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The Financial Sector Assessment Program After Ten Years: Experience and Reforms for the Next Decade

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GLOSSARY

ABS	Asset-Backed Securities
AM	Aide-Mémoire
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank of International Settlements
CAS	Country Assistance Strategy
CCA	Contingent Claims-Based Approach
CDS	Credit Default Swaps
CMU	Country Management Unit
CPSS	Committee on Payment and Settlement Systems
EU	European Union
EWE	Early Warning Exercise
FATF	Financial Action Task Force
FPD	Financial and Private Sector Development Vice Presidency
FSA	Financial Sector Assessment
FSB	Financial Stability Board
FSAP	Financial Sector Assessment Program
FSIs	Financial Soundness Indicators
FSLC	Financial Sector Liaison Committee
FSSA	Financial System Stability Assessment
GFSR	Global Financial Stability Report
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IEG	Independent Evaluation Group (World Bank)
IEO	Independent Evaluation Office (IMF)
IMFC	International Monetary and Financial Committee
IOSCO	International Organization of Securities Commissions
JMAP	Joint Management Action Plan
LICs	Low-Income Countries
MBS	Mortgage-Backed Securities
MCM	Monetary and Capital Markets Department
OFC	Offshore Financial Center
OECD	Organization for Economic Cooperation and Development
RAM	Risk Assessment Matrix
ROSC	Report on the Observance of Standards & Codes
SMEs	Small and Medium-Size Enterprises
TA	Technical Assistance
WEO	World Economic Outlook

EXECUTIVE SUMMARY

1. **Ten years after its inception, the FSAP has established itself as an important instrument for assessing financial systems around the world**. More than three-quarters of the membership have volunteered for FSAP assessments or agreed to do so in the near future, including almost all the G20 countries. Previous reviews have confirmed that the FSAP has helped deepen the understanding of countries' financial sectors and linkages with the rest of the economy, enriched the policy dialogue, and ensured consistency of Bank and the Fund advice, the last being a feature highly valued by participating countries. As also noted in the Malan Report, the collaborative nature of the FSAP adds value by effectively addressing areas of financial sector policy where developmental and stability concerns are interlinked and overlap and by facilitating knowledge spillovers between the two institutions. These past reviews have noted, however, the need to make the FSAP more flexible, responsive, and continuous, to deepen and strengthen the analytical toolkit, and to integrate the FSAP more closely with the Bank's and the Fund's other financial sector work.

2. **In the coming decade, FSAP assessments will be conducted in a very different environment from the one in which the program was framed**. Financial systems have become increasingly sophisticated and integrated across borders, while policymakers' concerns have changed, including those of multilateral fora such as the G20 and the Financial Stability Board (FSB). The recent crisis has also underscored the need to ensure that the FSAP better informs and guides Fund surveillance. While the crisis has illustrated that the FSAP can play only a limited role as an early warning instrument, it has also shown the advantage of systemic and holistic reviews of countries' financial sectors while, at the same time, extending the coverage to crisis management and macroprudential frameworks. At the same time, the new demands placed on the program will need to take careful account of the abiding financial sector needs of all member countries, particularly in the developing world.

3. **The proposed changes for reshaping the FSAP aim to preserve and capitalize on the successes and wide acceptance of the program among the membership**. As such, two key aspects of the program would remain the same: the FSAP would remain a joint Bank-Fund program in developing and emerging market countries (FSAPs in advanced economies would continue to be the sole responsibility of the Fund); and country participation would continue to be voluntary.

4. **Within the joint framework of the program, the option of modular assessments would introduce greater flexibility and help align the FSAP better with country needs**. Joint Bank-Fund assessment missions would remain the norm and would be conducted at a frequency determined by country circumstances and the strategic prioritization of each institution's resources. As is now the case, initial assessments would be expected to be wide-ranging and comprehensive, while the scope of updates would be more narrowly defined, based on country needs. A key proposed innovation in this regard is the option for FSAP modules focused on stability or developmental aspects when country circumstances warrant

and under the Financial Sector Liaison Committee (FSLC) guidance. This approach would facilitate a higher frequency of assessments and a more continuous dialogue. Combined with better off-site monitoring of financial sectors, this would help fill the gaps between assessments and ensure that the FSAP findings inform (and are incorporated in a more effective manner into) other Bank and Fund activities in financial sectors in member countries.

