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# Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward

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## LIST OF ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| AML | Anti-money laundering |
| BCP | Basel Core Principles for Effective Banking Supervision |
| CAS | Country Assistance Strategy |
| CFT | Combating the financing of terrorism |
| CPSIPS | Core Principles for Systemically Important Payment Systems |
| CPSS | Committee on Payment and Settlement Systems |
| FATF | Financial Action Task Force |
| FIU | Financial Intelligence Unit |
| FIRST | Financial Sector Reform and Strengthening Initiative |
| FSA | Financial Sector Assessment |
| FSAP | Financial Sector Assessment Program |
| FSIs | Financial Soundness Indicators |
| FSLC | Bank-Fund Financial Sector Liaison Committee |
| FSSA | Financial System Stability Assessment |
| IAIS | International Association of Insurance Supervisors |
| ICP | IAIS Insurance Core Principles |
| IMFC | International Monetary and Financial Committee |
| INPRS | International Network of Pension Regulators and Supervisors |
| IOSCO | International Organization of Securities Commissions |
| IOSCO Principles | IOSCO Objectives and Principles of Securities Regulation |
| MAE | Monetary and Exchange Affairs Department |
| MFP Code | IMF Code of Good Practices on Transparency in Monetary and Financial Policies |
| OFC | Offshore Financial Centers |
| QFSVR | Quarterly financial sector vulnerability report |
| ROSC | Reports on Observance of Standards and Codes |
| RSSS | Recommendations for Securities Settlement Systems |
| TA | Technical assistance |

## EXECUTIVE SUMMARY

1. **The Financial Sector Assessment Program (FSAP) is widely recognized by participating countries and by the international community as an important instrument for diagnosis of potential vulnerabilities and analysis of development priorities in the financial sectors of member countries of the International Monetary Fund (the Fund) and the World Bank (the Bank).** One objective of the FSAP is to help countries map a transition to a more diversified and competitive sector without creating vulnerabilities. A well-functioning financial services sector is essential for sustained economic development and poverty reduction. The existence of a wide and diversified set of sound, well-managed institutions and markets also reduces the likelihood and magnitude of a financial crisis.

2. **The program has added value from two perspectives: that of countries that have participated in the program, and that of the Bank and Fund and the international community at large. As one indication of the former, countries are now routinely volunteering to participate; about 95 countries have already participated or agreed to participate in the near future, including a significant number of systemically or regionally important countries.** Confirmation of the accepted benefits of the FSAP was also provided during a 2002 outreach meeting of FSAP participants. Representatives at the meeting noted that participation had provided their countries with a comprehensive and system-wide approach to analyzing financial sector issues, which domestic authorities might otherwise find hard to gain. Equally valued was the benefit of an independent review by objective outsiders who can often bring a fresh perspective. Developing, emerging market and transition countries have sought a substantial amount of follow-up assistance after the initial assessment. Finally, a number of countries have asked to be reassessed in order to have significant reforms or developments since the initial assessment recognized or simply to have an updated review.

3. **On the value of the program to the international community at large, in the Public Information Notice following the Fund Board's** Biennial Review of the Implementation of Fund's Surveillance and of the 1977 Surveillance Decision (SUR/02/242) it was noted that FSAP participation has generally been reflected in greater data availability, better assessments of financial system fragility (or strength), and sounder analyses of the potential impact of financial crises on macroeconomic conditions.

4. **Substantial ongoing research and work on the use and interpretation of a range of analytical and assessment tools have added to the program's value by strengthening the quality and consistency of assessments.** The same research and work have also greatly enhanced the two institutions' understanding of essential elements of a stable, well-functioning financial sector. Specific efforts have supported the development of a core set of Financial Soundness Indicators (FSIs), a wider range of stress tests and scenario analyses, and completion of a set of methodologies and templates for assessing financial sector standards and codes. Outreach efforts involving country authorities, experts from cooperating official institutions, and standard setters were used in undertaking this work.

5. **The modalities of incorporating FSAP findings into Article IV consultations are now well established.** There is a consensus by participating countries and Fund staff that the FSAP has significantly increased the depth and breadth of coverage of financial sector issues in surveillance. Many countries have decided to publish the Fund's Financial System Stability Assessment (FSSA), which summarizes the FSAP findings of relevance to surveillance based on discussions of these findings in the Article IV context, and which is provided to the Fund's Executive Board as part of a country's Article IV documentation. When the FSSAs and other FSAP related documents have been made public, transparency is increased, and the private sector can be better informed about countries' financial sectors.

6. **The link between FSAP findings and follow-up by the Bank and the Fund has also been established.** Technical assistance will continue to be offered to countries wishing to address financial stability and development issues and to update financial sector standards, in line with key concerns identified in the FSAP assessments. Mechanisms for improved and more systematic follow-up to elaborate priorities for action—through intensified work by the Bank and the Fund, together with national authorities, coordinated by the Bank-Fund Financial Sector Liaison Committee (FSLC)—are discussed in the paper.

7. **Procedures for country selection and the division of labor between the Bank and the Fund have continued to evolve.** Both managements have instituted a process for identifying priority countries for FSAP participation, drawing on inputs from Fund area departments, Bank regions, and national authorities and using criteria discussed by the Boards that balance stability and development considerations. In line with the Boards' guidance, priority is given in any one year to systemically important countries, while also maintaining a balanced coverage of countries. As a result, the pace of participation of systemically important countries has grown, with, for instance, more than half of G-20 member countries and a number of other major economies and financial centers having completed an FSAP, in the process of completing one, or planning to do so the near future. At the same time, a broad range of members have requested participation, and efforts are being made to schedule their assessments. **The division of labor between the Bank and the Fund has primarily reflected availability of expertise in the two institutions and the mix of countries in the program.** The mix of countries affects the division of labor because it influences the balance between stability and development issues and because the Fund has exclusive responsibility for assessments in industrial countries. The balance of coverage and division of labor will continue to evolve in line with the ongoing rationalization of the scope of the program as discussed in this paper.

8. **The average cost of the program has increased significantly over time, reflecting the priority given to systemically important countries, a bunching of such priority countries in FY2002 and FY2003 and the increase in the number of issues and standards assessed in depth. This has necessitated cuts in the pace of the program, particularly in FY2003, and efforts to sharpen its scope given resource constraints.** But continued rationalization of the pace and scope of the FSAP is needed. More than half of the Bank and Fund membership has yet to participate in the FSAP, with demand from countries for participation in the program remaining high. At the same time, demand for reassessments and updates is coming sooner than had been anticipated at the launch of the program, and

resources must be made available for other surveillance and follow-up efforts. Sharpening the scope of the program and better tailoring it to country circumstances are, in any case, necessary to maximize the program's contribution to financial sector stability and development.

9. **This paper sets out a framework for rationalizing the scope and pace of FSAP assessments going forward within the available resource envelope**. It notes that in addition to FSAP assessments and reassessments a broad range of tools will be deployed for surveillance and follow-up.

- **First, the scope of FSAP assessments will be sharpened by being more selective than previously about the number of issues and financial sector standards assessed** in detail in each FSAP assessment, and by tailoring the coverage of topics to country circumstances. We will aim to limit the number of standards for which detailed assessments are conducted in a typical assessment to three, excluding AML/CFT (compared to the current average of about five standards per FSAP). The precise number and type of standards to be assessed in each case will be based on country circumstances taking into account their relevance for financial system stability and developmental concerns. Considerations and principles to govern the selectivity in the topics and standards to be assessed in depth are discussed in the paper.

- **Second, the number of FSAP assessments and reassessments initiated in each year will be reduced to 17–19—**the pace already being implemented in FY2003 but below the previous number of 21–23 and up to 24 assessments per year indicated in earlier Board reviews.[1] The actual number of countries assessed each year would in practice fluctuate depending on the composition of countries assessed and the demand for other tools of ongoing surveillance and follow-up work. This reduced pace would help accommodate the priority placed on systemically important countries within the current resource envelope for FSAP, while also allowing a balanced coverage of countries.

- **Third, a broad range of tools will be deployed in addition to FSAP assessments and reassessments to be responsive to the need for follow-up work and ongoing monitoring of financial systems.** These include focused FSAP updates, specialist participation in Article IV or Bank missions, and off-site monitoring of developments through FSIs and other information. Criteria for deciding which financial systems are to be assessed, reassessed, updated, or followed up in an Article IV or Bank mission in a particular year, together with careful consideration of the scope of the assessments and updates, will be necessary to satisfy these competing demands on Fund and Bank resources—and on the resources of cooperating institutions. They also

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[1] Unexpected, even minor, changes in the timing of assessments can affect the number of assessments recorded in any given fiscal year. Note also that the fiscal year begins in July in the Bank and in May in the Fund.

provide a further incentive to use the experience gained to date to focus the scope of initial FSAP assessments, as well as FSAP reassessments, to the extent possible to maximize the number of countries that can be assessed.

10. **The paper stresses that FSAP assessments will continue to be comprehensive in areas covered, but the depth of coverage will be tailored to country circumstances. A proper understanding of financial system stability and development needs and priorities requires a look at all key components of financial stability and development—macro-prudential surveillance of risks and vulnerabilities, systemic liquidity arrangements, supervisory or regulatory capacity, financial system infrastructure, and impediments to market development. However, the depth and intensity of the assessment of individual components can be tailored to country specific circumstances.** For instance, in low-income countries with small financial systems, an assessment will likely devote relatively more effort to an analysis of factors explaining why markets are missing and identifying the most important structural and capacity building needs of the country. Over the next year, the Bank and the Fund will experiment with different ways to assess the financial sector in low income countries with small financial systems. The managements of the two institutions will look to these assessments to serve as a benchmark for future diagnostic work in similar countries. **Greater focus on medium-term and structural issues in developing countries will imply a greater role for Bank staff and experts in these countries,** with the Fund in the future allocating fewer team members, who will continue to focus, among other things, on key stability issues of relevance for Fund surveillance.

11. **Changes aimed at reducing overlapping documentation, streamlining the production and review of documents, and disseminating findings and analysis more usefully are outlined in the paper.** The Main FSAP Report will no longer be produced. It will be replaced by a revised aide-mémoire. This change will be responsive to those countries whose authorities have expressed disappointment when the FSAP Reports have been delayed in their finalization. The FSSA and FSA will draw on the revised aide-mémoire, distinguishing explicitly the common elements drawn there from the differing emphases of the FSSA and FSA.

12. **The paper proposes an extension of publication policy. It proposes to continue the current policy of voluntary publication of the Fund's FSSAs, the Bank's Financial Sector Assessments (FSAs), and associated Reports on Standards and Codes (ROSCs) and the policy of management authorization of voluntary publication by authorities of Detailed Assessments of Observance of Financial Sector Standards and Codes. In addition, it also proposes that managements provide authorization for publication by national authorities of Selected Issues notes of the FSAP Reports except for confidential sections dealing with highly sensitive information.** The Selected Issues cover specific aspects of the technical analysis supporting the FSAP assessment and, with the exception of stress test results, are not normally regarded as highly sensitive but could contain valuable information of general interest. At this point, publication of the revised aide-mémoire, as a confidential working document of the mission team, would not be authorized by the managements.

## I. BACKGROUND[2]

13. **The FSAP was initiated in May 1999 as a voluntary program in response to calls by the international community, the International Monetary and Financial Committee (IMFC), and the Development Committee to facilitate early detection of financial sector vulnerabilities and development needs, support a better coordinated dialogue with national authorities, and enhance effective collaboration between the Bank and the Fund**.[3] It has now become the principal platform for financial sector diagnostic work at the two institutions, allowing for a deeper, wider and more systematic financial sector information base and enhancing the work of both institutions under their respective mandates pertaining to financial sector issues. The program also helps to disseminate information on standards and codes and assessments of their observance, and has expedited the development of methodologies to be used in performing these assessments.

14. **Approximately 75 central banks, supervisory agencies, standards setting agencies, and other international institutions continue to cooperate in the FSAP.** See Appendix I for a table listing the institutions that have agreed to cooperate in the FSAP by providing or identifying experts, or by sharing information on assessment methodologies.

15. **When the Executive Boards of the Fund and the Bank last reviewed the program in December 2000 and January 2001, Executive Directors agreed on broad guidelines for the continuation of the program.** Directors agreed that the FSAP provided a coherent and comprehensive framework to identify financial system vulnerabilities and development needs. They noted that, within any one year, giving a higher priority to systemically important countries would be warranted, while reiterating the importance of including countries at various levels of development in order to give a full range of countries access to benefits from the program's support for strengthening their financial policies and institutions in line with international practices. They encouraged the staff to press ahead with the work being undertaken in the context of the FSAP to develop analytical techniques, including with regard to FSIs, stress testing and scenario analysis, and the assessment methodologies of financial sector standards in collaboration with standard setting bodies. They noted that the pace of the FSAP will depend on a number of factors, including how the suggested

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[2] The preparation of this paper has been coordinated by the FSLC. This Committee is responsible for the coordination of all aspects of the two institutions' financial sector work, including the FSAP process. For the most recent report on the FSLC's activities, see the October 2002 *Progress Report on the Bank-Fund Financial Sector Liaison Committee* (SM/02/308 and SecM2002-0507).

[3] See *IMF-World Bank Financial Sector Assessment Program (FSAP)* (SM/99/116 and SecM99-371) which provides a general description of the FSAP. *Financial Sector Assessment Program Progress Report—Lessons from the Pilot Exercise and Next Steps* (SM/00/54 and SecM2000-130) provides a report on progress with the program and contains some preliminary lessons from the pilot exercise. *Financial Sector Assessment Program—Update* (SM/00/205 and SecM2000-541) provides a brief update on the FSAP. *Financial Sector Assessment Program—A Review—Lessons from the Pilot and Issue Going Forward* (SM/00/263 and R2000-216) provides a review and broad guidelines for the continuation of the program.

prioritization translated into practice, and suggested that up to 30 assessments be undertaken per year. (Subsequently, in view of resource constraints, it was agreed that the pace of the FSAP should be reduced to up to 24 assessments per year.) Fund Directors agreed that, for surveillance purposes, focused updates of Financial System Stability Assessments (FSSAs) could be undertaken in the context of subsequent Article IV consultations. They also noted that the scope of FSSAs, particularly for countries with significant offshore financial centers, should be extended beyond domestic stability considerations to encompass possible cross-border effects.

