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I. INTRODUCTION

1. This paper provides background information on country experiences mentioned in the Board paper Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward. Section II provides an overview of common findings in FSAPs (mentioned in Section IV.A of the Board paper). Section III provides details on central banks’ responses to the post-FSAP feedback questionnaire (mentioned in Section IV.B of the Board paper). Section IV presents a survey of financial stability reports published by central banks (mentioned in Section III of the Board paper), and draws some preliminary lessons for the FSAP.

II. FSAP: A REVIEW OF COMMON ISSUES AND RECOMMENDATIONS

2. A review of completed FSAP documents has been carried out to identify the main issues and recommendations. The purpose was to survey recurrent issues or issues that have become more common in recent FSAPs, and to identify responses that have been already taken or should be taken in the program. The present chapter focuses on providing more details on the common findings. The Board paper discusses the adjustments of the program to these findings.

3. The survey is representative, but its findings must be interpreted with a considerable degree of caution, given the country-specific nature of mission recommendations. The survey covered the first 60 completed initial assessments (excluding those under the pilot program), including 15 assessments completed since the 2003 FSAP Board review. The results are based on the findings highlighted in the Executive Summary of the main document and recommendations in the summary tables of recommendations. When interpreting the results, caution needs to be exercised given that the reports are country specific and detailed recommendations are not included in the summaries.

4. Recommendations have been tailored to country circumstances. About 80 different types of recommendations were identified,1 of which most summaries in FSAP reports would include anywhere from 15 to 40.

5. Most recommendations focused on banking, but the coverage has been comprehensive. The high frequency of recommendations in banking reflects the dominance of the banking sector in most financial systems. In the areas of insurance, securities, payments, transparency, and AML/CFT the presence of a recommendation in the summary is positively correlated with the presence of a principle-by-principle assessment, but the relationship is not one-to-one (the correlation coefficient being 0.63). The fact that a recommendation does not appear in the summary does not mean that the area was not

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1 Each type would include recommendations with similar objectives, irrespective the detailed wording. For example, recommendations to “close banks X and Y” and to “close all unsound banks” would both be subsumed under the heading “close unsound banks.”
covered; in many cases, the sector was still analyzed and some more technical or minor recommendations were made.

6. **The most common set of recommendations relate to improvements in corporate governance of publicly-owned financial institutions.** Overall, these recommendations are found in about two thirds of reports. These recommendations are substantially more frequent in medium- and low-income country reports (80 percent of cases) than in high-income country reports (7 percent of cases). Some reports in this category recommended taking urgent steps to deal with problems in the publicly-owned financial institutions, and they often recommended divesting the government’s share in these institutions over time. Also, financial systems with large public ownership seem susceptible to weaknesses such as lighter supervision than privately owned firms. Some 90 percent of the reports in this category noted that regulators (even though in some cases they nominally have the requisite powers) are hindered in taking adequate action, and recommended steps to strengthen the independence of the supervisors.

7. **Credit risk tends to be the most important source of risk.** Of the FSAPs that explicitly compared the size of various sources of risk (60 percent of the surveyed FSAPs), virtually all (95 percent) noted that credit risk is the most important source of risk; in several cases, interest rate risk was considered substantial. Direct foreign exchange risk was found to be small in most FSAPs, but a majority of FSAPs in countries with hard pegs and increased dollarization raised concerns about indirect foreign exchange risk (i.e., credit risk resulting from exchange rate changes).

8. **In countries with the ratio of foreign currency deposits to total deposits above 50 percent, all reports discussed stability issues resulting from dollarization.** They highlighted that dollarization constrains policy implementation and the effectiveness of lender-of-last-resort facilities, while minimizing solvency and liquidity risks. In most of the countries it was noted that financial institutions are exposed to high potential losses due to client default.

9. **Substantial improvements in the legal and judicial framework** were suggested in about half of countries, and in virtually all low-income countries. Countries where such recommendations were made also typically suffered from other problems, such as weak competition in the financial sector and weaknesses in the AML/CFT framework.

10. **About one-half of FSAP reports noted the need to strengthen the governance of financial sector oversight agencies** by improving their structure, decision-making, independence, accountability, funding and staffing. In most cases, these findings have been highlighted and discussed in detail in the assessment of the MFPT code.

11. **About one-half of FSAP reports for medium- and low-income countries noted the need to strengthen supervisory staff by improving personnel policies or by training.** A common theme affecting implementation at the country level relates to human and financial resources. Insufficient regulatory resources and, in some instances, an acute
shortage of required skills often impede the achievement of regulatory objectives. More recently, several FSAPs in emerging markets noted that additional training may be needed in preparation for the new Basel accord.

