

## I. INTRODUCTION

1. This evaluation assesses the effectiveness of the Financial Sector Assessment Program (FSAP) from the perspective of the IMF. A parallel evaluation by the World Bank's Operations Evaluation Department (OED) assesses the World Bank's role.<sup>1</sup>

2. The FSAP was established in response to the financial crises of the late 1990s, which led to a call for the IMF and World Bank to jointly find an effective way to provide policy advice to strengthen the financial systems of member countries, facilitating early detection of financial sector vulnerabilities and identification of financial sector development needs. It was introduced to fill an identified gap in the international financial architecture in support of crisis prevention, based on a judgment that existing surveillance approaches at the IMF under Article IV consultations were not sufficient for effective financial sector surveillance. In this context, although a voluntary program, it has become a principal platform for financial sector diagnosis at the IMF. 111 country assessments (including Updates) were completed or underway as of the end of FY2005 (see Appendix Table I).

3. The design of the initiative has evolved over time, first as lessons from an initial pilot stage were absorbed and then as various reviews were completed. The most important of the latter was the 2003 review, which led to a number of modifications. However, the core features have remained unchanged:

- Voluntary participation
- A joint IMF-World Bank exercise (except in industrial countries)
- Differential outputs for different purposes<sup>2</sup>

4. The FSAP was conceived as a diagnostic and policy advice tool. In this connection, it was designed to work at two levels: (i) confidential advice to country authorities and (ii) peer review. The peer review element works through the regular Article IV process, with the FSSA report as part of the Article IV documentation distributed to the IMF Board. However, the precise legal position of the FSAP within this framework is a nuanced one. Strictly speaking, the FSAP is a form of technical assistance from the Fund and is not by itself an exercise of surveillance under Article IV. Rather, the FSAP "feeds into" surveillance through

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<sup>1</sup> The terms of reference for the evaluation are available on the IEO's website ([www.imf.org/ieo](http://www.imf.org/ieo)). The OED's Approach Paper is available at [www.worldbank.org/oed](http://www.worldbank.org/oed).

<sup>2</sup> Including (i) a confidential report to the authorities by the FSAP team (initially called the FSAP report and subsequently an aide memoire) followed by a volume of detailed assessment of standards and codes and typically one or more additional volumes on selected issues; and (ii) separate summary reports to the Boards of the IMF (the Financial System Stability Assessment, or FSSA) and the World Bank (Financial Sector Assessment, or FSA).

the FSSAs (i.e., provides material which deepens the understanding of the member's circumstances for the purpose of surveillance).<sup>3</sup>

### **Scope and methodology of the evaluation**

5. Evaluation of the FSAP, like other aspects of surveillance, faces significant methodological challenges because the final objectives are hard to define and measure and because attribution of particular outcomes to IMF activities is difficult.<sup>4</sup> There are generally-recognized difficulties in defining “financial stability” and the concept was not defined precisely in the various policy papers on the FSAP.<sup>5</sup> Some define it in the negative—i.e., by the absence of financial crises that have a significant impact on GDP. But there are potential tradeoffs between measures to increase resilience to crises and economic and financial efficiency. For example, requiring all banks to hold 100 percent of their assets in low-risk securities would minimize the risk of crises but would not foster growth. In this context, the final objective of the FSAP initiative can be summarized as to help countries reduce their financial sector vulnerabilities and thereby enhance crisis prevention, while helping to foster financial sector efficiency and development. The ultimate objective of reducing financial sector vulnerability has been linked to several intermediate goals that include: the systematic assessment and monitoring of financial systems to identify vulnerabilities and risks; the development of strategies for strengthening the financial sector; and the identification of development and technical assistance needs.