5. **In addition, a number of important changes, informed by the experience of the last decade and the recent crisis, are designed to strengthen the analytical basis for FSAP assessments and enhance their effectiveness in promoting appropriate policy responses**.

- The Fund will continue to refine stress testing methodologies and improve the analysis of macrofinancial linkages. This will involve placing greater emphasis on ensuring data quality, assessing off-balance sheet exposures, calibrating the shocks, and exploring more fully liquidity and cross-border risks.
- The Bank will enhance analytical tools to benchmark financial sector development and improve the analysis of areas that are becoming increasingly important, such as competition issues, incentives, and governance, and will incorporate lessons from the crisis for financial sector strengthening, such as the appropriateness of government policies for supervision and regulation.
- Stability assessments will become more rigorous, standardized, and comparable across countries through the introduction of a Risk Assessment Matrix.
- Recommendations in the area of financial sector supervision will draw on the emerging lessons from the crisis, including with regard to the perimeter of regulation, the procyclicality of prudential norms, the supervision of cross-border entities, and the capacity of national authorities to coordinate domestically and with foreign peers.
- Assessments will place even greater emphasis on crisis preparedness, such as central bank liquidity frameworks, lender-of-last resort facilities, bank resolution frameworks and tools, and inter-agency cooperation mechanisms, as well as exit strategies from the unprecedented policy interventions undertaken during the recent crisis.
- New methodologies for assessing macroprudential risks will be developed in parallel with national and international authorities and gradually become part of the FSAP.
- Although the FSAP is inherently a bilateral instrument, assessments will focus more squarely on cross-border linkages and incorporate the findings of multilateral analyses, such as the WEO, GFSR, the vulnerability exercise, and the Early Warning Exercise.

6. **Strengthened mechanisms for quality control and inter-institutional coordination through FSLC would ensure the continued integrity of the FSAP product**. These include a more systematic prioritization exercise and an upgraded role of the FSLC. FSLC will review and approve the proposed modality of FSAP updates (i.e., whether to mount "full" missions or more focused modules); provide guidance on the analytical and policy framework for the program; play a key role in forming the strategy and overseeing the implementation of the off-site framework; and serve as a vehicle for systematic information sharing of results from

assessments and modules. New principles and procedures have been established to enable FSLC to play this role.

7. **The extent and effectiveness of the proposed changes would depend on available resources**. The current crisis has necessitated a reprioritization of FSAP missions, but the long-term effect on the demand for FSAP updates among the membership, especially the G20, will only become clear over time. Nonetheless, increasing the frequency of assessments through full FSAP updates or modules; providing more in-depth assessments to facilitate better follow-up; expanding the program's analytical content in areas such as macroprudential risks; and enhancing off-site monitoring would, other things being equal, require additional resources. Keeping the current resource envelope broadly unchanged would require a strict prioritization of FSAP updates and modules that will tend to cover systemically important and vulnerable countries, at the expense of many developing and small industrial countries. These aspects of the program and, more broadly, the experience with the innovations proposed in this paper, will be the subject of an early review by staff and Management of the two institutions.

I. INTRODUCTION

8. **The Financial Sector Assessment Program (FSAP) is today at a crossroads**. Born in the aftermath of the financial crises of the 1990s, the FSAP has established itself as an important tool for comprehensive assessments of both financial stability and developmental needs. It is conducted at the request of the member country[1] by the Fund alone in advanced economies and jointly by the Bank and the Fund in developing countries. Over two-thirds of the members have now completed first-round assessments, and many have already undergone FSAP updates. The program also provides a valuable framework for Bank-Fund collaboration, helping to ensure consistent advice in developing countries, while allowing the two institutions to leverage their resources. But a new financial crisis is again changing profoundly the environment in which both the Bank and the Fund operate. Although lessons from the crisis are still evolving, it has already engendered a major refocusing and re-prioritization of both institutions'—but especially the Fund's—financial sector work, and requires major adaptations in their toolkit, including the FSAP.

