financial oversight expertise.

The EAC generally meets three times a year in Washington, DC, including with the Executive Board in January at the initial stage of the audit; in June, following the year-end audit; and in July to brief the Executive Board. The EAC holds discussions with the IMF staff and the audit firm throughout the year as necessary, and receives relevant documents and reports from the IMF on an ongoing basis.

The external audit firm has responsibility for performing the audit of the IMF's financial statements, in accordance with international standards for auditing, and issuing the audit opinion.

The external audit firm is selected by the Executive Board on the basis of a recommendation from the Audit Selection Committee and in consultation with the EAC. The Managing Director formally appoints the audit firm and determines its compensation.

The contract with the external audit firm is for an initial term of 5 years and can be renewed for an additional 5-year term. There is a mandatory rotation of the audit firm after 10 years.

At the conclusion of the annual audit, the EAC transmits the report issued by the external audit firm to the Board of Governors for approval, through the Managing Director and the Executive Board.

Additional Reading

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