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<sup>3</sup> For a discussion of the legal basis for surveillance under Article IV, see Appendix I of the *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Modalities of Surveillance* (SM/04/212, Supplement 1, July 2, 2004). Activities of the Fund that fall outside of Article IV may still inform an Article IV consultation. A FSSA under the FSAP is a technical service provided by the Fund to a member at its request under Article V, Section 2(b). However, the information obtained through the FSAP can be used for the purposes of informing discussions under an Article IV consultation. Many of the issues that are discussed in a FSSA do fall within the scope of surveillance under Article IV; in the absence of a FSSA, the issues that are normally discussed in such an assessment could be discussed by the Fund as part of surveillance. In identifying such issues, the Executive Board needs to be satisfied that they are relevant for this purpose. Under the Fund's present approach, the selection of topics to be covered by surveillance is based on their macroeconomic relevance.

<sup>4</sup> This is frequently referred to as the results chain or logical framework. See also Duignan and Bjorksten (2005) for a discussion of approaches to the design of a strategy for evaluating different aspects of surveillance where final objectives can be difficult to measure and attribution to specific IMF activities is even harder.

<sup>5</sup> Houben et al (2004) discuss various definitions of financial stability.

6. Moreover, while it is generally not possible to establish attribution between the FSAP and final outcomes, many important questions can be addressed by examining available evidence on the various links in the chain of influences that go from FSAP inputs through immediate outputs to intermediate and final outcomes (see Annex I). Specifically, the evaluation seeks to address the following sets of issues:

- i) *Inputs*: Has the allocation of resources under the FSAP followed priorities that are relevant for achieving its objectives and have FSAP processes worked effectively?
- ii) *Outputs*: Have the assessments of financial vulnerabilities been of good quality (i.e., effective in terms of identifying the principal sources of risks) and have findings and recommendations been clearly articulated and prioritized?
- iii) *Integration with surveillance*: Has the overall surveillance function of the IMF with regard to the financial sector improved as a result of the integration of the FSAP/FSSA into Article IV surveillance? Have the arrangements for follow-ups and reassessments resulted in effective support to ongoing financial sector surveillance?
- iv) *Outcomes*: Has the FSAP process as well as supporting IMF instruments contributed to policy and institutional changes that significantly reduced financial sector vulnerabilities?<sup>6</sup> Have follow-up activities by the IMF provided effective encouragement to this process?

7. As noted in the original terms of reference, **a number of issues are not addressed in this evaluation**, in order to keep the scope of the project manageable or because evidence to perform an assessment is not yet available:

- We do not evaluate the technical merits of particular codes and standards, but will examine how the IMF experience in assessing these standards has informed its feedback to the standard setting bodies. Nor do we attempt to assess whether the entire international architecture of standards and codes is better than other possible approaches, since such questions go well beyond the role of the IMF.<sup>7</sup>
- Specifics of the assessments of the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) standard and of Offshore Financial Centers—except to the extent that these activities affect the broader FSAP.
- Other crisis prevention activities of the IMF (e.g., the efficacy of multilateral surveillance activities; early warning system models, etc.).

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<sup>6</sup> Although a precise delineation between the stability and development aspects of the initiative is generally not feasible, the impact on aspects that are primarily in the realm of financial sector development are addressed in the parallel OED evaluation.

<sup>7</sup> For an alternative point of view on this broader issue, see Schneider et al (2003).

- Most aspects of IMF surveillance of the financial sector beyond the FSAP, except to investigate how such activities have been integrated with or complemented the FSAP.

8. **The evaluation used a variety of evidence** to address these questions with two goals in mind: (i) to check the robustness of emerging message by triangulating between different types of evidence; and (ii) since the design of the FSAP has changed over time, to check whether key messages remain valid for the most recent FSAP vintages:

*Cross-country analysis of the full sample of FSAP countries* (e.g., to examine how FSAP priorities were set in practice). The cut-off date for the sample was the end of FY2005.