9. **Recent reviews of the FSAP reaffirmed its contribution to the institutions' financial sector work but also pointed to weaknesses** (Box 1).[2] They noted that the FSAP has helped deepen the understanding of countries' financial sectors, articulate policy recommendations, and improve analytical discussions with authorities. It has encouraged policy and institutional changes and led to a better understanding of the key linkages between financial sector vulnerabilities and macroeconomic stability. At the same time, the reviews noted that the voluntary nature of the FSAP was a constraint on effective country coverage and the allocation of scarce resources. They pointed out that FSAP assessments needed to be better integrated into each institution's work, in particular the Bank's other financial sector work and IMF surveillance. And they called for efforts to streamline the program and improve its cost effectiveness, while enhancing its analytical foundations.

10. **More recently, a technical briefing to the Bank Board on the future of the FSAP (March 2009) reinforced some of the recommendations of past reviews**. It was largely based on an internal Bank stocktaking exercise that identified three major areas for improvement: (i) greater flexibility and the ability to address evolving country needs and adapt the assessments to meet the Bank's and Fund's financial sector priorities, including leveraging their resources effectively; (ii) enhanced analytical content, quality, and comparability of assessments; and, (iii) strengthened "off-site" work as a way to enhance the continuity of assessments and the effectiveness of "on-site" reviews.

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[1] For the Fund, FSAPs are legally a form of technical assistance.

[2] Independent Evaluation Group (IEG (2006)), Financial Sector Assessment Program, Review, IEG Review of the Joint World Bank and IMF Initiative; and Independent Evaluation Office (IEO (2006)), Report on the Evaluation of the Financial Sector Assessment Program.

Box 1. Summary of Key Findings of Past Board FSAP Reviews

Previous reviews of the FSAP concurred that the program is a good diagnostic instrument, a cornerstone of Bank/Fund financial sector work in member countries, and an example of effective Bank/Fund collaboration. It has helped deepen the understanding of countries' financial sectors and linkages with the rest of the economy, enrich the dialogue with authorities, and encourage policy and institutional changes. Finally, it has facilitated the pooling of resources of the two institutions and led to greater consistency in policy advice.

However, the reviews noted that the voluntary nature of the program was a constraint on resource allocation and prioritization of assessments, and stressed the need for improvements in several areas:

- Strengthened incentives for participation in the FSAP would ensure greater coverage of systemically important or vulnerable countries. At the same time, staff should signal to the Board when countries are viewed as high priority for FSAPs regardless of whether the countries had volunteered or not.
- Within the joint and collaborative framework of the program and the Financial Sector Liaison Committee (FSLC), greater flexibility in the scope of assessments, particularly updates, would allow staff to tailor them better to country circumstances. FSAP assessments should be more candid and the dissemination of outputs more timely.
- Further research was needed to underpin policy advice and improve the impact of the FSAP, including the development of assessment tools for regions with substantial cross-border links and improved approaches to missing market and access issues.
- There should be closer integration between the FSAP and Fund surveillance, as well as with Bank programs. Within the IMF, in particular, scarce financial sector expertise should be deployed more strategically across FSAPs and other financial sector work in order to enhance surveillance.
- Technical assistance follow-up to FSAP findings should be more systematic, including through the establishment of a clearer framework for coordination with the authorities and other donors.
- Greater effort should be made to streamline FSAP assessments further against the backdrop of constrained resources and emerging demands.

11. **In addition to these focused reviews of the program, the FSAP has also been covered by broader assessments of the two institutions' financial sector work, with broadly similar findings**.

- The 2007 Malan report underscored Bank-Fund collaboration on financial sector issues through the FSAP and the FSLC. Following the 2007 Malan report, the two institutions elaborated the Joint Management Action Plan, which included specific measures to improve coordination.
- The Fund's 2007 Financial Sector Task Force report and 2008 Triennial Surveillance Review provided a framework to improve the analysis of financial sector issues in Article IV consultations, and called for moving beyond the "coverage" of financial sector issues toward the "integration" of financial sector issues and, in particular, FSAP assessments, into Article IV surveillance. In February 2009, an informal Fund Board seminar discussed progress on this front and some preliminary proposals on how to reshape the FSAP.