16. **During the spring 2000 review of the FSAP pilot, Fund and Bank Directors agreed to authorize the publication of FSSAs and Financial Sector Assessments (FSAs), respectively.** At the time of the subsequent December 2000/January 2001 review of the program, Directors endorsed the managements' intended policy to provide authorization for the publication by the authorities of the detailed assessments of observance of standards and codes that comprise one volume in the FSAP reports. They further noted, however, that the policy of not providing authorization for the publication of the main volume of an FSAP report should be continued.

17. **The Bank and the Fund have sought continuous input into the determination of needed improvements to the various aspects of the program.** In early 2002, a joint Bank-Fund outreach meeting was held in Washington to discuss the quality and procedural aspects of the FSAP with those countries that had their FSAP missions completed in the previous year.[4] (Appendix II provides a summary of feedback received from participating countries.) Internal responses were solicited on the program from FSAP team leaders and deputy team leaders, Fund area department mission chiefs and Bank Financial Sector Board members. Comments were also gathered from relevant audiences on specific aspects including stress testing, standards assessments, and confidentiality issues. Beyond these efforts, feedback on the FSAP experience is also sought from country authorities through short questionnaires delivered with the final FSAP reports.

18. **The following discussion and recommendation draws on the results of the recent reviews of MAE's functions and organization and the Bank's Quality Assurance Group (QAG) evaluation of a sample of FSAP assessments. It also draws on reviews of FSAP reports, FSAs and FSSAs for post-pilot countries for which the FSAP either had been completed or was near completion.** Section II reports on country participation in the FSAP while Section III discusses the program from the perspective of participating countries. Sections IV and V evaluate the role that the FSAP has played in surveillance and in development and capacity building, respectively. The analytical tools used in the FSAP are discussed in Section VI with details in Supplement 1. Section VII reviews the operational

[4] Participating at the meeting were representatives from Croatia, Czech Republic, Dominican Republic, Finland, Gabon, Georgia, Iceland, Latvia, Mexico, Senegal, Slovenia, Tunisia, Uganda, and the Banking Commission for Central Africa. The outreach was the second such meeting since the launch of the FSAP.

status and progress of the program. Section VIII discusses issues going forward. Supplement 2 discusses development issues in the context of the FSAP.

## II. Status of Country Participation in the FSAP

19. **The selection of countries for the FSAP in any one year reflects both stability and development considerations as well as resource constraints.**[5] During the previous review of the FSAP, Executive Directors in both the Fund and the Bank discussed the criteria that should be employed to establish priorities for selecting countries to participate in the program. It was agreed that country selection should aim to maximize the program's contribution to the strengthening of national and international financial stability. Most Directors agreed that, within any one year, giving a higher priority to systemically important countries would be warranted. They noted that prioritization in this sense meant a difference in timing, not treatment, and that all members should have the opportunity to participate in the FSAP over time.[6]

20. **Following this guidance, the managements of the Fund and the Bank instituted a process for identifying priority countries for FSAP participation and encouraging those countries to participate in the program.**[7] Besides giving priority in any one year to systemically important countries, other criteria that are used to determine FSAP priority countries include: (i) external sector weakness or financial vulnerability; (ii) upcoming likelihood of major reform programs (as reflected, for example, in the Bank's Country Assistance Strategy (CAS)) that would suggest a benefit from a comprehensive financial sector assessment; and (iii) features of the exchange rate and monetary policy regime that make the financial system more vulnerable, such as inconsistency with other macroeconomic policies. Maintaining geographical balance among countries and balance across different levels of financial sector development is important. In addition to these criteria, given the voluntary nature of the program, the time which has elapsed since a country has volunteered also has to be considered when scheduling assessments. Similarly, the time elapsed and developments since previous FSAP or Offshore Financial Center (OFC) assessments will become other criteria for scheduling reassessments under the FSAP.

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[5] Assessments were initiated at a rate of around 21–23 per year in FY2001–02. Since then the number has been reduced to 18 in FY2003, in contrast to the initially expected pace of 24. See Section VII A for further discussion.

[6] See, for example, the IMF Public Information Notice *IMF Reviews Experience with the Financial Sector Assessment Program (FSAP) and reaches Conclusions on Issues Going Forward* (http://www.imf.org/external/np/sec/pn/2001/pn0111.htm).

[7] Crisis countries are not deemed appropriate candidates for the program. The FSAP is designed to assess risks and vulnerabilities of the financial sector at an early stage and is not intended as a crisis management tool. Moreover, the situation in crisis countries changes so rapidly that an assessment at any one point in time is not useful.

21. **This effort has been successful. Many systemically important countries have participated, with, for instance, more than half of G-20 member countries completing an FSAP or doing so in the near future (Table 1).[8] At the same time, participation has been encouraged across the entire membership, and a broad range of members have requested participation.** As of mid-March 2003, 45 countries—including the 12 pilot countries—have gone through a complete assessment.[9] Work was under way on an additional 25 economies, and 27 other countries have agreed and will be scheduled to participate in FY2004 or later. Thus about half of the Fund and Bank membership has committed to the program.[10]

## III. The Program from the Perspective of Participating Countries

22. **Participants in the 2002 outreach meeting noted that FSAP participation had provided a comprehensive and system-wide approach to analyzing financial sector issues, which domestic authorities might otherwise find hard to gain**.[11] They appreciated that because the FSAP covered the various sectors of the financial system, it has led to a broader assessment of risks, markets, and institutions. Equally valued was the benefit of an independent review by objective outsiders who often bring a fresh perspective. A number of countries noted that preparation for the FSAP, while time-consuming, provided them with the opportunity to carry out self-assessments in a number of areas, which they viewed as a helpful exercise. In addition, most countries valued the opportunity to discuss supervisory and regulatory practices with experts from other countries and to compare practices. They also emphasized the contribution the program makes through benchmarking one country's practices against internationally accepted practices and in stress testing the financial system to assess vulnerabilities to plausible shocks. Countries found the FSAP helpful either in confirming the authorities' own assessment or providing an opportunity for in-depth discussions of differences. Developing and emerging countries also emphasized the FSAP's contribution in identifying vulnerabilities, prioritizing reforms, and focusing the attention

[8] In their December 1999 Finance Ministers and Central Bank Governors Meeting, G-20 member countries agreed to undertake Financial Sector Assessments and the completion of ROSCs. They noted that this commitment will help mobilize support for measures to strengthen domestic capacity, policy, and institutions.

[9] Defined as when the FSAP reports are finalized.

[10] As of December 2002, FSAP work in 12 countries and economies with international financial centers has been undertaken; of these, work has been completed for five countries (Barbados, Ireland, Lebanon, Luxembourg, and Switzerland), and is under way for seven others (Costa Rica, Hong Kong SAR, Malta, Mauritius, Morocco, Singapore, and the United Kingdom). FSAP missions are scheduled/planned for six additional countries (ECCB area members) for calendar years 2003 and 2004.

[11] Compared to the previous outreach meeting that was conducted in October 2000, countries expressed greater satisfaction with the procedural aspects of the FSAP, reflecting steps that have been taken to address their earlier concerns. They also expressed a higher appreciation of the value added of the program, particularly in relation to its pan-sector view.

domestically on the need for reforms. Examples of FSAP findings for three countries with differing degrees of financial sector development are shown in Box 1.

Table 1. FSAP Participation
(as of mid-March 2003, G-20 countries in bold)

| Countries Completed | | Countries Under Way | Future Participation Confirmed |
|---|---|---|---|
| Armenia | Nigeria | Algeria | Antigua and Barbuda |
| Barbados | Peru | **Argentina** 1/ | Austria |
| Bulgaria | Philippines | Bangladesh | Azerbaijan |
| Cameroon | Poland | Bolivia | Belgium |
| **Canada** | Senegal | **Brazil** | Chile |
| Colombia | Slovak Republic | Cote d'Ivoire | Dominica |
| Costa Rica | Slovenia | **Germany** | Ecuador |
| Croatia | **South Africa** | Honduras | Fiji |
| Czech Republic | Sri Lanka | Hong Kong | **France** |
| Dominican Republic | Sweden | **Japan** | Grenada |
| Egypt | Switzerland | **Korea** | Jordan |
| El Salvador | Tunisia | Kyrgyz Republic | Kenya |
| Estonia | Uganda | Malta | Kuwait |
| Finland | United Arab Emirates | Mauritius | Macedonia, FYR |
| Gabon | Yemen | Morocco | Moldova |
| Georgia | | Mozambique | Netherlands |
| Ghana | | Oman | New Zealand |
| Guatemala | | Romania | Norway |
| Hungary | | **Russia** | Pakistan |
| Iceland | | Singapore | Paraguay |
| **India** | | Tanzania | Portugal |
| Iran | | Ukraine | **Saudi Arabia** |
| Ireland | | **United Kingdom** | St. Kitts and Nevis |
| Israel | | Uruguay 1/ | St. Lucia |
| Kazakhstan | | Zambia | St. Vincent and the Grenadines |
| Latvia | | | Sudan |
| Lebanon | | | Venezuela |
| Lithuania | | | |
| Luxembourg | | | |
| **Mexico** | | | |

1/ Postponed.

## Box 1. FSAP Findings—Selected Country Cases

**Iceland.** Significant vulnerabilities existed, particularly as a result of the rapid evolution of the financial market in recent years—outpacing to some extent the evolution of the regulatory framework. Weaknesses also existed, partly as a result of the emergence of imbalances in the macroeconomic environment, notably an enduring, large current account deficit and low national savings rate. Various stress tests concluded that the Icelandic financial system was vulnerable to market and credit risks, particularly as a result of significant foreign currency lending by banks, coupled with a number of institutional features of the financial system. Following the assessment, the authorities have made a coordinated effort to address the issues raised in the 2001 FSAP report. Most notably these include (i) the strengthening of the banks' capital adequacy positions; (ii) the increase in staffing to allow, among other things, for a more active program of on-site examinations; and (iii) issuance of improved regulations on loan loss provisioning, nonperforming loan valuation and new regulatory guidelines. Three pieces of legislation were also drafted: The Law on Financial Undertakings, which *inter alia* strengthens the supervisory powers of the Financial Supervisory Authority took effect on January 1, 2003 while the other two (on stock market and investment funds) are expected to be passed by Parliament before mid-2003. Finally, the March 2001 decision to exit the adjustable exchange rate peg of the króna and to implement an inflation targeting regime and grant full instrument independence to the central bank was fully in line with the recommendations made in the 2001 Article IV staff report and the underlying thrust of the FSAP reports. In the event, the financial system appears to have overcome the severe economic events of 2001 without systemic distress.

**Philippines.** The cumulative effects of substantial peso devaluation since 1997 and weakened economic performance had a significant adverse impact on performance indicators in the Philippine financial system. These fundamentals, combined with a legacy of uncoordinated reform efforts that have produced a distorted incentive framework (e.g., differentiated supervisory, tax and regulatory arrangements) favoring the development of conglomerate structures, have resulted in a financial system under stress. The interaction of this incentive framework with a weakened corporate sector has amplified the vulnerability of the financial system, resulting in a significant deterioration in the asset quality of the banking sector. In addition, the incentive framework has resulted in a bias against peso intermediation, favored particular instruments designed to circumvent taxes or supervision, slowed the growth of the domestic debt market, and discouraged resolution of troubled intermediaries. While important reforms are under way, a comprehensive and preemptive strategy is needed to avoid systemic problems and to deepen financial markets as a basis for prospective resilience. The mission emphasized the need to strengthen the supervision and resolution framework, including a more defined and explicit prompt corrective action framework as well as legal reforms to strengthen the enforcement powers of the supervisory authorities.

**Tunisia.** The banking sector, which dominates the financial system, had been strengthened but was not yet on a sound footing. Financial soundness indicators improved, but exposure to credit risk remained considerable—in particular in the state-owned banks that account for over half of the assets in the system—and provisioning policies were weak due to heavy reliance on real estate collateral that could only be realized with a significant delay. However, the system appeared unlikely to suffer from a generalized crisis since there was limited exposure to foreign currency risk, in particular due to limited capital mobility. In addition, macroeconomic risks were limited in view of the conservative and consistent macroeconomic policies pursued by the authorities. The FSAP team also noted that the authorities had undertaken several improvements to the financial system, including (i) massive modernization of the legal framework; (ii) reform of the insurance sector; (iii) support for the development of collective investment institutions; and (iv) promotion of mortgage securitization. The FSAP team stressed that the recapitalization needs of state-owned banks could represent a significant burden on the fiscal position and recommended a medium-term financial sector strategy that focused on reconsidering the extent of state ownership in the financial system. They also encouraged the establishment of foreign financial institutions and independent local operators. While Tunisia maintained extensive capital controls, the mission advised that full capital account liberalization should be adequately sequenced to ensure financial stability and should proceed only at a pace that allowed banks to reduce current vulnerabilities, develop expertise with international transactions, and further enhance their overall effectiveness. Subsequent to the FSAP, TA has been provided by the Bank in mortgage securitization, while additional TA on public debt management has been recommended. The authorities also requested and received follow-up TA from the Fund in the design of a strategy on capital account liberalization.

23. **However, country representatives also pointed to areas where the FSAP could be improved.** They noted that the composition of FSAP teams (and, in particular, the choice of outside experts) could be formed so as to enable a faster and more thorough understanding of the legal and regulatory traditions of the FSAP country. They also pointed out the limitations of stress testing due to data availability and complex exposures, the scope for enhancing the selection and analysis of FSIs, and the large resource cost involved for the authorities, particularly when undertaking detailed assessments of many standards in an FSAP. The lag between FSAP missions and the final production of the reports was noted to have been long in some cases, which may have limited the report's usefulness to the authorities. Based on the feedback that has been received from the authorities and other sources, staff have proposed revisions to the pace of the FSAP, its scope, and documentation that will help address the issues raised above (see Section VIII).

24. **Generally, countries have been responsive to FSAP recommendations.** In some cases, the FSAP was undertaken at an opportune moment when legal and regulatory reforms were under way and the FSAP team could contribute to sharpening or redirecting the authorities' proposed reforms.[12] In other cases, the authorities implemented new measures in response to FSAP recommendations or even during the FSAP process.[13] Staff and country authorities noted that, while in many cases—particularly in emerging and industrial economies—country authorities were aware of financial sector issues, the FSAP has helped them to realize the severity of problems and identify priorities for action on key issues. It also has highlighted the importance of prompt actions and assisted in the mobilization of the needed political support to speed up their implementation. More generally, it has promoted internal dialogue.

