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Use of Supervisory Standards in the Financial Sector Assessment Program—Understandings with Standard Setting Bodies

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USE OF SUPERVISORY STANDARDS IN THE FINANCIAL SECTOR ASSESSMENT PROGRAM (FSAP): UNDERSTANDINGS WITH STANDARD SETTING BODIES

Approved By
Tobias Adrian

Prepared by Udaibir S. Das, Nigel Jenkinson, Jennifer Elliott, and Jana Gieck Bricco.

EXECUTIVE SUMMARY

This paper informs the Executive Board of the staff-level understandings reached with global Standard Setting Bodies (SSBs) on the use of the three financial sector supervisory standards in FSAPs:

- the Basel Committee's Core Principles for Effective Banking Supervision (BCP), set by the Basel Committee on Banking Supervision (BCBS),
- the Insurance Core Principles (ICP), set by the International Association of Insurance Supervisors (IAIS), and
- the Objectives and Principles of Securities Regulation (Principles), set by the International Organization of Securities Commissions (IOSCO).

As graded assessments of compliance with supervisory standards are voluntary, FSAPs have adopted a flexible approach to the use of supervisory standards. A standard is either assessed in full, resulting in grades, or used as the basis for a deeper analysis of selected elements of the oversight framework in a focused review, without grades. The SSBs and Fund staff have reached understandings on a refinement of the existing flexible approach, with sets of "base principles" serving as the starting points for focused reviews.

1. **Financial sector supervisory standards have been used in FSAPs since 2000**. They also play an important role in technical assistance provided by the Fund and the World Bank. Developed through extensive international peer consultation, the financial sector supervisory standards represent an international consensus. The Fund and World Bank rely on them as evaluative tools and benchmarks to support financial sector policy recommendations. The financial sector supervisory standards have been revised and strengthened since the global financial crisis. They have been expanded in scope and improved to account for gaps.

2. **Assessments of compliance with financial sector supervisory standards, which result in graded Detailed Assessment Reports (DAR), are voluntary for Fund member countries.** Even in countries for which an FSAP stability assessment is a mandatory part of surveillance, graded assessments are voluntary.[1] Graded assessments are an optional but potentially very useful component of the FSAP, especially if the last graded assessments of compliance are dated or the standards have changed. In countries where compliance with financial sector standards has been established (based on earlier graded assessments) but where specific areas of systemic risk warrant deeper coverage, a focused review is particularly useful.[2]

3. **In line with the increased focus on systemic risk in the 2014 FSAP Review, staff proposed a "macrofinancial approach" to supervisory standards assessments.[3]** The macrofinancial approach would combine quantitative and qualitative criteria to identify a macrofinancially-relevant *subset* of individual principles in each of the three supervisory standards (for banking, insurance, and securities). These subsets of principles, complemented by additional principles if justified by country-specific financial stability considerations, would have been the focus of assessment work in FSAPs.

4. **Directors encouraged staff to consult with the SSBs and explore ways to focus assessments along the lines of the macrofinancial approach.** Directors agreed that key standards are a valuable tool for an assessment of financial supervision. Many saw scope for streamlining and targeting this work in ways consistent with the FSAP focus on systemic risk and, more broadly, the Fund's macrofinancial surveillance mandate. Several Directors expressed concern about the risk that evaluating only some areas covered by the standards might create gaps in the evaluation of financial sector supervision. Directors saw a need to balance the need to streamline with that of maintaining proper coverage of standards.

5. **Fund staff have consulted with the BCBS, IAIS, and IOSCO.** Discussions with SSBs were open and constructive. The SSBs gained a better understanding of the FSAP focus on systemic risk

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[1] In statements made in the London, Pittsburg and Toronto summits in 2009 and 2010, G-20 leaders explicitly recognized the key role played by international standards and committed to undertaking FSAPs, which raised expectations that countries would request standards assessments. The FSB publishes the date of the latest graded assessment (DARs) for each of the standards for member countries.

[2] Some recent examples are the United Kingdom and Luxembourg FSAPs. In the United Kingdom, a focused review of securities market regulation was successfully undertaken without resulting in a DAR; Luxembourg FSAP included a deep-dive on oversight of asset management companies drawing on the IOSCO standard but not leading to another graded assessment.