- The Bank's Financial Sector Strategy Review in 2007 and subsequent briefings to its Board have identified a strategy for strengthening the Bank's financial sector development work, ensuring a closer link of the FSAP to the other operations of the Bank, and leveraging of comparative advantage across instruments. They also called for stronger financial sector development benchmarks and indicators for monitoring and evaluating progress, and a results-focused approach.

12. **The recent financial crisis has created major new challenges for both institutions and underscored the need to adapt the FSAP to new realities**. In some areas, the crisis has amplified the urgency to address weaknesses already identified by previous reviews: for instance, to make the FSAP more nimble, focused, and flexible, and integrate it better with the Fund's surveillance. But it has also created some entirely new demands on the program. In October 2008, the International Monetary and Financial Committee (IMFC) called for work toward a reshaped FSAP that is better integrated with the Fund's surveillance mandate and embraces regional perspectives. And at their 2009 summit, the G20 leaders called for renewed efforts on crisis prevention, underlining the role of the international financial institutions in crisis response and the reform of the international financial architecture.

13. **This review looks at the FSAP experience over the past ten years and discusses options for the future**. It is the culmination of several threads of preparatory work, including the Bank stocktaking exercise mentioned above, as well as three special studies: a joint Bank/Fund survey of participating countries' views, an independent review of the performance of the FSAP in the context of the current financial sector crisis, and a Fund paper on the methodological development of the stress testing toolkit in view of the crisis. These studies are summarized here and presented in full in a separate background document. The next Chapter reviews the experience of the first ten years, covering the structure, organization, and coverage of the program; the scope and impact of the FSAP; and the relationship between the FSAP and IMF surveillance and Bank support to financial sector development. Chapter III outlines a vision for a new FSAP, including the focus and content of the program; flexibility, rigor, candor, transparency, and stronger regional/thematic coverage; improved Bank-Fund coordination; and concludes with a discussion of resource implications and tradeoffs.

II. The First Ten Years

A. Structure, Organization, Scale, and Cost

Structure and organization of the program

14. **The FSAP was established as a voluntary joint Bank-Fund program to assess countries' financial sector vulnerabilities and developmental needs.** It was one of several initiatives to strengthen the international financial architecture following the crises of the 1990s. The key elements of the program were the following:

- FSAP assessments are undertaken at the request of country authorities. The voluntary nature of the program was seen as instrumental for ensuring the country authorities' ownership of the process and findings.

- The focus of the assessment is broad and comprehensive—although FSAP updates are supposed to be more focused—and may include detailed Reports on the Observance of Standards & Codes (ROSCs).

- Assessments are supposed to identify stability weaknesses and developmental needs and propose remedial actions to enrich the policy dialogue between countries and the two institutions, as well as between policy-makers and other stakeholders. They are separate from the rest of the two institutions' financial sector work but, in the countries that choose to participate, the assessments inform and guide surveillance (Fund), financial sector lending operations (Bank), and technical assistance (Fund and Bank).

15. **Most assessments are conducted jointly by the Bank and the Fund, but the two institutions maintain a different focus and follow separate internal reporting modalities**. In advanced economies, FSAPs are the responsibility of the Fund. In all other countries, they are conducted by joint Bank/Fund teams composed of staff and expert consultants. The analysis of stability issues is the main focus of the Fund, while the Bank covers financial sector development issues; but there is, of course, considerable overlap between the areas. Once the assessment is completed, a joint Aide-Mémoire is delivered to the authorities. The two institutions then follow different internal reporting processes, focused on their respective mandates and priorities: the Fund generates a Financial System Stability Assessment (FSSA), focused on financial sector vulnerabilities, which is discussed by its Executive Board alongside the regular Article IV consultation report; the Bank produces a Financial Sector Assessment (FSA), focused on the main financial sector development needs, which is distributed to the Bank's Executive Board for information.