## IV. The Role of the FSAP in Surveillance

25. **The modalities of incorporating FSAP findings into Article IV consultations have remained much the same since the inception of the program.** The FSAP assessments, combined with discussions of FSAP findings in the subsequent Article IV consultation context, serve as the basis for the FSSAs, which emphasize stability issues of relevance to surveillance and which are provided to the Fund's Board as part of the Article IV consultation documentation for a country. Ideally, the FSAP mission work is completed about three months prior to the Article IV consultation mission so as to allow sufficient time for the draft FSAP findings to be available for discussion during the Article IV consultation, in which the FSAP team leaders usually participate. The final FSAP documents are normally prepared after the Article IV consultation mission. There have been

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[12] Examples among the countries reviewed include Mexico, where the FSAP provided inputs on a number of new laws and initiatives; Latvia, where it provided timely input on the transition to unified financial sector supervision; and Luxembourg, where it redirected the authorities' work in the area of anti-money laundering.

[13] For example, following the Slovenia FSAP, the authorities developed a comprehensive financial sector action plan based on FSAP recommendations, which they feel has progressed sufficiently to warrant a reassessment.

some exceptions to the link with the Article IV consultation. In the case of Brazil, for example, the FSSA was discussed in the context of the Board discussion on a Review of the Ongoing Stand-By Arrangement in December 2002. The intention is that this approach will be followed in the future in some cases, especially as regards program countries on a 24-month Article IV consultation cycle, when an FSAP assessment is warranted in the near term but the Article IV consultation is still some time away.

26. **There is a consensus that the FSAP has significantly increased the depth and breadth of coverage of financial sector issues in surveillance, and has better integrated macroeconomic and financial sector surveillance, including for industrialized countries (Box 2)**.[14] FSAP missions have assessed the implications of the macroeconomic environment and policies on the health of the financial sector and, conversely, systemic risks implied by financial sector conditions, and the interaction of the two. Various analytical tools—including FSIs and stress tests—have been used to highlight sensitivities of the financial sector to macroeconomic shocks and to direct the attention to areas where the country authorities need to be vigilant.

27. **In general, the FSAP has contributed significantly to enhancing the Fund's knowledge of financial sector issues and risks that are essential to surveillance in the countries assessed**.[15] Area departments noted that the FSAP has provided the Article IV consultation with much needed knowledge and expertise to cover financial sector issues, in addition to increasing the capacity of the Article IV missions to cover these issues. They also underscored the importance of the FSAP in enhancing the surveillance capability through its contribution to the Fund-wide interdepartmental exercise of vulnerability assessment for emerging market countries, and the compilation of a database on FSIs. In addition, particularly in the case of emerging economies, area departments highlighted the benefit of the FSAP in providing assessments based on internationally accepted practices.

[14] The *Biennial Review of the Implementation of Fund's Surveillance and of the 1977 Surveillance Decision—Overview* (SM/02/82) noted that FSAP participation seems to have been the most important factor accounting for differences in coverage of financial sector issues in Article IV consultations.

[15] Four of the six Fund area department survey responses valued the FSAP's contribution to enhancing financial sector surveillance as high while the remaining two viewed it as medium.

## Box 2. Themes Relevant to Fund Surveillance

The focus of assessments has varied among countries which undertook the FSAP, but general themes relating to Fund surveillance have emerged. As would be expected, the areas covered under the FSAP have been largely dependent on the degree of financial sector development in the country assessed.

**Developing countries.** Vulnerability assessments have looked mostly at the banking sector, which tends to dominate the financial system in this group. Generally, most issues in the nonbank financial sector relate to development needs rather than short-term systemic stability. In a large proportion of countries assessed, stability assessments revealed banking sector vulnerabilities to macroeconomic shocks and/or adverse macroeconomic conditions that could affect the banking sector, calling for immediate attention and specific banking sector regulatory measures supported by macroeconomic consolidation to ensure stability. In addition, most countries shared a broad range of weaknesses that needed to be addressed in the medium-term to strengthen the financial system including in banking supervision, the legal and regulatory frameworks covering both banks and nonbanks, payment systems, monetary policy implementation, and bank restructuring, calling for comprehensive and carefully sequenced reform strategies to support economic and financial stability.

**Emerging economies.** A large number of emerging economies have recovered from financial crisis and/or have made significant progress toward the restructuring and reform of their financial systems. These economies were found to have relatively robust systems supported by increasingly more stable macroeconomic conditions. The FSAP identified significant financial sector vulnerabilities in about one-quarter of the economies assessed, with the systemic risk assessed to be high in only one case. In most cases, capital and money markets exist but are still thin and not well established. Due to the small size of the nonbank financial sector, FSAP assessments generally concluded that the nonbank sector is not expected to be a source of systemic risk; however, the nonbank sector was found to have a broad range of deficiencies in regulation and supervision. Most economies have already achieved broadly adequate bank supervision and regulation. Deficiencies were largely related to the inability of the regulatory and supervisory authorities to keep up with the proliferation of financial services, and were concentrated in specific areas such as consolidated and risk-based supervision and cooperation among supervisory agencies. Other common issues included supervision enforcement and prompt corrective action.

**Industrialized countries.** Generally, these countries have advanced and overall sound financial systems, complying well with international standards and codes. Banks and nonbank financial institutions and markets were found generally to be healthy overall. However, the FSAP teams stressed a number of challenges that commonly arise in this group of countries, particularly in view of the trends characterizing the global financial system today relating to financial conglomeration, internationalization of finance, and consolidation among financial institutions. The dominance of large and complex financial institutions that offer multiple financial products in addition to bank intermediation poses challenges to the institutions and their supervisors in ensuring an appropriate monitoring of risks, both across activities and across borders. In addition, the highly concentrated nature of the financial systems and the dominant role of financial conglomerates pose challenges to crisis management. Furthermore, the growing concentration of market transactions amongst a smaller number of large and complex financial institutions raises potential contagion issues and issues for the management of systemic liquidity and liquidity risks. This is particularly important in cases where unsecured interbank markets are the dominant source of market liquidity for banks. The predominance of large financial institutions also raises too-big-to-fail considerations. The rapid growth in new instruments of risk transfers, such as credit derivatives, requires a closer look at the robustness of these markets and their capacity to withstand a broad-based weakening in a downturn. Finally, traditional sources of risk, particularly credit and interest rate risks in the banking book, continue to be relevant to the soundness of financial institutions. In a number of countries, the increases in corporate debt-equity ratios, the increasing income gearing of the household sector, and the softening of real estate prices are factors that could affect credit quality if the global outlook weakened further.

28. **The recent reviews of MAE provided recommendations on the FSAP and its role in surveillance.** The main recommendations relate to: (i) the need to view the FSAP as part of an array of instruments to support the surveillance process; (ii) a rationalization of the scope and pace of FSAP assessments; (iii) prioritizing assessments of standards and codes in any particular FSAP; (iv) the need for an elaboration on how updates are to be undertaken; (v) a systematic approach to follow-up work based on FSAP findings, supported by strengthened managerial and quality control; and (vi) a larger role for the Bank in developing country FSAPs.

## V. The Role of the FSAP in Development and Capacity Building

29. **A well-functioning financial services sector is essential for sustained economic development and poverty reduction.** The existence of a wide and diversified set of sound, well-managed institutions also reduces the likelihood and magnitude of a financial crisis by helping to absorb adverse shocks. The FSAP can play a central role in this regard by highlighting the linkages between stability and development. The Bank has given priority to strengthening and deepening domestic financial sectors by improving the management of financial systems through the implementation of good practices for prudential regulation and supervision within the sector and by helping to build the institutional capacity to deliver the financial services needed for growth.

30. **The financial system development agenda seeks to provide countries with an increased ability to monitor their own systems following assessments conducted under the FSAP.** Supervisors and regulators have indicated that they are interested in and willing to conduct self-assessments regularly to determine their progress in the implementation of internationally–accepted good practices. Countries also have expressed an interest in collecting and monitoring data that permit ongoing compilation of FSIs. Supervisory agencies and even some banks have expressed interest in acquiring and routinely using risk management tools such as stress testing and scenario analysis. Bank and Fund staff provide guidance to countries in these efforts, which may help foster the countries' ownership of the FSAP's findings.

31. **An objective of the FSAP is to help countries map a transition to a more diversified and competitive sector without creating vulnerabilities.** Many countries have for some time been strengthening the official oversight of the financial sector, but FSAP analyses suggest that such enhancements have not yet fostered broadly more resilient systems that are both more competitive and better able to manage risks. The program helps to enumerate and prioritize needed structural reforms intended to make the sector more efficient in mobilizing and allocating resources and less crisis-prone (Box 3). Such reforms have both short- and medium-term dimensions, and consideration of both has been well served by combining the expertise of the Fund and the Bank.

32. **Representatives of developing countries at the 2002 outreach meeting indicated that there was scope for increased emphasis on the sequencing of reforms and on institution building that would support their growth objectives.** They noted that analysis

of development issues, evaluated in light of a country's specific risk profile and stage of development, should help enhance the intermediation role of the financial system in a number of ways—to support growth, find ways for providing more complete access to financial services, and strengthen domestic legal and institutional capacity.

33. **The FSAP has contributed significantly to enhancing the breadth and depth of knowledge with respect to financial sector issues and risks.** CASs have begun to incorporate FSAP findings and recommendations. Assessments, in some cases, have been followed with adjustment operations and TA loans to implement the reforms and continue with the institutional development needs identified in the FSAP.

34. **The Bank's Quality Assurance Group (QAG) has carried out a pilot evaluation of four FSAP assessments.** In terms of their (i) strategic relevance and timeliness; (ii) internal quality; (iii) dialogue and dissemination; and (iv) likely impact, preliminary findings rate three of the four as highly satisfactory and the fourth as satisfactory. An Implementation Follow-up Survey conducted within the Bank's regions, while finding the FSAP output useful, has urged that FSAP work be better taken up in operations. To this end, Bank staff and management are considering additional ways to make the link between FSAP analysis and other Bank work more systematic and durable. To strengthen the link between the FSAP and CASs, loan agreements and other documents, FSAP team leaders will intensify their work with the Bank's country teams and regional finance teams and with national authorities for greater focus on the priorities for action and a more elaborated action plan.

## VI. Analytical Tools Used in the FSAP—Experience and Progress to Date

35. **The FSAP builds on a number of complementary analytical tools and assessments to establish an overall assessment of the financial sector**. These broadly include several elements: (i) the systematic analysis of FSIs and stress testing used to identify risks and vulnerabilities; (ii) the assessments of standards and codes used to assess institutional and regulatory structures; and (iii) the assessment of the broader financial stability policy framework which helps in the assessment of the robustness of the financial sector infrastructure. The third consists of a broad range of analyses, including systemic liquidity arrangements, governance and transparency framework, and financial safety nets and insolvency regimes. A considerable amount of work has been done since the inception of the FSAP to develop the main insights and analytical tools to improve its quality and to bring about consistent treatment among countries.

### Box 3. Important Developmental Issues Addressed in the FSAP

**The implementation of the legal framework.** FSAP missions have attempted to differentiate between legal frameworks with appropriate laws and regulations and their actual implementation. This has been a particular concern of the assessors of observance of international standards and codes. Closing the gap between "laws on the books" and implementation is an element of a potential development priority to help countries enhance the competence, political independence, and impartiality of courts.

**Access to credit by small- and medium-sized enterprises and micro-credit.** FSAP missions covered issues related to access of small- and medium-sized enterprises to bank and nonbank financial institutions' services. While not a significant short-term stability risk, the absence of nonbank industries such as leasing, factoring, insurance, and venture capital may handicap overall stability in the longer-term or retard the inclusion in the economy of larger groups of individuals who can easily be left out of the formal financial sector.

**Institutions for specialized development finance.** This sector serves segments of the population that are traditionally under-served. Frequently, these institutions are subsidized by the government and perform specialized functions such as financing agriculture or low-income mortgages. They may have a different management approach from a bank and operate under different fiscal conditions. As credit cooperatives or credit unions, they may be supervised, if at all, outside the formal banking system's supervisory framework. Taken together, these institutions can be so small that the failure of the whole group would not threaten the system's stability. However, failure of such institutions could have a substantial impact on low-income households, costing them their savings and, perhaps, their confidence in financial institutions as a whole. FSAP missions have suggested creating new regulations and a legal framework specific to the nature of these institutions.

**Contractual savings.** FSAP assessments have highlighted the central role of contractual savings in generating long-term savings and their potential contribution to the development or expansion of capital markets. Some analyses have identified serious risks and potential imbalances in pension schemes and the associated risks.

**Other.** FSAP missions have assessed the housing financing mechanisms, their sources of funding, and their contribution to economic and social development. Teams have also assessed, sometimes in association with specific standards assessments, legal and informational aspects supporting the functioning of the financial system, including bankruptcy laws, auditing and accounting standards, and the credit information industry. In addition, FSAP missions have provided advice on the development of efficient and liquid local capital markets.

36. **In the context of the FSAP, specific efforts have focused on developing a core set of FSIs, stress testing and scenario analysis, and methodologies for assessing standards and codes.** The following section summarizes the experience to date and highlights the purpose for which these tools are being used, issues related to their use, key policy issues arising from the analysis and assessments, and progress in addressing these issues and in developing the tools. A more detailed discussion can be found in Supplement 1.

## A. Financial Soundness Indicators

37. **FSIs are intended to monitor the soundness of the financial sector and complement macroeconomic indicators in identifying risks to financial stability.** They also provide a common set of indicators to be continuously monitored, which helps maintain an enhanced level of financial sector surveillance following FSAP participation, including on Article IV consultations. Disclosure of these indicators can enhance transparency and contribute to market discipline. (See Appendix III for a list of FSIs.)

38. **Work is under way to establish an FSI database that would strengthen the capacity to monitor financial sector vulnerabilities following FSAP participation.**[16] A test version of an MAE database is now operational and has provided insights into the use of FSIs in the FSAP.[17] To improve the consistency and comparability of data across countries, Fund staff are working on the development of an FSI *Compilation Guide*, aimed at assisting compilers as well as official and private users of FSIs. The guide is currently under preparation, with the support of an outreach program for involved users and standard setters,

[16] In its June 2001 review of the FSIs, the Executive Board of the Fund supported the selection of both a core set and a broader "encouraged" set of FSIs and endorsed a number of proposals for future work, including development of an FSI database and *Compilation Guide*, and further analytical work on the uses of FSIs. It called for a systematic compilation of FSIs in the FSAP and in Article IV consultations where data are available and where in-depth financial sector assessments are undertaken. The Board also emphasized the importance of the early implementation of the core set of FSIs covering the banking sector—chosen for their analytic relevance and availability—to maximize the near-term contribution of FSIs to the FSAP. The Board noted that the development of the encouraged set should occur in parallel, with priority given to indicators for the corporate sector, real estate markets, and nonbank financial institutions. Also emphasized was the need for flexibility in the use of indicators, since financial structures differ across countries, as does the need to pay attention to the distribution of risk exposures through, for example, the use of FSIs in peer group analysis.