12. **About one half of reports also suggested various improvements in the supervisory data and reporting systems.** These ranged from minor adjustments in the existing framework (e.g., including certain items in the report) to major strengthening of the data collection framework.

13. **About one-third of FSAP reports for emerging markets noted the need for supervisors to look carefully at financial institutions’ expanding credit portfolios.** In some cases, to illustrate the risks of rapid credit growth, stress tests in the FSAP included a scenario with high-credit growth.

14. **About one-third of reports called for increased supervisory attention to the cross-ownership in the financial sector.** Typically, these reports recommended a tightening of licensing requirements and suggested to investigate more closely the owners of financial institutions.

15. **A major overhaul of the AML/CFT framework was recommended in about one third of countries.** The coverage of AML/CFT issues was substantially enhanced since the 2003 review, reflecting the Boards’ decision to include formal AML/CFT assessments in all financial sector assessment under the FSAP except for countries that already had an AML/CFT assessment. All these reports included some recommendations in the AML/CFT area, ranging from minor adjustments to substantial improvements or a major overhaul in the AML/CFT framework.

16. **Competition was found to be weak in about 20 percent of the reports,** and specific measures were recommended. The finding was typically based on a detailed analysis of interest rate spreads and margins. The sources of the weak competition differed from country to country, but generally included restrictions on foreign entry and other sources of market contestability, underdeveloped securities markets, connected lending and the general investment climate. The outcome typically is that entrepreneurs lack access to a range of sources for funds for capital and investment, and households have trouble finding affordable mortgages and consumer finance.

17. **Since the 2003 review, the attention given to development-related issues has increased.** This change is difficult to quantify, given that many recommendations have both developmental and stability-related elements. With this in mind, an indirect indication of this trend is the fact that in medium- and low-income country assessments, frequency of recommendations in the areas of microfinance, loan recovery and property rights, and information infrastructure have risen since the 2003 review.
III. SURVEY OF POST-FSAP FEEDBACK RESPONSES

18. A survey of feedback received in the post-FSAP questionnaires was conducted, to summarize the authorities’ reactions to the assessment. After FSAP missions, team leaders are expected to hand to the authorities questionnaires, with six questions asking the authorities about their experience with the assessment (Box 1). This survey is based on 28 responses, including 18 received before the 2003 review and 10 received since then. The survey includes 26 initial assessments and 2 updates.²

Box 1. Post-FSAP Feedback Questionnaire

The post-FSAP feedback questionnaire contains the following questions.

1. What was the main reason for your country’s interest in participating in the FSAP?
2. Was the purpose of the FSAP clearly communicated to you? Did you agree with the coverage of topics for the FSAP?
3. What were the most burdensome aspects of participating in the program? What were the greatest benefits? Which aspects of the FSAP could be improved?
4. Were you satisfied with the quality of the FSAP report?
5. Were you comfortable with the way in which confidential information was handled by the team?
6. In what ways, if any, would you be able to utilize the team’s findings in the near and medium-term? What was your overall impression of the FSAP?

19. Virtually all responding country authorities described their overall impression of the FSAP as good or very good, and—notwithstanding concerns of some, in particular about the workload involved in the exercise—they noted that the participation has been valuable or very valuable.

20. The main reason for the country's interest in participating was to obtain an independent expert evaluation of the financial sector and its regulatory framework. This was noted in 70 percent of responses overall, and in all of the high-income countries. Other reasons also noted were to enhance the credibility of the system (40 percent) and the fact that other countries participated or could participate as a result of a country’s

² The response rate is about 38 percent of all assessments completed (50 percent for assessments completed after the 2003 review). Among the factors contributing to the relatively low overall response rate is the fact that the questionnaires were not always distributed to the authorities (in earlier assessments) and the response lag (in more recent assessments).
participation (30 percent). Thirty-five percent of countries (60 percent of medium- or low-income countries) saw the FSAP as a vehicle for identifying measures for reform or obtaining technical assistance, and to learn new tools such as stress testing.

21. **The purpose of the program was clearly communicated**, according to 96 percent of the responding countries. In 50 percent of the countries, this was achieved through pre-FSAP contacts with the mission chief or other staff. Virtually all (93 percent) of the country authorities thought that the coverage of topics in the program was adequate and comprehensive, even though 15 percent noted some specific topics deserving further attention.

22. **A majority of the country authorities (64 percent) noted the considerable work involved in participating in the program.** Most of these countries mentioned that providing the data requested by the mission was the most burdensome aspect of the exercise. Several suggested longer lead times for providing the necessary data and in some cases to translate the necessary documents. Notably, the FSAP updates for which a feedback is available did not include concerns about the workload involved.