16. **Assessments of compliance with various financial sector standards and the associated Reports on the Observance of Standards and Codes (ROSCs) are closely related to the FSAP**. The Boards of the Bank and the Fund have endorsed 11 Standards and Codes of the 12 designated by the Financial Stability Board (FSB) as key for sound financial systems (Appendix III). These standards are broadly accepted as representing minimum "good practices." Six of the twelve standards are assessed as part of the FSAP. Five of them—Banking Supervision, Securities, Insurance, Payments and Securities Settlement Systems, and Anti Money Laundering and Combating the Financing of Terrorism (AML/CFT)—are assessed jointly. In addition, the Fund assesses Monetary and Financial Policy Transparency. Corporate Governance, Accounting, Auditing, and Insolvency and Creditor Rights are assessed either independently or as part of the FSAP by the Bank, depending on country circumstances (however, the standard in the area of Insolvency and Creditor Rights has not yet

been endorsed by both Boards). Finally, two additional standards are not assessed in the context of the FSAP but reviewed independently by the Fund.[3]

17. **The Bank and the Fund have developed mechanisms for coordination (Box 2) and for integrating the FSAP into their other country work**.

Box 2. Role of the Financial Sector Liaison Committee (FSLC)

Efforts to strengthen collaboration between the Fund and the Bank have always been viewed as a high priority for the two institutions, essential for each to fulfill its mandate and best serve the interests of its members. However, the financial crises of the late 1990s highlighted the need for substantial improvement in inter-institutional coordination in the financial sector as a means for ensuring greater consistency in the advice provided to countries and improving the utilization of scarce resources. This was one of the motivations for the creation of the Financial Sector Liaison Committee (FSLC) in September 1998.

The main objective of the FSLC is to foster better collaboration between the Bank and the Fund on financial sector work, which is distributed widely within the two institutions. In that context, the Committee assumes responsibility for operational inter-institutional coordination and management for the joint aspects of the FSAP. Other priorities for FSLC in recent years have been the coordination of technical assistance provided through the FIRST program and the identification of regional and global lessons for financial sector reform.

It is constituted as a joint committee of senior staff from the Fund and the Bank. Facilitating early and continuous dialogue on the allocation of work between the two institutions helps ensure that the two institutions deliver sound and timely advice and support to member countries, and that the limited expert resources available are engaged in the most effective way.

The Malan Committee report and the follow-up Bank-Fund Joint Management Action Plan (JMAP), echoing many of the recommendations of past FSAP reviews, highlighted FSLC as a good example of Bank/Fund collaboration. They recommended that the mandate of the Committee be widened to the promotion of collaboration on all financial sector issues, including being specifically empowered to better coordinate technical assistance to member countries. The Malan Report encouraged FSLC to promote a robust dialogue, the exchange of information, and joint work planning.

- The Bank works through a central management unit within Financial and Private Sector Development Vice Presidency (FPD)'s Financial Systems Department, which maintains close collaboration with its six Regions, Country Management Units (CMU), the FIRST Initiative, and the Fund. Country Assistance Strategy (CAS) documents are the key vehicle for incorporating FSAP findings into the Bank's country work. The CMU is also critical in driving FSAP follow-up, ranging from assistance in the

[3] The Code of Good Practices on Fiscal Transparency and Special Data Dissemination Standard-General Data Dissemination Standard.

identification of more specific sector reform priorities to fitting detailed FSAP recommendations into existing Bank programs in the country.

- In the Fund, FSAP-related work is the responsibility of the Monetary and Capital Markets Department (MCM), which collaborates closely with area departments. The key vehicle for integrating FSAP findings into bilateral surveillance is the FSSA, which is produced in cooperation with the relevant area department Article IV team, approved by both the Director of MCM and the Area Department Director, and discussed by the Board alongside the Article IV staff report. Follow-up capacity-building work is also the responsibility of MCM, the technical assistance provider on financial sector issues in the Fund.

Country participation

18. **Participation in the program is voluntary, but country requests are prioritized based on criteria established by the two Boards**. The prioritization criteria include: (i) the systemic importance of the country; (ii) external sector weaknesses or financial vulnerabilities; (iii) major reform programs that might benefit from a comprehensive financial sector assessment; and (iv) features of the exchange rate and monetary policy regime that make the financial system more vulnerable, such as inconsistency with other macroeconomic policies. Maintaining a balance across regions and different levels of financial sector development is also important, as is the time elapsed since the initial FSAP or previous FSAP update. Based on these criteria, the staff prepares priority lists twice a year—before the Spring and Annual Meetings—that guide the planning of assessments and are communicated to the Managements of the two institutions.

