Financial System Soundness

Weak financial institutions, inadequate regulation and supervision, and lack of transparency were at the heart of the financial crises of the late 1990s as well as the recent global financial crisis. The recent crisis also highlighted the importance of effective systemic risk monitoring and management. This is why the IMF has stepped up efforts to help countries implement policies to support sound financial systems.

Why are sound financial systems important?

A country's financial system includes its banks, securities markets, pension and mutual funds, insurers, market infrastructures, central bank, as well as regulatory and supervisory authorities. These institutions and markets provide a framework for carrying out economic transactions and monetary policy and help to efficiently channel savings into investment, thereby supporting economic growth. Problems in financial systems not only disrupt financial intermediation, but they can also undermine the effectiveness of monetary policy, exacerbate economic downturns, trigger capital flight and exchange rate pressures, and create large fiscal costs related to rescuing troubled financial institutions. Moreover, with increasing connectivity among financial institutions and tighter financial and trade linkages between countries, financial shocks in one jurisdiction can rapidly spill over across financial sectors and national borders. Therefore, resilient financial systems that are well-regulated and well-supervised are essential for both domestic and international economic and financial stability. Moreover, recent analytical work by IMF staff points to crucial links between financial stability, financial depth, and financial inclusion. The analysis underscores that it is important for policymakers and regulators to consider tradeoffs and synergies between financial stability and financial and economic development.

How the IMF helps to promote financial system soundness

The IMF promotes financial system soundness in member countries through its ongoing bilateral and multilateral surveillance, the design of its lending programs, and the provision of technical assistance.

Bilateral Surveillance is the regular dialogue and policy advice that the IMF is mandated to provide to all its members. This is known as Article IV consultations, and covers countries' macroeconomic and financial developments and policies. To deepen the coverage of financial system issues in this process, the Fund introduced in 1999 the Financial Sector Assessment Program (FSAP) to provide member countries with a comprehensive evaluation of their financial systems. Introduced on a voluntary basis, the FSAP became a mandatory part of the Article IV consultation for 25 countries with systemically important financial sectors in 2010, and the list was expanded to 29 countries in 2013. The FSAP's in-depth analysis complements the regular macrofinancial surveillance conducted in Article IV consultations. Increasingly, FSAPs have provided a systematic analysis of cross-border exposures and spillovers, and have promoted greater consistency in approaches to regulatory reform and the use of macroprudential policies.

Multilateral Surveillance introduces a multi-country or global perspective to surveillance. As economies and financial systems are increasingly integrated, many relevant issues span multiple jurisdictions, and spillovers from one country or financial system to another occur frequently. Through its multilateral work, the Fund seeks to identify underlying vulnerabilities related to such interlinkages and promote policies that support orderly global financial conditions. The IMF's *Global Financial Stability Report* takes a multilateral perspective on financial stability and assesses key financial market developments and risks with a view to identifying systemic vulnerabilities. The IMF's Spillover Notes present detailed IMF work on these effects and form the basis for the Special WEO chapters on spillovers. Other examples of multilateral surveillance include the semiannual Early Warning Exercise, carried out by the IMF jointly with the Financial Stability Board, and regional financial sector surveillance projects covering Central America, the West African Economic and Monetary Union, the Central African Economic and Monetary Community (CEMAC), the Eastern Caribbean Currency Union (ECCU), and the European Union.

Effective financial surveillance at the bilateral and multilateral levels has become a key strategic priority for the IMF. Following the 2014 Triennial Surveillance Review, IMF staff has devoted considerable effort to integrate and deepen risk and spillover analysis and enhance the coverage and integration of macrofinancial issues in Article IV consultations by mainstreaming macro-financial surveillance.

IMF-supported programs often include measures to strengthen member countries' financial systems. In addition to providing financial assistance, the IMF assists members in identifying and diagnosing financial system problems; designing strategies for systemic reforms and bank restructuring; and ensuring that such strategies are consistent with, and supported by, appropriate macroeconomic and other structural policies. Examples of recent programs with important financial sector components include Cyprus, Greece, Iceland, and Ireland.

Technical assistance provided by the IMF helps member countries to implement specific reforms to develop and strengthen their financial systems. Such assistance may include training and advice on monetary and macroprudential policy frameworks, debt management, foreign exchange and capital market development, the design of payment systems and deposit insurance arrangements, regulatory and supervisory frameworks governing the activities of financial institutions, and strategies for crisis preparedness, management, and bank resolution.

The IMF has also identified sets of core and encouraged Financial Soundness Indicators (FSIs), which are critical in assessing strengths and vulnerabilities in financial systems. The IMF supports country efforts to compile and disseminate FSIs. The Fund also contributes to the broader effort to compile data on financial inclusion through its Financial Access Survey.