[17] Within the core set, FSIs for capital adequacy, asset quality, and bank earnings were always compiled, although within each of these categories some FSIs were viewed as substitutes for others. Liquidity FSIs were compiled in 90 percent of FSAPs. However, FSIs of the sensitivity to market risk were compiled in just over half of the FSAPs, largely due to the extensive reliance on stress testing to assess this source of risk. Consistent with the emphasis on the core indicators, the frequency with which FSIs in the encouraged set were compiled was significantly lower on average. This was also the case for FSIs of the nonfinancial sectors and nonbank financial sectors that were given a higher priority in the encouraged set, due to data availability constraints. Risk exposures monitored using FSIs were also frequently examined in an alternative fashion through stress testing.

including the Bank. The guide should improve the usefulness and comparability of FSIs by clarifying the definition of each FSI and how it should be compiled.[18]

39. **Further analytical work on FSIs is continuing and is focused on strengthening the framework for assessing risks to financial stability.**[19] One area of work involves strengthening the integration of FSIs and stress testing in the FSAP. Recent work has focused on using stress testing to help interpret future movements in FSIs. A second area aims to enhance the usefulness of FSIs of non-financial sectors as indicators of risks to the financial sector. As indicated by participants in the FSAP outreach, such indicators could provide early warning to policy makers on future financial sector problems. A third area of ongoing work involves further analysis of how FSIs should be interpreted in the context of specific structural characteristics of the financial system, such as the effectiveness of supervision, the robustness of the financial infrastructure and the relative importance of the banks, nonbank financial institutions and foreign financial institutions in the financial system. In addition, FSIs can, over time, help to monitor progress being made in enhancing financial sector performance.

## B. Stress Testing

40. **Stress tests are a component of all FSAP assessments and are used to supplement the other analyses undertaken in the FSAP.** The objective of stress tests in the context of the FSAP is to help assess risks and vulnerabilities arising from macro-financial linkages by analyzing the impact of exceptional but plausible shocks to macroeconomic variables on the soundness of the financial system. The exercise typically integrates a forward-looking macroeconomic perspective, a focus on the potential systemic effects suggested by those scenarios, and a uniform approach that applies a common set of scenarios and shocks to assessing the impact across a group of institutions in a financial system. It offers the authorities a way to look at risk measurement and management, and thereby provides a supplementary tool to financial stability policy makers.

41. **Risks routinely evaluated in the FSAP relate to interest rates, exchange rates, credit, liquidity, and other asset prices.** To evaluate these risks, stress tests employ a range of approaches to trace the effect of macroeconomic shocks on FSIs in order to assess potential vulnerabilities in the financial sector. These could include: (i) *sensitivity analysis*, which seeks to identify the vulnerabilities of the financial system to changes in individual financial variables, such as interest rates, exchange rates, and equity prices; (ii) *scenario analysis*, which seeks to assess the resilience of the financial system to scenarios that entail

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[18] See *Financial Soundness Indicators: Analytical Aspects and Country Practices*, IMF Occasional Paper 212, 2002, which presents the results of the IMF *Survey on the Use, Compilation, and Dissemination of Macroprudential Indicators*.

[19] As proposed in the Fund's SM/01/159, progress made in all of these areas will be reported in a paper on FSIs being prepared for discussion by the Fund Board.

simultaneous changes in a number of macroeconomic variables, which are then mapped into implications for financial risks; and (iii) *contagion analysis,* which seeks to assess the impact of a shock transmitted from an individual financial institution to the rest of the financial system.[20]

42. **Efforts have been made to involve the authorities in every phase of the stress testing process.** In particular, in response to feedback received from participating countries, recent FSAP missions have conducted early discussions with the authorities on the stress testing methodology, data requirements and scenarios. This closer cooperation is viewed to be helpful in better identifying scenarios and the data needed to carry out the exercise, in transferring the expertise to the authorities, and enhancing the authorities' ownership of the exercise. The type of stress testing that can be done varies significantly from country to country. When feasible, FSAP missions have worked with financial institutions to analyze the effects of common shocks using the institutions' own risk assessment models. This approach facilitates the assessment of financial conglomerates' risk since, by using the institutions' own risk assessment models, stress tests are more easily applied to the consolidated groups as a whole, incorporating the activities of their nonbank subsidiaries such as insurance. In addition, it enables the inclusion of off-balance sheet positions including derivative positions—information that is only available to the institutions themselves—and enhances the assessment in cases where financial institutions are hesitant to share with the mission commercially sensitive balance sheet data. Accordingly, it is useful if the country authorities encourage large private institutions to participate in the stress testing exercise.

43. **Work is ongoing at the Fund and the Bank to further improve stress tests.** Both institutions have benefited from a dialogue with the international community in this area, including in the context of FSAP missions to industrialized countries. External experts and internal training seminars are being used to enhance the implementation of stress tests. In addition, work is continuing on methodological issues.

## C. Assessments of Standards and Codes

44. **The assessments of observance of international standards and codes have played an important role in the FSAP and form an integral component of the FSAP assessments.** When combined with other analysis undertaken in the FSAP, the standard assessments have helped to identify weaknesses and gaps in institutional and regulatory structures and practices. (See Appendix IV for examples of the findings from standards assessments.) The standards assessments have also helped to formulate an overall stability

[20] Mainly due to data limitations, most stress tests have not formally quantified contagion risks among institutions, although FSAP reports have commented on the possible importance of contagion risks. Only three recent FSAP missions (Gabon, Luxembourg, and Sweden) conducted contagion analysis. For example, the Swedish and Luxembourg FSAP stress tests incorporated contagion analysis to estimate the impact of a bank's settlement failure on other banks' liquidity and capital.

assessment by examining the extent to which the observance of standards serves to manage and mitigate the identified risks and vulnerabilities. By setting these in a broader macro prudential and institutional context, they also have helped to identify the priorities and sequencing for regulatory reform and capacity building, as well as to formulate the immediate priorities to reinforce stability and specify the medium-term reforms and development needs in the areas covered by the standards. Standards assessments have also helped country authorities identify operational and supervisory risks and evaluate their own systems against international benchmarks. In addition, summary standards assessments that flow from the detailed assessments have become financial sector modules of the ROSCs, and are presented in the FSSA and reflected in the FSA.[21] Furthermore the promulgation and dissemination of standards worldwide has raised countries' awareness of and interest in enhancing their observance of these standards. [22]

45. **As of end-December 2002, over 283 assessments of standards and codes have been conducted under the FSAP (Figure 1).** The standards typically assessed consist of the: (i) IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Code); (ii) Basel Core Principles for Effective Banking Supervision (BCP); (iii) Core Principles for Systemically Important Payment Systems (CPSIPS); (iv) International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation (IOSCO Principles); (v) International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP); and (vi) the Financial Action Task Force (FATF) Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism.23 In addition, other standards, principles and guidelines may be used to facilitate

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[21] Directors have previously agreed that the FSAP process provides a proper context within which to assess financial sector standards (see Public Information Notice *IMF Reviews Experience with the Financial Sector Assessment Program (FSAP) and Reaches Conclusions on Issues Going Forward* (http://www.imf.org/external/np/sec/pn/2001/pn0111.htm)). Financial sector standards assessments by the Bank and the Fund are also undertaken on a stand-alone basis as part of technical support in implementation of standards by member countries and as part of the preparatory work for a future FSAP assessment. Experience with the implementation of standards (including financial sector standards and codes) was reported to the Fund Board in *Assessing the Implementation of Standards—A Review of Experience and Next Steps* (SM/01/11). Another review will be presented to the Bank and Fund Boards in conjunction with this review of the FSAP.

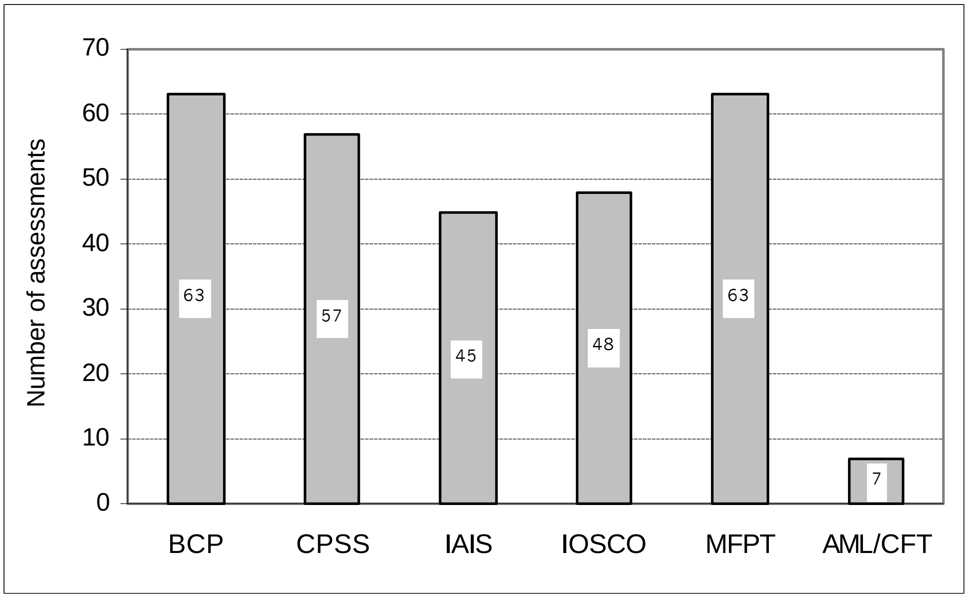
[22] The experience with the assessments of individual standards and codes has been reported to the Bank and Fund Boards in several documents. The review of the experience with the BCP (SM/00/77), the MFP (SM/00/269), the IAIS Insurance Core Principles (SM/01/266), the CPSIPS (SM/02/124 and SecM2002-210), and the IOSCO Principles (SM/02/121 and SecM2002-209) have already been completed, and several consequent changes have been affected in the assessment framework for these standards. An update of the experience with the BCP assessments has been presented to the Bank and Fund Boards in 2002 (SM/02/310 and SecM2002-0554). Supplement 1 of this paper presents an overall view of the experience with the assessments of standards and codes and is based largely on the individual reviews noted above.

[23] Most recently, the Bank and the Fund's Boards formally added AML/CFT to the list of standards and codes for which Reports on Standards and Codes (ROSCs) are useful to the two institutions' work and adopted the FATF 40 Recommendations for anti-money laundering and the 8 Special Recommendations for combating the financing of terrorism (FATF 40+8 Recommendations) as the associated standard (PR/02/52, November 8, 2002 and SecM2002-0554, November 4, 2002.) However, the Bank and the Fund's Boards had already agreed

(continued...)

the analysis in the FSAP. These include: (i) the OECD Corporate Governance Principles; (ii) World Bank Principles for Effective Insolvency and Creditors Rights; (iii) CPSS-IOSCO Recommendations for Securities Settlement System (RSSS);24 and (iv) International Accounting and Auditing Standards.

Figure 1. Number of Countries in which Observance of Standards and Codes was Assessed Under the 65 Completed and Ongoing FSAP Assessments




46. **A 12-month pilot program to conduct Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) assessments and prepare associated ROSCs is now under way**. Participants in the pilot include the Fund, the Bank, the FATF, and the FATF-Style Regional Bodies.[25] Since the start of the pilot, the Bank and the Fund have used the

in 2001 to include AML/CFT assessments in FSAPs as one of several measures to intensify involvement in AML/CFT issues (BUFF/01/176 and Sec2002-0006); however, these earlier assessments were not used to produce ROSCs.

[24] Recommendations for Securities Settlement System are a new standard recognized by the Financial Stability Forum (FSF), which has been assessed in a number of recent FSAP assessments and used in others to facilitate the analysis in this area. The *OECD/International Network of Pension Regulators and Supervisors (INPRS) Principles on Private Pensions* are also being developed and inform staff's analysis in the areas of pension regulation and supervision.

[25] The Asia Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the Eastern and Southern African Anti-Money Laundering Group (ESAAMLG), the Financial Action Task Force on Money Laundering in Latin America (GAFISUD), the Council of Europe's Select Committee of Experts on the Evaluations of Anti-Money Laundering Measures (MONEYVAL), and the Offshore Group of Banking Supervisors (OGBS).

*Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism* (the comprehensive methodology) in six FSAP cases. In addition to including AML/CFT assessments and preparation of ROSCs in all FSAP cases initiated during the pilot, the FATF and FSRBs will also conduct assessments based on the comprehensive methodology, which will be used to prepare ROSCs. Staff will prepare a report to the Boards of the Bank and the Fund on the experience gained in the pilot program.

47. **Work is ongoing in close cooperation with standard setting agencies to improve consistency in standards assessments through the adherence to assessment methodologies and assessment guidance notes.** In addition, steps have been taken to strengthen the post-assessment review process. The Fund has recently established a roster of external reviewers in banking, insurance, payment, and securities to reinforce the internal review process by enlarging the pool of available reviewers, generally drawn from the cooperating institutions. Bank and Fund staff also have actively participated in the recently completed work of the Joint Forum on the comparison of banking, insurance, and securities core principles, and in work with standard setters on reviewing methodologies based on assessment experiences.

48. **In addition, Bank and Fund staff will continue working on a number of issues relating to standards assessments.** These include: (i) the appropriate scope and coverage of assessments; (ii) ways to account for country-specific factors based on their relative significance depending on stages of development, sector specific vulnerabilities, and the regulatory and supervisory preconditions; (iii) identification of cross-sectoral issues and interdependencies between standards; and (iv) circumstances in which assessment of observance of a particular standard might not be warranted.