19. **About 80 percent of the member countries have participated in the program—or agreed to do so in the near future** (Appendix I). Preparations are underway for FSAPs in China, Indonesia, and the United States. Once these assessments have been completed, the majority of systemically or regionally important financial systems, including almost all the G20 (Table 1) will have participated in the program.

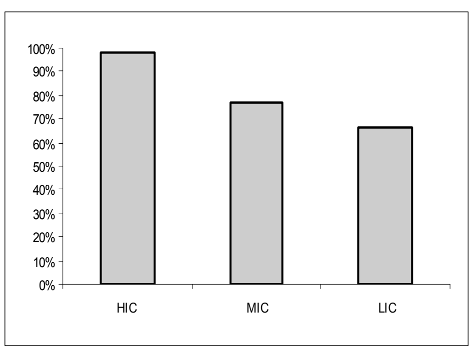
20. **Coverage across geographic regions has been strong everywhere except Asia, with the highest participation rate in Europe** (Figures 1 and 2). Most of the European countries have been assessed at least once, and several have had updates. Participation in the Middle East and North Africa has also been strong, as it has been in North, Central and South America and the Caribbean. In Sub-Saharan Africa, most countries have been covered, including in the context of regional FSAPs for the monetary unions of Central and West Africa. Despite the lower participation rate in East Asia, most countries with large financial sectors have completed or are planning assessments.

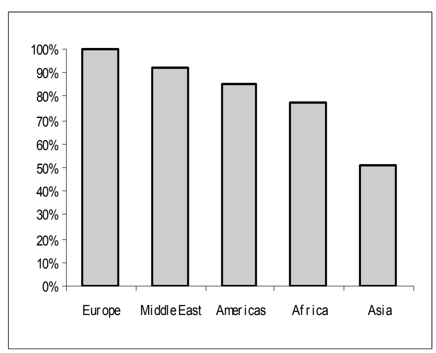
Table 1. G20 Participation in the FSAP

	Initial Assessment	Update	Planned
Argentina (1)	FY01		
Australia	FY06		
Brazil	FY03		
Canada	FY01	FY08	
China			FY10
France	FY04		
Germany	FY04		FY10
India	FY01		
Indonesia			FY10
Italy	FY05		
Japan	FY04		
Mexico	FY02	FY07	
Russia	FY04	FY08	
Saudi Arabia	FY06		
South Africa	FY00	FY08	
South Korea	FY04		
Turkey	FY07		
United Kingdom	FY03		
United States			FY10

Source: World Bank FSAP Management Unit.
1/ The Argentina FSAP was not completed due to the emergence of the crisis.

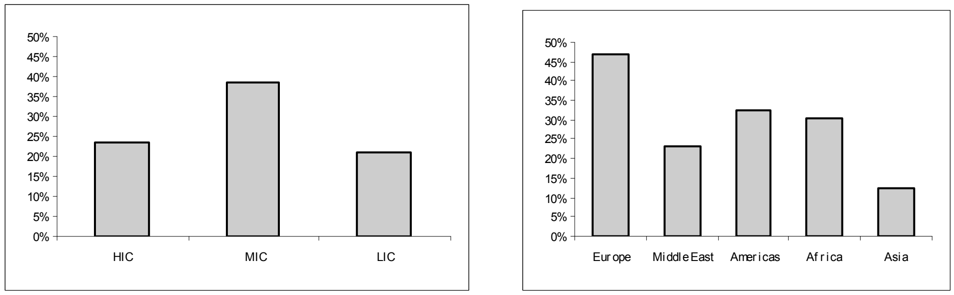
Figure 1. Initial Assessments (by Income and Region)





Source: World Bank and IMF FSAP Databases.

Figure 2. Updates (By Income and Region)



Source: World Bank and IMF FSAP Databases.

21. **The interval between assessments tends to be long**. The 2003 FSAP review noted that demand for updates was stronger than had been anticipated at the start of the program, and recommended focusing the scope of updates and tailoring them more closely to country circumstances in line with budget constraints. The 2005 FSAP review additionally called for more selective thematic coverage and a target interval of about five years between updates. In the event, the average period between updates has been six years and the average size of Bank-Fund teams has varied relatively little.