23. **The authorities were generally comfortable with the way the FSAP teams handled confidential information.** In one cases, the authorities noted that they had some concerns regarding confidentiality, but those concerns were addressed early in the discussions.

24. **Virtually all the country authorities noted their satisfaction with the quality of the report.** Some countries suggested that more information be provided on certain topics or in follow-up work. Fifty percent of country authorities saw as the greatest benefits of the program the discussions with the experts and other team members. Some (20 percent) considered the discussions even more important than the report itself.

25. **All country authorities noted that they are likely to utilize the team’s findings in the near and medium-term.** Fifty percent of country authorities noted that they already started implementing some of the recommendations of the FSAP. Thirty-five percent of respondents thought that the FSAP will be very useful in discussing financial sector reforms with other stakeholders. Twenty percent noted that the FSAP prompted them to develop their own stress testing models.

26. **The authorities also made a number of suggestions going forward.** In particular, responses from countries assessed before the 2003 review focused on suggestions to sharpen the scope of the assessment, increase selectivity about issues and standards assessed, and deploy other tools in financial sector surveillance and follow-up. Responses both before and after the last review asked for improvements in the methodology for developmental issues, more research on financial stability issues, studying how standards affect the financial systems, addressing gaps in existing standards and methodologies, and creating swifter mechanisms for the provision of follow-up TA.
IV. CENTRAL BANKS’ FINANCIAL STABILITY REPORTS: RECENT TRENDS AND LESSONS FOR FINANCIAL SECTOR SURVEILLANCE

A. Recent Trends

27. In recent years, authorities in high- and medium-income countries have been increasing their focus on financial sector stability. This can be illustrated by a growing number of financial stability reports (FSRs) published by central banks. The first stand-alone FSRs were published in mid-1990s in the UK and several Nordic countries. Since then, the number of central banks publishing FSRs has grown and reached 25 in 2004 (Figure 1). The FSRs are published by central banks in high-income countries (17) and emerging markets (8); low-income country central banks do not generally publish stand-alone FSRs, even though many cover financial sector issues to some extent in annual reports or other publications. Geographically, Europe accounts for a majority (15) of the published stand-alone FSRs. Of the 30 OECD countries, 20 publish FSRs.

Figure 1. The Number of Countries Publishing Stand-Alone FSRs

28. FSRs provide a wealth of financial sector information. To assess the stability of the financial system, FSRs rely on a number of financial indicators, including indicators that are equivalent or closely related to financial soundness indicators (FSIs). For example, all of

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3 Some FSRs use different titles, such as Financial Stability Review, Financial System Review, or Monetary and Financial Stability Report. However, all these reports share a focus on financial system stability and a regular nature (about two thirds are published semi-annually, one third is published annually). In some countries, central banks publish separate reports on financial system structure or on related development issues.

4 Reviewed were the 157 central bank websites listed at http://www.bis.org/cbanks.htm as of December 31, 2004. Several central banks are producing FSRs, but not publishing them. Some are considering their publication in near future.
the surveyed FSRs provide FSIs related to capital adequacy, asset quality, and earnings and profitability. Most FSRs present quantitative indicators in a graphical form, but many include tables, and some central banks started to make the data available also in an electronic, ready-to-use format. Wider availability of FSRs and in some cases the underlying data mean that more information is becoming available to market participants and also for financial sector stability work by Fund staff and others.

29. **Countries that have volunteered to participate in the FSAP are more likely to publish FSRs** (Table 1). All FSRs published so far are by central banks that have participated or volunteered to participate in the FSAP. This indicates that the reasons for publishing FSRs are similar to those prompting countries to volunteer for the FSAP.

<table>
<thead>
<tr>
<th>Participated or volunteered to participate in the FSAP?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>25</td>
<td>14</td>
</tr>
<tr>
<td>No</td>
<td>0</td>
<td>9</td>
</tr>
</tbody>
</table>

1/ Based on a sample of 50 high-and medium-income economies (25 publishing and 25 not publishing stand-alone FSRs).

30. **Even though FSRs reflect only a part of central banks’ financial surveillance work, they offer useful insights into how central banks conduct financial sector surveillance.** The FSRs are the most visible product of the new work program, but the range of studies and debates conducted at central banks on financial stability is generally much wider. In particular, the analysis presented in FSRs may be based on models that are not presented in FSRs (even though some central banks publish separate, more detailed documentation describing such models). Nonetheless, the FSRs give a rough indication of the objectives that central banks seek to achieve through the publication of FSRs; the way they define financial stability; the tools central banks use to assess the soundness of their financial system; and the way in which they communicate their findings to the public.