*In-depth investigations of a sub-sample of 25 FSAP cases* (Appendix Table 2). This include desk reviews, interviews with country authorities, including a number of country visits, as well as interviews with IMF and World Bank staff. The sample was chosen to reflect different FSAP “vintages” (i.e., the pilot stage and before and after the 2003 FSAP review) as well as different levels of complexity of the financial system and geographic diversity. In conducting the country reviews, particular attention has been paid to organizing qualitative information in a systematic manner. A detailed template covering a wide range of questions concerning all stages of the FSAP process was completed for each country. For a number of questions, IEO assessors used a (four point) rating scale to summarize judgments on how effectively particular FSAP exercises had implemented a particular component. Such ratings inevitably involve an element of subjective judgment but we have sought to minimize this by preparing guidelines on what we would expect to see to justify different ratings. An example of the detailed template is provided in Annex III.

*Desk reviews for all post-pilot FSAP Updates and all post-2003 full FSAPs.* All of the Updates completed as of end-June 2005 were subject to a desk review using a streamlined template based on that used for the 25-country sample, with the focus on the adequacy of the review of vulnerabilities and the stock-taking of policy and institutional changes since the initial FSAP assessment as well as on linkages to Article IV surveillance. Similarly, all post-2003 full FSAPs were reviewed using a similar template to check the conclusions reached from the in-depth 25-country sample.

*Surveys of country authorities, FSAP teams, and IMF and World Bank staff.*<sup>8</sup> The surveys were conducted anonymously, with the aid of professional survey consultants and the overall response rate (averaging 53 percent) was high for this kind of (full sample) survey. Many of the questions were designed to test the broader applicability of the results emerging from the

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<sup>8</sup> The evaluation also draws on the results of surveys of member countries, market participants, and Fund and Bank staff on the effectiveness of the broader standards and codes initiative undertaken as part of an internal review. See *The Standards And Codes Initiative—Is It Effective? And How Can It Be Improved?* (SM/05/252, July 1, 2005).

in-depth review of 25 country cases. Details of the surveys and a summary of the results are presented in Annex II.

*Structured interviews with a range of market participants, including rating agencies, investment banks, and asset fund managers.*

*Brief desk reviews of the contents of financial sector surveillance in a group of systemically important countries that have not undertaken an FSAP*

9. The remainder of the report is organized as follows. Section II discusses the effectiveness of priority-setting across and within countries. Section III discusses the quality of FSAP processes and diagnostic tools, and Section IV the FSAP content. Section V discusses how well the IMF has used the FSAP output in its surveillance, technical assistance, and program activities. Section VI discusses evidence on the impact of the FSAP on countries' policies and on markets. Section VII concludes with some overall lessons and seven recommendations.

## **II. EFFECTIVENESS OF PRIORITY-SETTING UNDER THE FSAP**

10. Choices on priorities under the FSAP—which countries to assess and what issues to examine within each country—are critical to the program's overall effectiveness. Three aspects of the FSAP make priority setting especially challenging. First, the voluntary nature of the exercise means that some countries that would otherwise be ranked as high priority may choose not to participate. This raises the important question of what incentives should be used to encourage participation. Second, the FSAP exercise is resource-intensive. As a result, resource constraints have required some scaling back of the number of assessments—from an initial goal of completing 24 cases a year to a rate of 17–19 a year following the 2003 review. The latter rate would imply that a comprehensive assessment of the entire membership would take a little over a decade. The 2003 review also called for more selectivity by reducing the depth of analysis of certain issues and the number of standards to be assessed in detail for each country, while remaining comprehensive in coverage.<sup>9</sup> Third, the FSAP's multiple objectives as well as its joint IMF-World Bank nature, with inevitable differences in institutional priorities, implies balancing a complex set of priorities.

11. In this context, the evaluation asked the following questions: (a) Are the priority-setting criteria set by the two Executive Boards the relevant ones, in the sense of being clearly linked to the overall objectives of the FSAP initiative; and (b) how effectively have they been implemented in practice? Our overall assessment is as follows (see Annex IV for further details):

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<sup>9</sup> The 2003 review called for a typical FSAP to limit the number of standards assessed in detail to three, excluding AML/CFT, compared to a previous average of about five standards per FSAP.