## VII. Operational Status

### A. Scale and Scope of Assessments

49. **It has become the practice in most cases to spread the FSAP assessment work over two missions.** The first mission typically undertakes the majority of standards assessments, collects preliminary information, including FSIs, for the macro-prudential analysis, and discusses with the authorities the scope for the remainder of the work, including the kinds of stress tests to be undertaken and the scenarios to be used. The second mission completes the work and presents the preliminary findings to the authorities. FSAP findings are further discussed with the authorities in the context of the Article IV Consultations. Subsequently, a set of reports—FSAP Reports for the authorities, the FSSA for the Fund Board, and the FSA for the Bank Board—are finalized.

50. **Reflecting the large number of countries with complex financial systems, the scope of analytical tools, including stress tests and standards and codes, employed in the FSAP has expanded over time.** The research and experimentation in support of improving stress tests have added to the resource demands of the analytical work, particularly in countries with more advanced financial sectors. In addition, the number of standards and

codes assessed has risen from between two to four per assessment for the 12 pilot countries (average of 3.7 per FSAP) to about four to six per assessment more recently (average of 4.9 per FSAP).[26] The rise is attributed largely to the increase of the frequency at which insurance and securities markets are assessed. The five financial standards are now being assessed in about half the cases and four in the remainder (Figure 2). Recently, AML/CFT work has been added in the context of the pilot discussed earlier.

51. **The expansion in FSAP coverage has meant an increase in average mission size and assessment costs and an increased reliance on outside experts and standard setting bodies**. The expanded scope of work has also presented a challenge to the management of the program, including ensuring consistency in the assessments among countries, and has required an intensified effort in implementing the assessment process. Furthermore, in response to the increased quantity of work, both the Selected Issues and the Detailed Assessments sections of the FSAP Report have grown in length, raising the costs of review as well as production.[27]

## B. Resource Costs

52. **Early FSAP pilot cases provided the basis for estimates for the labor cost of the FSAP.** The cost of assessments of larger countries and/or those with more regional systemic importance was estimated, on average, to be almost 2 person years. Assessments of countries with smaller, less developed financial systems were budgeted to have a lower resource requirement. Given the expected mix of countries to be assessed, it was thought that the total staff requirement for assessing 24 countries in FY2001 would be about 45 person years. The Fund's share of this staffing would be slightly greater than half, given the Fund's predominant role in the FSAP for industrial countries and the additional cost of integrating FSAP findings into the Article IV process. The costs of administering and coordinating the program also had to be taken into account. No specific allocation was made at the time for the additional costs of updating assessments in subsequent years.

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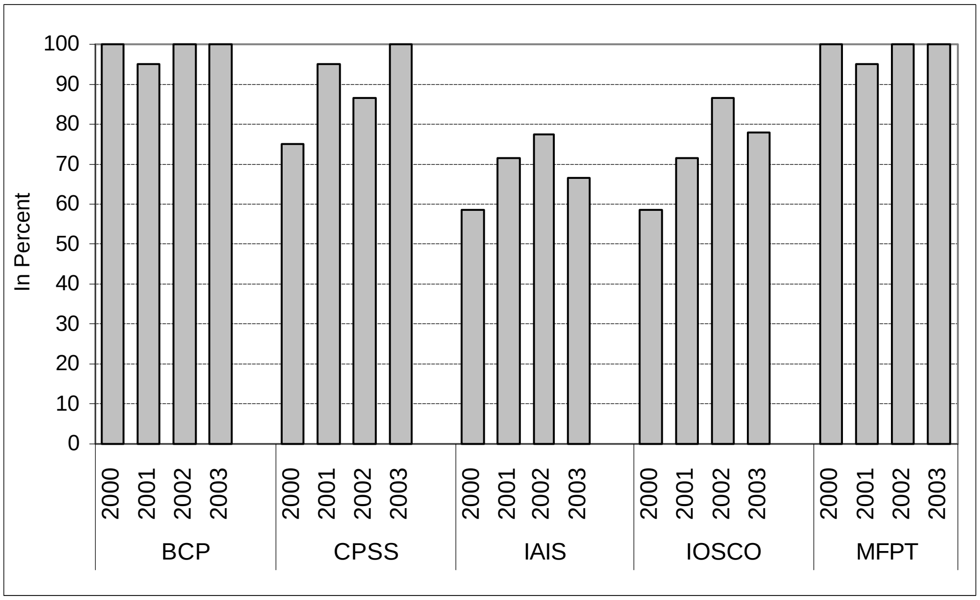
[26] This increase does not include the AML/CFT assessment that has been added recently. It includes other standards covering areas such as accounting and auditing, corporate governance, and insolvency and creditor rights that, when considered relevant, have also been assessed in the FSAP context.

[27] FSAP reports consist of three parts: a "Main Report," which is an overall assessment covering short-term vulnerabilities, medium-term risks, and reform needs; a second part, "Selected Issues notes," comprising the background material covering stress test results and other relevant analysis and information; and a third part, "Detailed Assessments of Observance of Financial Sector Standards and Codes."

Figure 2. Frequency of Assessment of Observance of Standards and Codes in Completed and Ongoing Countries
(Number of individual standards assessments as percent of number of FSAP assessments)




53. **The average FSAP cost has increased over time, despite cost savings achieved through efficiency gains and some streamlining of FSAP documentation and review and clearance procedures.** Actual labor costs were close to estimates for FSAP assessments completed in the early stages of the program.[28] The average cost for the Fund and the Bank together was on the order of 2 person years for the pilot countries. The average cost is estimated to have risen to about 2.8 person years for post-pilot countries as a large number of industrial and systemically important countries and economies with complex financial systems participated in the program, a full range of standards was assessed, and a substantial

[28] Note that the data underlying these cost calculations are not precise and are not strictly comparable between the Bank and the Fund.

number of issues were covered in depth.[29] [30] With the correspondingly high cost of assessments in industrial countries, and the predominant role of the Fund in these countries, both the total costs and the share of the Fund in the total have risen.[31]

54. **Reflecting the variation in the size and complexity of financial systems in participating countries, there has been a wide variation in cost across countries**, ranging from less than 2 person years for some smaller countries to more than 4 person years for some complex cases, for example, Brazil and the United Kingdom.[32] Countries with larger economies or more complex financial systems, or those that have many critical developmental issues have been significantly more resource intensive reflecting the full complement of standards and special issues that were assessed in detail. In a few cases, the FSAP mission work for countries with large and/or complex financial systems has been preceded by a period of fairly intensive discussions, often involving small staff visits, concerning how best to structure and undertake the FSAP work. **For this reason, placing greater priority on systemically important countries has added significantly to the average cost of the program.** Costs are lower for smaller countries, especially for those where the issues that arise are more straightforward.

55. **The expanded scope of the FSAP has added not just to the costs of assessments themselves but also, and importantly, to the costs of review.** For instance, reviewing assessments of standards and codes to ensure quality and consistency across countries has become a substantial task. Experts from cooperating official institutions have been called upon to support staff review activity at headquarters by contributing to the review of detailed assessments of financial sector standards under the FSAP.

56. **Against this background, steps have been taken to help contain overall costs of the program within the available budget envelope, while keeping systemically**

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[29] The cost of the FSAP is split approximately 40/60 between the Bank and Fund. This includes travel costs and management oversight of the program but excludes the cost of AML/CFT work done in FSAP as this is budgeted separately. The Fund's share is more than half because the Fund bears the full cost of assessments for advanced economies and because of higher post-mission costs relating to preparation and review of FSSAs. The cost and split between the Bank and Fund for each FSAP have varied depending on the country and scope of assessment. In the Fund, the FSAP represents on average about 14 percent of MAE's departmental budget; in the Bank the FSAP budget of $5.8 million is about 14 percent of the budget for the entire financial sector network.

[30] Systemically important cases assessed in FY2002–03 included Brazil, Hong Kong SAR, Korea, Japan, Russia, and the United Kingdom.

[31] Experts from cooperating institutions are counted as Fund or Bank staff for these purposes, depending on which institution funds them. See SM/00/54 and SecM2000-130, page 30.

[32] The more resource intensive assessments have generally been for industrial and emerging market countries, with an average cost for those countries of about 3 person years. The resources required for developing countries are lower, with an average of 2.5 person years.

**important countries a priority.** The number of assessments initiated had to be limited to 22 in FY2002 and is being reduced further in the current fiscal year, while the scope of individual assessments at any one time is being rationalized. (See Section VIII A.)

### C. Publication and Confidentiality

57. **At the time of the spring 2000 review of the FSAP pilot, the two Executive Boards agreed that publication of FSSAs, FSAs, and associated ROSCs on a voluntary basis was appropriate.**[33] At the time of the subsequent December 2000/January 2001 review of the program, Executive Directors endorsed the policy that management would provide authorization for the voluntary publication by national authorities of the detailed assessments of observance of standards and codes that are included in FSAP reports.[34] Directors supported the policy that the Main FSAP Report is a confidential document that may not be published. A thorough and comprehensive analysis of a financial system generally requires the provision of highly market sensitive information, especially as regards individual financial institutions.

58. **During earlier discussions of publication policies for FSAP-related documents, Executive Directors had expressed concerns regarding the possible peer pressure arising from a more liberal publication policy and the implications of this for participation in what is a voluntary program, for the provision of market sensitive information to FSAP teams, and for the candor of discussions.** As of end-December 2002, of the 32 post-pilot countries that had completed FSAP participation, 20 chose to have their FSSAs published and five chose to have their FSAs published.[35] In addition, one (Hungary) of the three FSAP pilot countries that already had a comprehensive FSSA update has chosen to publish the update. The observed trend in publication indicates that, as familiarity with the program has increased, the proportion of countries that have opted to publish has also increased. The increasing proportion of countries electing to publish the FSSA or FSA indicates that they are comfortable with the key messages in FSAP reports being conveyed to the general public. Moreover, neither the countries that have chosen to

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[33] In the Fund's case, such publication is subject to the same deletions policy regarding highly market-sensitive information that applies to Article IV staff reports. The same rules on internal circulation and release to outside agencies that apply to Article IV staff reports are also followed. It was agreed that publication of an FSSA could proceed even if the member concerned did not consent to the publication of the relevant Article IV consultation report. In the Bank's case, publication of the FSA is subject to the standard procedures for treatment of confidential and sensitive information. The publication policy of the FSSA and the FSA does not apply to pilot countries, where the FSSAs and FSAs were not allowed to be published.

[34] To date, only the Czech Republic and Sweden have elected this option. However, some of the detailed assessments prepared under the Fund's technical cooperation and OFC assessment programs have been published (e.g., Brazil, Cyprus, France, Gibraltar, and Panama).

[35] Four of the countries did not receive an FSA as they are industrialized countries. Three additional FSAs have been posted on the Bank's web-site since end-December 2002.

publish nor those that have elected not to publish reported any concerns or problems arising from peer pressure to publish.

59. **The Confidentiality Protocol followed by staff as well as experts from cooperating institutions has been working well.**[36] While the key developmental and stability findings are reported in the Main FSAP Report, FSSA and the FSA, it has been possible to confine highly market sensitive information on individual institutions to a separate note (as a component of Selected Issues) which is classified as "STRICTLY CONFIDENTIAL" and which has extremely limited circulation within the Fund and the Bank and by the national authorities.

## VIII. Issues Going Forward

60. **The FSAP has become the preferred tool for strengthening both the monitoring of financial systems under Fund surveillance and the Bank's development work in the financial sector.**[37] Comprehensive FSAP assessments and reassessments, occurring—depending on the pace of the program—at, on average, a frequency of once in 7 to 10 years, provide a periodic baseline assessment, analysis, and benchmarks that help set the priorities and focus for subsequent work in the intervening years between FSAP assessments. Thus baseline FSAP assessments serve as the foundation that supports a comprehensive framework for surveillance and other work that includes a range of other instruments discussed below. In such a framework, the expectation is that all countries will participate in an FSAP assessment over time.

61. **At this stage, less than half of the membership has participated in the FSAP, and demand from countries for participation in the program remains high**. At the same time, a number of countries already assessed are requesting either reassessments or updates. Resources must also be made available to support a wider range of tools in addition to FSAP assessments and reassessments for follow-up work and ongoing financial sector surveillance as well as to improve program coordination. Criteria for deciding which financial systems are

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[36] The Protocol was circulated to the two Boards as an attachment to the Spring 2000 report on the FSAP, *Financial Sector Assessment Program (FSAP)–Lessons from the Pilot Exercise and Next Steps* (SM/00/54 and SecM2000-130).

[37] During the April 2002 *Biennial Review of Surveillance,* Fund Executive Directors welcomed the expanded coverage of financial sector issues in Fund surveillance, noting that FSAP participation generally translated into an in-depth coverage of financial sector issues. They were concerned that, in the absence of an FSAP, the quality of financial sector surveillance has been uneven across countries, since a typical Article IV consultation mission is generally not in a position to undertake an in-depth analysis of financial sector issues. They agreed on the need to bring the coverage of financial sector issues up to par with coverage of other core areas of surveillance. Directors had a broad discussion of possible means to bring in the necessary resources and expertise in cases where a member has not participated in an FSAP or where significant developments have occurred since FSAP participation. These included adding MAE staff to Article IV missions, or carrying out full FSSA updates, as has already been done in a few instances. (See Public Information Notice *IMF Executive Board Reviews the Fund's Surveillance* (http://www.imf.org/external/np/sec/pn/2002/pn0244.htm)).

to be assessed, reassessed, updated, or followed-up in an Article IV or Bank mission in a particular year, together with considerations to better tailor the scope of assessments and updates is discussed below. Such criteria are necessary to satisfy competing demands on Bank and Fund resources—and on the resources of cooperating institutions—within the existing overall resource envelope.

### A. FSAP Assessments, Reassessments, and Updates

62. **As the time since the original assessment lengthens the need to reassess a particular financial sector or at least to update an assessment of a specific element of the previous assessment increases.** National authorities may like recognition for actions that they have taken in response to recommendations made in the initial FSAP assessment, or they may simply want an update of the health of their financial system. Updates, especially of observance with various standards and codes, are likely to be desired to inform markets of improvements.

63. **Reassessments and updates are particularly important for systemically important countries and for those whose financial systems are evolving at a rapid pace**. Follow-up—largely in the form of technical assistance—is also viewed as essential if momentum for financial sector reforms and development is to be maintained. These issues were flagged at the time of the previous FSAP review, but are of increased importance now, as three years have passed since the first countries were assessed.