[3] IMF (2014), "Review of the Financial Sector Assessment Program: Further Adaptation to the Post Crisis Era."

and financial stability. Staff explained the rationale to be flexible in the use of standards as part of overall goal of the FSAP to evaluate financial stability risks and make related recommendations to address these risks. Fund staff also consulted with World Bank staff and periodically briefed the FSB's Standing Committee on Standards Implementation (SCSI).

6. SSBs advised against using a subset of principles when a graded assessment of compliance is undertaken in FSAP. They argued that the various elements within each supervisory standard are interrelated, that the principles are best assessed as a full standard. In addition, the SSBs made the following points:

- **Assessments:** Standards are a coherent and holistic package with all principles of equal importance. Principles should not be tiered in any way, and therefore, they need to be considered as a cohesive whole.

- **Flexibility:** A subset of principles could be the starting point for analyzing specific aspects of the oversight framework, but flexibility should be maintained such that other principles, in agreement with authorities, can be added to the list.

- **Costs vs. benefits:** SSBs, while aware of resource limitations, believe that the benefits of full assessments should be considered alongside the costs. Full assessments provide strong incentives to jurisdictions to improve their supervisory systems and practices.

- **Cross-border consideration:** Full assessments are viewed as important cross-border supervisory tools that support a risk-focused approach. Home supervisors rely on assessments to evaluate the quality of supervisory systems in other jurisdictions (i.e., host countries).

- **Frequency of full assessments:** Frequency of full assessments needs to be carefully considered, and long intervals between a full-scope graded assessment should not lead to missing emerging issues.

- **Self-monitoring:** Member countries are willing to undertake self-monitoring of progress vis-à-vis the standards on a regular basis.

7. The SSBs and staff reached the understanding that a refinement of the existing flexible approach would be the best way forward. The SSBs and staff agreed that financial sector supervisory standards will continue to be used in one of two ways:[4]

- ***Graded assessment:*** given that the various principles are inter-related, the standard will be assessed in full when it is assessed with grades based on the assessment methodology laid out by the individual SSB. The output will continue to be a "Detailed Assessment Report."
- ***Focused review:*** a standard can also be used as a benchmark to analyze specific prudential or supervisory gaps, which could exacerbate or fail to contain systemic risk. A focused review

[4] Following a 2010 Board decision (reference), partial graded assessments are allowed under specific conditions. However, experience has shown that the conditions are difficult to meet, so very few partial graded assessments have been done. The main challenges are (i) deciding which principles to assess when they are inter-related, and (ii) the changes in standards and assessment methodologies over time.

will continue to not involve any graded assessment and can be based on a subset of principles. The refinement to the existing approach is that staff and the SSBs reached agreement on sets of "base principles" (Annex) that will serve as the starting point for discussions between staff and the authorities about the scope of the focused review. The output of the focused review will continue to be either an FSAP Technical Note or simply input to the Financial System Stability Assessment (FSSA).

8. The decision about whether to conduct a graded assessment or a focused review drawing on a supervisory standard in a specific area will continue to be by agreement between staff and the authorities. The decision will be based on the relative importance of the specific sector, the degree of vulnerabilities, the overall priorities of the FSAP, the extent of changes in the sector or the oversight framework, and the extent of changes in the standard or assessment methodology since the last graded assessment. Staff will draw upon desk analysis of macrofinancial risks, structural and conjunctural factors, recent institutional and supervisory developments, and an up-to-date self-assessment provided by the authorities. A specific frequency for the timing of graded assessments is not part of the understandings with SSBs as it would go against the voluntary aspect of standard assessments.

9. Going forward, staff will continue to monitor the use of financial sector supervisory standards in FSAPs. Staff will periodically consult with the SSBs and report to the Executive Board. It is expected that the next FSAP Review (planned for 2019) will evaluate the use of financial sector supervisory standards in FSAPs.