31. **FSRs share the common objective of monitoring and presenting to the public the central bank’s appraisal of developments relevant for the financial sector and of their impact financial sector stability.** Other explicitly stated objectives in the FSRs include encouraging an informed debate on financial stability issues, disseminating information for transparency purposes, and influencing market participants. Some central banks see their FSRs as a tool to encourage greater cooperation between supervisory and regulatory authorities, and others intend the FSR to help clarify its role in protecting stability of their financial system. Some central banks also present their views on developmental issues, but the focus on FSRs is on risks and vulnerabilities.

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In addition, even in countries that do not publish formal stand-alone FSRs, financial sector (or at least banking sector) are typically discussed every year in an annual report.
32. **The FSRs recognize that financial stability is a complex concept; the exact notion of financial stability somewhat varies across the FSRs.** Those central banks that attempted to explicitly define financial stability noted the difficulty of this task. There is a general understanding that financial stability refers to smooth functioning of the components of the financial system (financial institutions, markets, and payments, settlement, and clearing systems). This notion implies the absence of financial crises, generally defined as system-wide events in the financial sector that have an impact on the allocation of resources in the economy and its overall effectiveness. Some FSRs define financial stability as the absence of such crises, but most use wider definitions that include also robustness of the financial system to shocks.

33. **The coverage of FSRs in terms of issues used has been increasing over time.** Later FSRs tend to have more comprehensive coverage, which includes not only banks, but also other important segments of the financial systems. (Some central banks started publishing “banking stability reports,” and renamed them to FSRs after including other sub-sectors and issues.) The FSRs have been paying increasing attention to non-financial sectors as potential sources of risk. Many FSRs also include sections dealing with payment system stability. In terms of risk factors, credit risk was covered in all FSRs, and many explicitly noted that credit risk is the most significant source of risk. A majority of central banks also analyzed exchange rate risk and payment and settlement risk. Interest rate risk and liquidity risk were explicitly presented in half of the FSRs. Country risk was reported in a third of FSRs surveyed. Recently, several FSRs included a section on contagion risk.

34. **The coverage in terms of techniques has also been rising.** In addition to the basic indicator analysis, the proportion of FSRs reporting results of more sophisticated tools such as early warning systems and stress tests has been increasing and has exceeded a half of the published FSRs. Recent FSRs are also more likely to include a discussion of the regulatory framework or a (self-) assessment of compliance with the regulatory standards.

35. **Most of the overall assessments in recent FSRs have been positive.** In a survey of the latest issues of the 25 stand-alone FSRs, a majority (24) have included a positive overall assessment of soundness of the domestic system (characterizing the health of the financial system as being, e.g., “in good shape,” “solid,” or at least “improving”), even though all of the FSRs also noted various macroeconomic and other risks. The prevalence of positive overall assessments may partly reflect the fact that the countries deciding to publish FSRs have in place robust financial systems.

### B. Preliminary Lessons for the FSAP and Other Financial Sector Work

36. **The stability analysis in the FSAP complements the financial stability analysis carried out by country authorities.** Just as the Article IV process complements authorities’ policy analysis. Even for countries publishing their FSRs, the FSAP can have value by providing an independent check-up on the health of the financial system and advice on the regulatory framework (as indicated by authorities’ responses to the feedback questionnaire,
summarized in Section III). FSAP teams always make an effort to build on the country-specific knowledge of the authorities and on the work contained in FSRs, and carry out independent assessments. The FSAP work can complement the financial sector analysis done by the authorities in several respects, including:

- An important element not covered in FSRs are **assessments of compliance with international standards and codes**. Even though many FSRs include descriptions of the regulatory framework, and some include or refer to authorities’ self-assessments of compliance with international financial sector standards and codes, the ability to provide an independent assessment is Fund’s and Bank’s important comparative advantage.

- **Financial soundness indicators** used in the stability analysis in the FSAP provide for a quantification of the financial sector’s soundness that is standardized across countries.

- **System-focused stress testing** is a standard part of the analytical toolkit in the FSAP. Its use in the FSRs is limited, even though it has been on the rise recently, in some cases after a country has undergone an FSAP assessment.

- FSAP assessments may have an advantage in covering **issues that involve several institutions and agencies**, such as systemic liquidity or crisis management framework.

37. **As the scope and quality of financial stability work by country authorities increases, the quality of Fund-Bank financial sector analysis will be judged against a higher standard.** This may require more staff training, research and other analytical work at headquarters and in the field, and focusing on the Fund’s and Bank’s strengths and comparative advantages.

38. **Fund and Bank play a role in promoting financial sector analysis in a wide range countries, subject to the countries’ implementation capacity.** The FSRs have so far been prepared only in high-income countries and some emerging market countries, and have focused on stability issues. In low-income countries, financial sector diagnostics needs to cover a broader set of topics than typically covered in FSRs, and in particular focus more on developmental issues.