64. **The following modalities have been identified for delivering FSAP assessments, reassessments, and updates as central components of surveillance and the ongoing financial sector work of the Bank and Fund:** (i) **initial, baseline FSAP assessments** jointly undertaken by the Bank and the Fund as per current procedures; (ii) **reassessments**, also undertaken by Bank and Fund staff, where the passage of time or the pace of the reform process in a country indicate that comprehensive updating of an initial FSAP assessment is desirable; and (iii) **focused updates**, including updating of stability and standards assessments where relevant, to be coordinated jointly by the Bank and the Fund and implemented by the Bank, the Fund, or jointly, with experts from cooperating institutions, depending upon the issues. These assessments and updates would continue to be undertaken in the context of Fund surveillance and Bank operations.[38] In light of the limited number of focused updates undertaken to date, the mechanisms for their conduct will be worked out in the coming months. In addition, staff analysis of current financial sector conditions and selected issues would (as now) be undertaken by regular **Article IV missions** with or without specialist financial sector staff; **ongoing monitoring from headquarters of FSIs** and other financial sector developments; and Fund and Bank **technical assistance and other**

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[38] Some FSAP assessments can be undertaken in the context of a program review, with the FSAP findings discussed in a broader macro and structural policy context, during program review missions, with FSSAs serving to facilitate program review discussion by the Fund's Board.

**missions**.[39] A further discussion of these modalities is contained in paragraphs 65–72, with additional discussion in the context of Fund surveillance in paragraphs 84–87.

**Updating assessments of financial sector standards and codes**

65. **Reassessments of financial sector standards will be undertaken as part of the FSAP reassessments and focused FSAP updates**. These reassessments would be undertaken in areas where there have been major reforms or other developments that warrant an intensive review and issuance of a new ROSC. This would be done using the current country selection procedures for FSAP. This is distinct from updates, following earlier assessments of a standard, where there is no reassessment of the standard by an expert using relevant methodologies but rather simply updating of facts and recent developments. Such factual updates could be undertaken in Article IV missions, or Bank and Fund technical assistance and other missions. In so far as demand for reassessments and updates is likely to be high, various options and alternatives will need to be developed in coordination with the standards setting bodies in order to meet this demand. A separate joint Bank-Fund paper on the standards initiative discusses wider issues on the assessments of standards and codes.[40]

**Greater selectivity in the scope of future assessments**

66. **To date, the scope of FSAP assessments has been generally both comprehensive and detailed, covering key dimensions of financial system stability, development, and market integrity.** Assessments have looked at macro prudential surveillance, financial sector supervision, financial system infrastructure, and financial market integrity, with detailed assessments of relevant standards serving as an integral part of the overall FSAP assessment, along with other analysis and tools.

67. **Based on three years of experience in about 65 countries, the scope and emphasis of future assessments can be rationalized and better targeted to country circumstances based on the considerations suggested below**. These considerations allow for a broad coverage of areas relevant for financial stability and development, while limiting assessments along three dimensions: the number of standards to be assessed in detail, the range of issues to be addressed in depth, and the timing and phasing of assessments. Such a rationalization of the scope of assessments is necessary to ensure balanced coverage of countries and issues to maximize the program’s contribution to stability and development within the resources available.

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[39] Databases of FSIs and other relevant information are being developed to assist in this process, as is a *Compilation Guide* to facilitate systematic compilation of FSIs.

[40] *International Standards, Strengthening Surveillance, Domestic Institutions and International Markets* (forthcoming).

68. **Considerations:**

- **FSAP assessments should continue to be comprehensive in areas covered but the depth of coverage of various issues and standards would be adjusted.** A proper understanding of financial system stability and development needs and priorities requires a look at all key components of financial stability and development. These would include macro prudential surveillance of risks and vulnerabilities, systemic liquidity, supervisory or regulatory capacity, financial system infrastructure and impediments to market development. However, the depth and intensity of the assessment of individual components can be better tailored to country specific circumstances.

- **Bank and Fund staff recognize the utility of the standards and codes that have been devised in recent years, while at the same time realizing the burden their assessment places on authorities.** Detailed—that is, principle-by-principle—assessment of some standards may not be needed for countries where the relevant sector, market, or infrastructure is nascent or a high degree of non-compliance is expected or both. In contrast, in more complex financial systems, a set of inter-related standards may need to be assessed together owing to synergies in the assessment process and inter-linkages. Reflecting these considerations, **the number of standards assessed in detail, excluding AML/CFT, would typically be limited to an average of about three per FSAP assessment** compared to the current four to six (average of 4.9 per FSAP in FY2003). The precise number and type of standards to be assessed in each case would of course be decided based on country circumstances taking into account their relevance for financial system stability and developmental concerns while seeking to minimize the risk of missing key vulnerabilities.

- **For low-income countries with small, less-developed financial systems,** relatively more effort could be devoted to an analysis of factors explaining why markets are missing and what the top developmental needs of the country are. (See Supplement 2.) This would support better targeting and prioritizing of financial sector reforms and institutional-strengthening initiatives. **In some of these countries, implementation, supported by technical assistance, should precede a detailed assessment of a standard.**

- **For countries with complex financial systems, where the number of topics and standards to be assessed in detail as well as the depth of coverage is high, an FSAP covering key topics and standards could be undertaken initially, with the remaining topics and standards to be examined (or updated as is the case) in the context of subsequent reassessments and updates.** This would enable a distribution of work over time, provide support for ongoing surveillance of the financial sector and avoid crowding out other financial sector work. For example, an assessment of an emerging market or an industrial country could cover key risks and vulnerabilities and core structural components, such as systemic liquidity arrangements, while limiting the detailed standard assessments to either inter-related regulatory standards such as the BCP, IAIS, and IOSCO, or other relevant standards and codes. If a standard were not assessed in detail initially but were considered relevant, assessments would be undertaken subsequently in focused FSAP updates.

- **Standards such as corporate governance, accounting, and insolvency that have a much broader application than the financial sector will not normally be covered in detail in the context of an FSAP assessment.** However, where relevant, issues in these areas would continue to be addressed.

- **AML/CFT issues will be assessed in all countries participating in the FSAP**, although the scope and modalities of the assessment will depend to some extent on the specific circumstances of each country. The assessments, where relevant, will be used to design a program for technical assistance and capacity building based on country requests. Guidance on the scope and coverage of AML/CFT assessments and their links to the FSAP and to technical assistance will be developed during the pilot AML/CFT assessment program.

69. **The scope of reassessments will adhere to a similar process of selectivity.** Reassessments are expected in countries where there have been major reforms and other developments that warrant an intensive review or, especially in systemically important countries, where there has been a lengthy period since the last update. Reassessments might be undertaken also in cases where the initial FSAP work was selective in the topics and standards covered in depth, and detailed assessments of other aspects of the financial system are warranted.

70. **The scope of the focused updating exercise also will vary by country.** It would be expected to include an update of the analysis of the country's financial sector vulnerabilities, based on updated FSIs, done to some extent at headquarters, and an updated assessment of observance of one or two standards if it is felt that there have been significant developments that warrant such updates. It might also include a review of a specific issue or set of issues identified in the FSAP or subsequent Bank or Fund work, or at a country's request. The update will be undertaken typically by a small Fund, Bank, or joint mission depending upon the scope of work and linked to the Article IV process as with FSAP assessments and reassessments.

71. **Some degree of updating also will take place in the context of technical assistance or other Bank or Fund missions.** For example, when appropriate the Bank will undertake update work when the findings would be integral to the proper formulation of strategies for development and capacity building. This updating will occur as an element of the preparation of a CAS or as input to other products. This work can be done by a small Bank mission—with Fund staff participation, as needed—to update selected aspects of the FSAP analysis. Similar work might be undertaken in the Fund use of Fund resources missions with MAE and Bank support as necessary.

72. **Finally, the scope of follow-up work and ongoing monitoring of the financial sector undertaken by the Fund area department Article IV missions** might include the collection and analysis of FSIs and monitoring of developments in a few areas including developments in the areas covered by key standards, drawing on baseline FSAP findings where available. Depending upon the scope of work, specialist staff would participate in the missions.

**Resource implications and country prioritization**

73. **The proposals above for a broadening of the range of tools for financial sector assessments and for tailoring and sharpening the scope of assessments have a number of implications for the pace and cost of the program, the distribution of costs between the Bank and the Fund, and country prioritization process.**

74. **In order to help contain the costs of the program in line with the existing resource envelope and in the face of a bunching of a number of systemically important countries and economies, the number of FSAP assessments initiated in FY2003 is expected to be reduced to 18. Based on the pipeline of countries that have volunteered or are expected to volunteer for future participation in the FSAP, it would seem prudent to continue at this pace of 17–19 assessments per year going forward.** This slower pace will free up resources to cover systemically important countries in both FSAP assessments and updates. Carrying out the FSAP at this pace would still allow for the inclusion of countries at various levels of development in order to give a full range of countries access to the program's benefits. However, this pace would imply comprehensive assessments for the entire membership over about a 10-year period, as compared to a periodicity of about 7–8 years initially envisaged. Any further reduction in the pace of FSAP assessments and reassessments would not allow sufficient scope for timely participation by countries.

75. **The extent of resource savings going forward will be influenced by several factors, but will depend primarily on the actual number of assessments in any one year, as well as the mix of countries (among industrial, emerging markets, and developing countries) participating in the program.** With the pace of assessments and reassessments reduced to 17–19 per annum, and with fewer large and complex countries remaining to be assessed, resources will be available for updates and for coverage of a broad range of other countries. In addition, the steps being taken to sharpen the scope of assessments and limit the number of standards assessed, including in the systemically important countries, aim to reduce costs. Reassessments and focused updates will build on the strong base of institutional, structural, and vulnerability information and analysis provided by the original FSAP and hence would cost less.[41] Also, the cost of standards assessments when undertaken

[41] While we have no experience yet with reassessments, the limited experience with focused FSAP updates by the Fund seems to suggest an average cost of 0.4 person years. This average could be even higher because of greater priority to systemically important countries in FSAP updates and larger cost of standards assessments

(continued...)

in smaller number at any one time (or on a stand-alone basis in an update) could be higher than if undertaken at the same time in an FSAP assessment or reassessment.[42]

76. **The proposals for updates and follow-up work, and for greater selectivity of issues for detailed work in FSAP assessments and reassessments depending upon country circumstances, imply a reallocation of the use of resources between the Bank and the Fund, depending upon the mix of countries covered in any one year.** Reflecting the fact that key dimensions of financial stability and financial sector development necessarily overlap and interact, neither institution has an exclusive role in a particular area. Accordingly, since the inception of the FSAP program, the primary topics of responsibility of FSAP team members have been assigned pragmatically to the Bank or the Fund or both, reflecting the availability of expertise in the two institutions.[43] Going forward, the joint Bank-Fund approach will continue, with adjustments to reflect the larger role for the Bank in developing country assessments.

77. **The proposed greater focus on medium-term and structural issues in many developing countries implies a greater role for Bank staff and experts in these countries; the Bank will typically lead the team and the Fund will field fewer team members, who will continue to focus on key stability issues of importance for Fund surveillance.** The greater role for the Bank in developing countries is in a sense analogous to the greater role of the Fund in industrial countries. However, in contrast to the industrial country cases, where the Fund is solely responsible (but where the Bank may provide selected specialists to facilitate the analysis), the FSAP effort in developing countries will remain joint because financial sector assessments in these countries are critical for both the setting of development priorities and the Fund's surveillance function. Countries benefit by combining, in a coherent way, the different perspectives of the two institutions. The division of labor between the Bank and the Fund for any particular FSAP assessment will continue to be coordinated by FSLC.

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when done separately. Allowing for these factors, one less comprehensive FSAP assessment at the average cost might provide resources for four to six focused updates.

[42] The cost of assessing standards in an FSAP is lower because the cost of compiling and analyzing information on financial institutions, infrastructure, risks, and vulnerabilities—necessary for an in-depth assessment—is spread over a number of inter-related standards.

[43] A review of the primary areas of responsibility assigned to FSAP team members shows areas of nearly equal distribution of expertise in debt and money markets, AML/CFT assessment, and stress testing. Not surprisingly, central bank issues, liquidity, monetary operations, foreign exchange markets, and the MFP assessment have been addressed almost exclusively by Fund staff. Meantime, the Bank's staff have been primary providers of expertise in areas relating to the legal framework, securities markets, and nonbank financial institutions including insurance, contractual savings, finance for rural, micro, small- and medium-sized enterprises. Outside experts contribute primarily to the assessments of banking supervision and payment systems, with the numbers of Bank and Fund staff who participate in these activities being nearly equal.

78. **Given the complex factors affecting costs and their distribution between the Bank and the Fund, the country selection for assessments, reassessments, and focused updates will have to be closely managed (taking into account other ongoing monitoring, surveillance, and TA activities) in order to maximize the program's contributions. Country selection procedures for assessments and reassessments that currently apply will be extended to focused FSAP updates** and will be based on the views of Fund area departments and Bank regions in line with the current FSAP country prioritization criteria, modified in the case of reassessments to take into account the time since the last assessment. **A key objective in the coming two years is to make progress with the initial round of comprehensive assessments at a reasonable pace, by enabling a broad range of countries to participate, while continuing to give priority to systemically important countries.** However, as more countries volunteer to take part in the program, a reduced pace and greater selectivity would mean that some countries might have to wait a while before an assessment would be initiated. Against this background, we expect to carry out in FY2004 17–19 assessments and reassessments and about four to six focused FSAP updates.[44]

### B. Streamlining of Documents and Publication Issues

79. **The objectives of the documentation produced within the FSAP—**namely to form the basis for a policy dialogue with the authorities on financial sector stability and development issues, and to provide the agreed-upon common technical platform for subsequent Fund-Bank work**—have remained unchanged from the launch of the program**.[45]

80. **The structure of this documentation also has not changed significantly over the program's first three years, although it has grown in length in light of the expansion in the scope of the work. The resources required to prepare and review this documentation have also increased accordingly.** Some overlap among different FSAP-related reports prepared for different purposes is inevitable. This occurs in the Main FSAP Report; the FSSA, which supports surveillance; and the FSA, which provides information to the Bank's Board and input into the work program of the Bank's regions. Nevertheless, there is scope to reduce this overlap, streamline document production, and eliminate any confusion on the part of readers arising from the different documents. At the same time, the FSAP documentation must always be sufficient to ensure that the wealth of data and other information gathered in the FSAP process are preserved in the institutional memories of both

[44] In the Fund, there would be room to increase the number of Article IV missions with specialist participation in order to further strengthen the monitoring of the financial sector in surveillance, which will draw on FSAP findings, where available. The resource implications of rebalancing the FSAP program and broadening the range of tools for financial sector surveillance will be taken up in greater detail in the context of the budgetary processes of the Fund.