Appendix. Base Principles

BCP Elements[1/]

(Base Principles Boldfaced)

Responsibilities, objectives and powers (CP1)
Independence, accountability and legal protection (CP2)
Cooperation and collaboration (CP3)
Permissible activities (CP4)
Licensing criteria (CP5)
Transfer of significant ownership (CP6)
Major acquisitions (CP7)
Supervisory approach (CP8)
Supervisory techniques and tools (CP9)
Supervisory reporting (CP10)
Corrective and sanctioning powers (CP11)
Consolidated supervision (CP12)
Home host relationship (CP13)
Corporate governance (CP14)
Risk management process (CP15)
Capital adequacy (CP16)
Credit risk (CP17)
Problem assets, provisions and reserves (CP18)
Concentration risk and large exposure limits (CP19)
Transactions with related parties (CP20)
Country and transfer risks (CP21)
Market risk (CP22)
Interest rate risk in the banking book (CP23)
Liquidity risk (CP24)
Operational risk (CP25)
Internal control and audit (CP26)
Financial reporting and external audit (CP27)
Disclosure and transparency (CP28)
Abuse of financial services (CP29)

[1/]It is understood that the IMF remains flexible on the selection of these Principles

ICP Elements[1/]

(Base Principles Boldfaced)

Objectives, Powers and Responsibilities (ICP 1)

Supervisor (ICP 2)

Information Exchange and Confidentiality (ICP 3)

Licensing (ICP 4)

Suitability of Persons (ICP 5)

Changes in Control and Portfolio Transfers (ICP 6)

Corporate Governance (ICP 7) [2/]

Risk Management and Internal Controls (ICP 8)

Supervisory Review and Reporting (ICP 9)

Preventative and Corrective Measures (ICP 10)

Enforcement (ICP 11)

Winding-up and Exit from the Market (ICP 12)

Reinsurance and other forms of Risk Transfer (ICP 13) [2/]

Valuation (ICP 14)

Investment (ICP 15)

Enterprise Risk Management for Solvency Purposes (ICP 16)

Capital Adequacy (ICP 17)

Intermediaries (ICP 18)

Conduct of Business (ICP 19)

Public Disclosure (ICP 20)

Countering Fraud in Insurance (ICP 21)

AML/CFT (ICP 22)

Group-wide Supervision (ICP 23) [2/]

Macroprudential Surveillance and Supervision (ICP 24)

Supervisory Cooperation and Coordination (ICP 25)

Cross-border Cooperation and Coordination on Crisis Management (ICP26)

[1/] It is understood that the IMF remains flexible on the selection of these Principles

[2/] Added by SSB through consultation process

IOSCO Elements[1/]

(Base Principles Boldfaced)

Responsibilities of the regulator (P1)
Operational independence and accountability (P2)
Adequate powers, proper resources, and capacity (P3)
Clear and consistent regulatory process (P4)
Staff professional standards and confidentiality (P5)
Monitor, mitigate and manage systemic risk (P6)
Review the perimeter of regulation regularly (P7) [2/]
Ensure that conflicts of interest and misalignment of incentives are avoided (P8)
SROs should be subject to oversight and confidentiality standards (P9)
Comprehensive inspection, investigation and surveillance powers (P10)
Comprehensive enforcement powers (P11)
Effective and credible use of powers and implementation (P12)
Authority for information sharing (P13)
Information sharing mechanisms (P14)
Assistance to foreign regulators (P15)
Full, accurate and timely disclosure of financial results by issuers (P16)
Holders of securities should be treated in a fair and equitable manner (P17)
International accounting standards (P18)
Auditors should be subject to oversight (P19)
Auditors should be independent (P20)
Audit standards should be of high and internationally acceptable quality (P21)
Credit rating agencies should be subject to oversight (P22)
Other entities offering evaluative services should be subject to oversight (P23)
Regulatory standards for collective investment schemes (CIS) (P24)
Rules governing CIS and the segregation and protection of client assets (P25)
Disclosure to evaluate the suitability of CIS for investors (P26)
Proper and disclosed basis for CIS asset valuation, pricing and redemption (P27)
Hedge funds should be subject to oversight (P28)
Minimum entry standards for market intermediaries (P29)
Prudential requirements for market intermediaries (P30)
Market intermediaries' standards for business conduct and risk management (P31)
Procedures for dealing with the failure of a market intermediary (P32)
Trading systems should be subject to authorization and oversight (P33)
Ongoing regulatory supervision of exchanges and trading systems (P34)
Promote transparency of trading (P35)
Detect and deter manipulation and unfair trading practices (P36) [2/]
Proper management of large exposures, default risk and market disruption (P37)
Settlement systems and CCPs subject to adequate regulation and supervisor (P38) [2/]

[1/] It is understood that the IMF remains flexible on the selection of these Principles

[2/] Added by SSB through consultation process