[45] FSAP reassessments would produce the same documentation as initial FSAP assessments while in a focused update a revised FSAP report and FSSA/FSA would be issued. Revised documents would be subject to the publication policy applying to the relevant initial documents.

institutions, in order to facilitate updates and follow-up work. The following changes are intended to address these issues:

- Instead of producing and reviewing a Main FSAP Report, the aide-mémoire prepared in the field as a working document, and discussed with the authorities at the end of the main FSAP mission, will be reviewed expeditiously at headquarters. A revised aide-mémoire, capturing comments from peer reviewers and the authorities, will be returned to the authorities. This change would be responsive to those authorities who have expressed disappointment when FSAP Reports have been delayed in its finalization. Resource savings will come primarily from the streamlined review process.

- The FSSA and FSA will draw on the revised aide-mémoire and will be fully reviewed at headquarters in line with normal procedures. But they will explicitly distinguish between the common elements drawn from the aide-mémoire and the differing emphases of the two documents, with clear cross-referencing. The FSSA will continue to highlight short-term systemic stability considerations, macro prudential analysis of risks and vulnerabilities, and linkages to observance of standards, and will cross reference the FSA (where appropriate) in addressing medium-term structural issues of importance to stability. Likewise, the FSA will focus on capacity building and medium-term structural aspects of the FSAP findings, and will be better designed to strengthen the link where appropriate to providing warranted follow-up efforts; cross references will be made to the FSSA when addressing issues with an important stability dimension.

81. **Taken together, the proposals here will simplify FSAP documentation, reduce unnecessary duplication and clarify both the joint core of the work and the additional analyses needed for the different purposes of the Bank and Fund.** The proposals will help to save resources in producing and reviewing the various documents. Perhaps even more importantly, they will help to sharpen the key messages arising from the program.

**Publication issues**

82. **As noted earlier, the Boards of the Bank and the Fund have agreed that FSSAs and FSAs can be published on a voluntary basis.** The Main FSAP Report is a confidential document that cannot be published. The Boards have also endorsed both managements' policy to provide authorization for the publication by the authorities of the detail assessments of observance of standards and codes that are included in FSAP reports. However, there has been no discussion on whether the Selected Issues (covering detailed stress test results and notes on selected issues and analysis) that are provided to the authorities could be published if the authorities so requested.

83. **It is intended to extend managements' policy to provide authorization for publication by national authorities of the Detailed Assessments of Observance of Financial Sector Standards and Codes, to also cover Selected Issues notes except for**

**confidential sections dealing with highly sensitive information.** Selected Issues notes contain specific aspects of the technical analysis supporting the FSAP assessment and, with the exception of stress test results, are not normally regarded as highly sensitive but could have valuable information of general interest, suggesting that publication would be less problematic and desirable. Several national authorities have indicated interest in sharing some of these documents with a wider audience. However, it is not intended to provide authorization for the publication of the revised aide-mémoire, a working document of the mission team, which will replace the Main Report.

### C. Surveillance

84. **The framework specified earlier in Section VIII A, for FSAP assessments, reassessments and focused FSAP updates provides three main elements in the Fund's framework for monitoring of the financial sector in surveillance.** This framework will be supported by enhanced financial sector surveillance for countries that have not undertaken the FSAP, and more continuous monitoring of countries—through the use of FSIs and information on financial sector developments—to prepare vulnerability analysis as part of the Fund's interdepartmental exercise of vulnerability assessments for emerging market countries. Thus, a broader range of tools of financial sector surveillance will be used to complement and build on baseline FSAP assessments thereby strengthening the program's contribution to stability.

85. **The coverage of financial sector issues in Fund surveillance should be strengthened for countries that have not participated in the FSAP, particularly for systemically important countries, countries with potential vulnerabilities, or those facing significant structural changes.** Such countries may not have participated in the FSAP, either because the program could not accommodate them yet, or because they have not yet volunteered to participate. Strengthened monitoring of financial sector issues typically calls for a targeted assessment of key issues through the analysis of FSIs as well as selected focus on observance of standards and institutional developments. This could be done in the Article IV consultation mission or, with the concurrence of the authorities, through a small dedicated mission prior or parallel to the Article IV consultation, depending on the range of issues to be covered. In either case, the findings would contribute to the staff report and Selected Issues Paper, as appropriate. In the case of a dedicated mission, a separate financial sector report could also be produced. An FSAP exercise would still be the preferred vehicle for conducting financial sector assessments as input to Fund surveillance. Accordingly, in countries that have not volunteered yet for the FSAP and that face systemic financial sector issues, the staff have recommended (in the staff appraisal in the Article IV staff report) that the country participate in the FSAP.[46]

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[46] In the last review of the FSAP, Fund Directors agreed that when relevant, the staff should be prepared to recommend—for instance in discussion with authorities in the staff appraisal in Article IV report—that the country participate in the FSAP.

86. **As a contribution to the Fund-wide exercise of vulnerability assessments for emerging market countries, Fund staff have started producing a quarterly financial sector vulnerability report (QFSVR).** For now, this is being done on an experimental basis. FSAP assessments and updates, where available, and ongoing monitoring of FSIs provide the information for this exercise. The format of the QFSVR is evolving, with efforts under way to streamline the product and improve the underlying template.[47] This information will also serve as inputs into the Fund's Global Financial Stability Report.

87. **Country-specific monitoring of financial sectors and country desk surveillance is facilitated through the participation of Fund area department staff in FSAP missions.** It will also be supported by the ongoing work, jointly with the Statistics Department, on the methodology for compiling FSIs. In addition, such an approach will be reinforced with continued progress in developing the database on FSIs in collaboration with other departments.

### D. Support for Development and Structural Reform

88. **Experience to date with the assessments and feedback received from participating countries suggest that there is scope for tailoring the FSAP more specifically to countries' development priorities and needs in countries where financial sector development issues are predominant.** As emphasized earlier, the FSAP is an important instrument for diagnosing potential vulnerabilities and analyzing development priorities in the financial sectors of member countries. More focus could be given to various aspects including access to finance, long-term savings, pensions, and housing finance—topics that are already diagnosed to a certain extent under the FSAP. In these cases, a trade-off might be needed between the coverage of standards and codes and an expansion of the depth of coverage of development issues. Follow-up TA could be used more effectively to deliver advice on issues that cannot be covered in sufficient depth under the FSAP. Over the next year, the Bank and the Fund will experiment with different ways to assess the financial sector in developing countries with small financial systems. Experience gained from this will be used to better tailor FSAPs to countries' particular development priorities.

89. **In addition, Bank staff and management are considering ways to make the link between the FSAP analysis and other Bank work more systematic, durable and transparent.** Currently, FSAs are prepared by FSAP team leaders. They summarize the FSAP report, highlighting the development aspects, and are distributed to the Bank's Executive Directors for their information. To strengthen the link between the FSAP and CASs, other documents and the preparation of loans, FSAP team leaders will work with regional finance teams to focus on priorities for action. Where warranted, team leaders would

[47] The evolved template will center around three building blocks: (i) selected country-by-country analysis of FSIs and potential financial sector vulnerabilities; (ii) analysis of the systems' sensitivity to potential vulnerabilities and risks; and (iii) an assessment of the regulatory/supervisory and financial stability policy developments.

work with national authorities to develop a more elaborated action plan. Such a process would encourage and facilitate the explicit consideration of the FSAP analysis in the context of the formulation of the broader country strategy.[48] Efforts will be made to schedule the FSAP assessments to correspond more closely to the CAS schedule. More focus on priorities for action would also be useful in the context of the Financial Sector Reform and Strengthening (FIRST) Initiative (see below). Finally, Bank management and staff are considering how best to engage Executive Directors in a discussion about the findings from FSAP assessments.

### E. The Role of the FSAP in Fostering Technical Assistance

90. **The FSAP is designed to highlight the need for strengthening various aspects of countries' financial systems, both to enhance financial system stability and to establish conditions more conducive to development.** These reform needs could be supported by TA, if requested, either through joint Bank-Fund missions or separately by the Bank or the Fund, in line with the mandates and established priorities for TA.[49] Indeed, a large number of countries have already requested TA to develop the FSAP recommendations further and to build the needed institutional capacity to implement recommended reforms. Technical assistance already has been provided, spanning a wide range of issues including, monetary policy implementation; banking sector, insurance, and capital markets supervision and regulation; unified supervision; AML/CFT legislation and implementation; payment system reform; legal reform; sequencing of capital account liberalization; public debt management; inflation targeting; and bank restructuring. Nevertheless, TA priorities following from FSAP findings should be incorporated more systematically into the Bank's and Fund's overall TA programs.

91. **Usually, standards assessments recommend actions that should be assigned priority from the perspective of addressing short-term vulnerabilities or reforms required to strengthen the overall supervisory framework.** These have provided a good basis for independent follow-up by the supervisory authority or by requesting follow-up technical assistance from the Bank and the Fund. In several cases, the countries have reported that the recommendations helped them to formulate their own policy priorities. Assessed countries have also raised the issue of closer TA follow-up after the assessments.

92. **Standards assessments have generated a number of TA requests from participating countries.** For example, in insurance, follow-up technical assistance has been provided in the areas of insurance legislation, regulation, and organization of the insurance supervisory body. Technical assistance in the area of securities markets regulation has been

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[48] In some instances, urgent requests for TA following FSAP assessments have been addressed, even prior to the preparation of the FSA. Indeed, TA is often provided, *de facto*, as an element of the assessment process itself.

[49] For the Fund, see *Review of Technical Assistance Policy and Experience* (SM/02/180).

somewhat limited; however, growing interest in this area as an outcome of FSAP assessments may act to broaden the involvement of the Bank and the Fund. In the area of payment systems, technical assistance has covered topics involving features in real-time gross settlement systems (for example, queuing of payments, payment message types, and central bank intraday lending to participants), as well as broader issues like payment system reforms, involving either large value payment systems or retail payment systems or both. As regards banking supervision, the demand for technical assistance for assessed countries, to help them address any deficiencies appearing from the assessments, is high and is likely to increase.

93. **The IMFC, G-7, G-20, Financial Stability Forum, and the Executive Boards of the Bank and the Fund have called for the establishment of a mechanism to support systematic follow-up of TA from FSAP/ROSC efforts and to increase financial resources available for this purpose, in a manner that complements Bank and Fund TA.** As one response to these calls, a new multi-donor partnership—the Financial Sector Reform and Strengthening (FIRST) Initiative—has been established.[50] FIRST is an international initiative jointly undertaken by the Bank, the Fund, and national development agencies: the U.K. Department for International Development, the Canadian International Development Agency, the State Secretariat for Economic Affairs of Switzerland, and the Ministry of Foreign Affairs in the Netherlands. The Bank and the Fund are members of the Governing Council of FIRST, which is currently chaired by Jeffrey Goldstein, Managing Director, World Bank. The main role of the Governing Council will be to decide on the criteria, allocation and prioritization of the TA to be financed by the trust fund and supervise the Management and Coordination Units that will implement the decisions of the Governing Council.[51] At the same time, the Bank and the Fund will also participate by submitting to FIRST requests from countries for TA arising from the FSAP (as well as ROSCs) which supplement Bank and Fund TA. Coordination within FIRST would serve to avoid duplication and conflicting advice where the Bank, Fund, and other providers are giving assistance in the same financial sector areas. As reported to the Boards,[52] the FSLC will also focus on

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[50] The partners in FIRST have pledged to provide some US$10–12 million a year over the next four years, held in a trust fund, to support TA and capacity building based on the FSAP and ROSC exercises. The Bank has contributed $500,000 from its Development Grant Facility to FIRST to be used to fund pilot programs and the Coordination Unit. The Bank will also allocate resources from its budget for its participation in the Governing Council and Steering Committee. The Fund made an in-kind contribution limited to one-person-year, reflecting participation in the coordination unit and resources spent for taking part in Governing Council deliberations. These resources already are part of the costs devoted to coordination efforts in TA within MAE's budget allocation.

[51] Specifically, these units will operate the mechanism to (i) follow-up on TA recommendations from FSAP/ROSC; (ii) disseminate this information to other interested providers; (iii) formulate and facilitate implementation of TA projects funded by FIRST; (iv) monitor and evaluate effectiveness; and (v) establish a shared database containing country experiences and a roster of available TA experts and providers from the public and private sectors.

[52] *Progress Report on Bank-Fund Financial Sector Liaison Committee (FSLC)* (SM/02/308 and SecM2002-0507).

improving coordination of financial sector technical assistance between the Bank and the Fund, as well as with other donors.

94. **The Bank and the Fund are also working with the regional multilateral development banks to coordinate the provision of technical assistance.** These institutions should be informed about the analysis and recommendations and TA arising from the FSAP so as to avoid significant duplication of effort.

## INSTITUTIONS COOPERATING IN THE FSAP

| Central Banks and Supervisory Agencies | |
|---|---|
| Central Bank of Argentina<br>Reserve Bank of Australia<br>Australian Prudential Regulatory Authority<br>Austrian National Bank<br>National Bank of Belgium<br>Banking and Finance Commission, Belgium<br>Central Bank of Brazil<br>Bank of Canada<br>Office of the Superintendent of Financial Institutions, Canada<br>Banking Commission of the Central African States<br>Bank of Central African States (BEAC)<br>Central Bank of Chile<br>Superintendence of Banks and Financial Institutions, Chile<br>Banco de la República, Colombia<br>Czech National Bank<br>National Bank of Denmark<br>Financial Supervisory Authority, Denmark<br>Deutsche Bundesbank<br>European Central Bank<br>Bank of Finland<br>Financial Supervision Authority, Finland<br>Bank of France<br>Ministry of Foreign Affairs, France<br>Hong Kong Monetary Authority<br>Financial Supervisory Authority, Hungary<br>National Bank of Hungary<br>Reserve Bank of India<br>Central Bank of Ireland<br>Department of Trade, Enterprise and Employment, Ireland<br>Bank of Israel<br>Bank of Italy<br>Bank of Japan<br>Financial Services Agency, Japan | Bank Negara Malaysia<br>Bank of Mexico<br>CNBV (Banking and Securities Commission) Mexico<br>CDVM (Securities Commission), Morocco<br>Netherlands Bank<br>Reserve Bank of New Zealand<br>New Zealand Securities Commission<br>Central Bank of Norway<br>Banking, Insurance and Securities Commission, Norway<br>Central Reserve Bank of Peru<br>National Bank of Poland<br>Bank of Portugal<br>Saudi Arabian Monetary Agency<br>Monetary Authority of Singapore<br>Reserve Bank of South Africa<br>Financial Services Board, South Africa<br>Bank of Spain<br>Comisión Nacional del Mercado de Valores, Spain<br>Central Bank of Sri Lanka<br>Bank of Sweden<br>Financial Supervisory Authority, Sweden<br>Swiss National Bank<br>Bank of Thailand<br>Central Bank of Tunisia<br>Central Bank of the Republic of Turkey<br>Bank of England<br>U.K. Financial Services Authority<br>U.S. Federal Reserve System<br>U.S. Federal Deposit Insurance Corporation<br>U.S. Office of the Comptroller of the Currency<br>Banking Commission of West African States<br>Central Bank of West African States (BCEAO) |
| **Other Institutions** | |
| African Development Bank<br>Bank for International Settlements | FATF-Style Regional Bodies<br>Inter-American Development Bank |
| **International Standards Setting Bodies**[1/] | |
| Basel Committee on Banking Supervision (BCBS)<br>Committee on Payment and Settlement Systems (CPSS)<br>Financial Action Task Force (FATF) | International Association of Insurance Supervisors (IAIS)<br>International Accounting Standards Committee (IAS)<br>International Organization of Securities Commissions (IOSCO) |

1/ These institutions support the FSAP by, inter alia, helping as needed to identify experts, and by sharing information on assessment methodologies.

### Summary of the 2002 Joint World Bank/IMF FSAP Outreach

95. In early 2002, a joint World Bank-Fund outreach meeting was held in Washington to gain feedback on the scope, quality, and procedural aspects of the FSAP from those countries that had their FSAP missions completed in FY2001.[53] The outreach meeting was the second such meeting since the launch of the FSAP in 1999. Overall, national authorities from the countries that participated in the outreach have indicated a strong support for the program. The participants emphasized the benefits of undergoing a comprehensive review with an objective and expert counterparty. Developing and emerging countries also emphasized the FSAP's contribution in identifying vulnerabilities and prioritizing reforms and also in sharpening the focus domestically on the need for reforms. Following is a summary of key points made during this meeting.

## FSAP Process

96. ***Number of FSAP missions.*** Most participants agreed that the main FSAP mission should be preceded by a relatively short mission(s) that could discuss the overall scope and content of the work. Also, most countries noted that they preferred that the preparation of draft assessments of standards and codes be completed prior to the main mission, since this gave adequate time to both the authorities and the mission to reflect on those assessments. It was also noted that if auditing and accounting standards were to be assessed, they should be assessed prior to the assessments of other standards.

97. ***Size of FSAP teams.*** Some participants noted that the very large size of FSAP teams has often posed logistical problems (e.g., putting together meeting schedules or finding special rooms for large meetings) and thought that multiple smaller missions would be easier to handle. Others felt that the logistics were not problematic so long as there was sufficient time to prepare. Larger missions also enabled more topics to be covered in a short time.

98. ***Composition of FSAP teams.*** Most participants viewed FSAP teams as well-prepared and professional. A number of participants found it helpful that some of the experts from cooperating institutions were from similar countries as it meant that they were familiar with the issues. However, in the area of standards assessments, some participants argued that the differences in the assessors' backgrounds (due, for example, to differences in the regulatory frameworks) may have had some implications for the FSAP conclusions and recommendations. Also, the different legal traditions more generally gave rise to time consuming discussions over what were relatively mundane issues, so that careful selection of experts covering critical areas was necessary to ensure that they have the appropriate background and an understanding of the legal and regulatory tradition in the FSAP country.

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[53] Participating countries were Croatia, the Czech Republic, Dominican Republic, Finland, Gabon, Georgia, Iceland, Latvia, Mexico, Senegal, Slovenia, Tunisia, and Uganda; the Banking Commission for Central Africa also participated.

99. ***Review and commenting.*** Most participants felt that the review and commenting phase worked fairly well, with comments in most cases being reflected in the final reports.

100. ***FSAP timing.*** Ideally, FSAP missions should be as close as possible to Article IV missions, in order to ensure an efficient completion of the process. When the FSAP mission work was undertaken earlier than normal relative to the Article IV mission, the FSSA has often required a significant updating prior to issuance. This was the case particularly for countries undergoing reforms where significant changes often took place over relatively short periods.

101. ***Confidentiality.*** Legal restriction regarding data confidentiality did not allow several participating countries to release information on individual institutions to FSAP missions. Solutions were generally found, however, for example by missions obtaining information directly from banks, or by receiving data from the authorities in format that conceal the identity of individual banks (such as a frequency distribution of data). Countries were content with the confidentiality protocol and its application.

**Analytical Tools of the FSSA**

102. ***Financial soundness indicators (FSIs).*** In general, participants noted that FSAP reports could provide a broader analysis of FSIs. Some participants felt that more work should be made on identifying leading (core) indicators, including sectoral indicators (for household, corporate, and real estate sectors) that could provide early warning on future banking problems. Indicators on contagion (such as interbank exposures) and concentration (to capture systemic risk) would also be useful.

103. ***Stress testing.*** Participants viewed the stress testing exercise in the FSAP as a valuable tool. Many participants noted that the limitations of stress tests have not been always adequately recognized so that the results of some stress tests may have been overemphasized. The majority of participants noted that more efforts should be made to conduct early discussions with the authorities on the stress testing methodology, data requirements, and scenarios. Such discussions could assist both the mission and the authorities in better identifying the data needed for the exercise and the scenarios to be used. Also, it would enhance the authorities' ownership of the exercise, and could also help in transferring the knowledge to the authorities to enable them to replicate the exercise on periodic basis.

104. ***Assessments of standards and codes.*** There was a broad agreement that standards assessments play a critical role in the FSAP. Self-assessments were viewed as very useful, both in terms of assisting countries in evaluating their supervisory and regulatory frameworks more objectively using assessment methodologies and in enhancing countries' ownership of the FSAP process. Despite recent progress in producing new methodologies, a number of countries noted that the use of assessment methodologies in the FSAP was not sufficiently transparent as these methodologies allowed for a large degree of subjective judgments by assessors. In relation to this, some participants questioned the benchmarks used in the

assessments. Namely, whether the used benchmarks were best international practices or best "western" practices. Some participants noted that the assessments did not take the countries' development stage into consideration. Moreover, countries emphasized the need to assess implementation rather than focus merely on regulation.

**FSAP Updating, Follow-Up Assessments and Related Technical Assistance**

105. ***Implementation of FSAP recommendations.*** Most of the participants acknowledged the value of the FSAP in terms of helping the authorities to focus on the need for reform. Some countries have established a special committee to allow for a proper follow-up on FSAP recommendations and to ensure national ownership in their implementation. A number of participants from developing countries were, however, concerned that there should not be a linkage between FSAP recommendations and conditionality of the Fund programs, except perhaps where the findings relate to immediate and significant financial system vulnerability. It was felt that any such linkage could reduce national authorities' ownership of the findings and could, at the extreme, deter some countries from participating.

106. ***FSAP updating.*** There was general support for FSAP follow-up in the context of the Fund's bilateral surveillance and more detailed follow-up in the context of technical assistance.

107. ***Technical assistance.*** Many participants from developing and transition countries stressed the need for follow-up technical assistance by the Fund, the Bank, and other donors, to help the authorities develop national institutional capacities. This technical assistance could be in the form of small short-term missions or the provision of longer term resident experts. It was also noted that the FSAP had generally provided a good basis for defining future technical assistance needs.

**FINANCIAL SOUNDNESS INDICATORS**

| Core Set | |
|---|---|
| Deposit-taking institutions | |
| *Capital adequacy* | Regulatory capital to risk-weighted assets |
| | Regulatory Tier I capital to risk-weighted assets |
| *Asset quality* | Nonperforming loans to total gross loans |
| | Nonperforming loans net of provisions to capital |
| | Sectoral distribution of loans to total loans |
| | Large exposures to capital |
| *Earnings and profitability* | Return on assets |
| | Return on equity |
| | Interest margin to gross income |
| | Noninterest expenses to gross income |
| *Liquidity* | Liquid assets to total assets (liquid asset ratio) |
| | Liquid assets to short-term liabilities |
| *Sensitivity to market risk* | Duration of assets |
| | Duration of liabilities |
| | Net open position in foreign exchange to capital |

| Encouraged Set | |
|---|---|
| Deposit-taking institutions | Capital to assets |
| | Geographical distribution of loans to total loans |
| | Gross asset position in financial derivatives to capital |
| | Gross liability position in financial derivatives to capital |
| | Trading income to total income |
| | Personnel expenses to noninterest expenses |
| | Spread between reference lending and deposit rates |
| | Spread between highest and lowest interbank rate |
| | Customer deposits to total (non-interbank) loans |
| | Foreign currency-denominated loans to total loans |
| | Foreign currency-denominated liabilities to total liabilities |
| | Net open position in equities to capital |
| Market liquidity | Average bid-ask spread in the securities market 1/ |
| | Average daily turnover ratio in the securities market 1/ |
| Nonbank financial institutions | Assets to total financial system assets |
| | Assets to GDP |
| Corporate sector | Total debt to equity |
| | Return on equity |
| | Earnings to interest and principal expenses |
| | Corporate net foreign exchange exposure to equity |
| | Number of applications for protection from creditors |
| Households | Household debt to GDP |
| | Household debt service and principal payments to income |
| Real estate markets | Real estate prices |
| | Residential real estate loans to total loans |
| | Commercial real estate loans to total loans |

1/ Or in other markets that are most relevant to bank liquidity, such as foreign exchange markets.

## EXAMPLES OF STANDARDS ASSESSMENT FINDINGS

108. In addition to highlighting the importance of meeting the preconditions for effective banking supervision, the assessments of the ***Basel Core Principles for Effective Banking Supervision*** have shown that a number of improvements in observance of the BCPs are particularly needed. These include the BCPs on credit policies and connected lending, as poor lending practices remain by far the most serious threat to banking stability. Furthermore, loan evaluation and loan provisioning practices tend to be weaker in practice than they are on paper. Country risk, market risk, foreign exchange risk, and interest rate risk tend to be underestimated in many developing countries, even if at the current time these risks may not be a main threat. In addition, especially when the supervisory authority does not have full independence, the actual implementation of remedial measures against banks is also still an area that requires attention, even if the regulations theoretically provide sufficient options. A key area, with a view to increasing the effectiveness of prudential standards and the need to supervise effectively large and complex financial institutions, is the area of consolidation of accounts and supervision on a consolidated basis. Also, in light of the heightened attention given to AML/CFT issues, many countries will need to speed the introduction of the necessary regulations.

109. The assessments of the ***CPSIPS*** suggest that systemically important payment systems in advanced economies and, to a large extent also in transition economies, observe most of the core principles. In developing countries, a significant majority of the systems suffer shortcomings of various importance in their design and operation that may expose them to risks in the event of a problem. In many cases, participants are unable to manage credit, liquidity and other risks leaving the system unprotected against the inability of one participant to settle its obligations. While this is a concern, it should also be noted that the volume of funds in these payment systems is not as significant as in systems in more advanced economies, and that several countries are improving their SIPS. Other problem areas include: a legal framework that does not support the payment system rules and regulations and an insecure operating system and environment.

110. In the insurance supervision area, the assessments of the ***IAIS Insurance Core Principles*** have brought out shortcomings in meeting the preconditions necessary for effective insurance supervision such as divergent accounting and actuarial practices and the absence of internationally acceptable standards relating to capital. Assessments revealed common weaknesses in a number of areas, including: (i) weak organization of the insurance supervisor, characterized by weak institutional and inadequate supervisory skills; (ii) no clear criteria for denying changes in control; (iii) inadequate corporate governance and internal controls; (iv) weak prudential rules on investment and exposure limits for assets; (v) the inadequacy of the supervisors' power to review or set standards for the use of reinsurance by direct-writing companies; (vi) inadequate market conduct and a complaint-handling system; and (vii) weak rules for the use of derivatives and the disclosures made by insurance companies in respect of their use of these instruments. The supervisory deficiencies identified do not appear to pose serious risks to the insurance systems in the countries assessed. However, a potential systemic impact on the insurance sector can arise, with the

most common source being exposure to equity risks or guarantees exposures to the banking sector (including credit and mortgage guarantee insurance). In addition, the growth of liberalized and competitive insurance markets is posing new and more complex challenges for the supervisory authorities.

111. The assessments of the ***IOSCO Principles*** have revealed a number of common weaknesses in the regulatory and supervisory systems for securities markets. These include: (i) institutional weaknesses particularly as a result of limited resources available to the supervisory authorities; (ii) a spread of regulatory responsibilities across several agencies or the lack of clarity of roles; (iii) the lack of independence of the regulator including from a budgetary point of view; (iv) weaknesses in the ability of regulators to enforce compliance with the law and administer appropriate penalties; (v) weaknesses in the ability of the regulator to share information with other domestic regulatory bodies; (vi) the lack of adequate powers—and the administrative capability—to prevent the issue of a prospectus into the market if minimum content requirements were not met; (vii) shortcomings in continuous disclosure regimes with respect to the content and timeliness of reporting obligations; (viii) weaknesses in provisions relevant to the protection of minority shareholders' interests; (ix) weaknesses in the role of auditors in ensuring appropriate financial reporting and corporate disclosure; (x) shortcomings in aspects of the regulation of intermediaries, such as risk management and internal organization of firms, capital adequacy and other prudential controls, and procedures in the event of the failure of an intermediary; (xi) weaknesses in the detection and prosecution of manipulation and other unfair trading practices; and (xii) weaknesses in the oversight of clearing and settlement systems in some assessments. The absence of an investor protection (guarantee) fund, to mitigate losses and ensure the orderly winding up of an intermediary in the event of a failure, was a concern to assessors in some jurisdictions.

112. In addressing weaknesses identified in the ***MFP Transparency Code*** assessments, staff recommendations to enhance openness have focused on both the content and forms of disclosure. In monetary policy, recommendations have included the need for improved disclosure and explanation of the monetary policy analysis, framework and procedures; and more public consultations on proposed technical changes to monetary regulations. Financial policy issues have focused on the public disclosure of relationships between financial agencies, information sharing, and improving the frequency of data reporting by financial agencies. Common to both monetary and financial policies was the emphasis on achieving greater accountability and integrity of monetary and financial institutions.