Cost of the program

22. **The total cost of the program has been contained, in part owing to the shift over time toward updates**. The total cost of the FSAP to the Fund in recent years (including staff, consultants, and travel costs but excluding overtime and general overhead and support activities) has been in the order of US$7½-11 million annually (Table 2). About 90 percent of this has been borne by MCM, where FSAP-related work represents over 10 percent of the department's total budget. The Bank's cost of the FSAP has been in the order of US$4-5 million per annum (including staff, consultants, travel costs, and program coordination). Table 3 includes information on the size and duration of FSAP updates.

23. **The IMF downsizing exercise in 2008 did not have a major impact on the resource envelope for the program, but nonetheless necessitated some adjustments**. Under MCM's FY09–11 business plan, the targeted number of FSAPs has remained at 7–8 initial assessments and 10–12 updates. However, the number of headquarters-based financial sector experts available to staff missions declined, requiring greater use of externally sourced experts. To increase efficiency, the Offshore Financial Center (OFC) Assessment Program was absorbed into the FSAP (http://www.imf.org/external/np/pp/eng/2008/050808.pdf).

24. **The Bank has kept its financial contribution to the program stable over the years, but the number of its financial sector experts has gradually diminished**. In recent years, as priorities shifted to other sectors, the pool of experienced financial sector experts available to perform assessments has shrunk. The adopted Bank financial sector strategy already plans for

resource replenishment, and a structured approach to train and mentor new FSAP leaders is being developed. However, the capacity to replenish skilled human resources will depend on the continuity of available financial resources over the years.

Table 2. FSAP Costs

	FY2005	FY2006	FY2007	FY2008	FY2009
		(Thousands of U.S. dollars)			
Fund Total Annual Costs	**7,431**	**7,504**	**8,679**	**11,007**	**7,458**
Personnel Costs [1,2]	5,023	4,765	6,933	7,979	5,425
Travel Costs	2,408	2,739	1,746	3,028	2,033
Bank Total Annual Costs	**4,787**	**4,889**	**4,813**	**5,319**	**3,791**[3]
Personnel Costs	3,708	3,657	3,654	3,975	2,934
Travel Costs	1,079	1,232	1,159	1,344	857
Total Annual Costs	**12,218**	**12,392**	**13,492**	**16,326**	**11,250**

Source: Staff estimates.
[1] Does not include overtime, which added 11–13 percent to Fund cost for 2007–2009.
[2] 2003–2006 figures estimated from partial data.
[3] FSAP demand in FY09 was lower owing to the effect of the crisis.

Table 3. Profile of Assessment Missions (Bank and Fund)

(FY06–09 averages)

	Total	**Initial Assessments**	**Updates**
Average number of missions per assessment	1.7	1.8	1.5
Average length of missions (days)	18.9	20.1	14.6
Average size of missions (staff and consultants) [2]	13.2	16.2	9.5

Source: Staff estimates.
[1] 1999–2009; figures include preliminary scoping missions.
[2] Staff members and consultants participating in more than one mission per assessment are counted once.

B. Scope, Impact, and Dissemination

FSAP recommendations and implementation

25. **The Bank stocktaking exercise (2008) compiled a database categorizing FSAP report recommendations into three areas (infrastructure, oversight, and public policy) and tracking their implementation** (Appendix II). Prudential oversight accounted for over half of all recommendations. In addition, the developmental focus of the FSAP (infrastructure, market competition, and financial promotion policy recommendations) has risen over time. This mainly reflects increases in the information aspects of infrastructure (e.g., accounting and

auditing, rating, registries) and a growing focus on the state's financial sector promotion policies, including direct intervention in financial intermediation, or indirectly through subsidies, guarantees, or regulations (Table 4). In terms of sectoral coverage, the vast majority of FSAP recommendations relate to the banking sector, reflecting the bank-centric nature of many middle- and low-income financial systems (Table 5).

Table 4. FSAP Recommendations by Topic

(percent share of the total)

	2002–2004	2005–2007
A. Infrastructure	**20.6**	**20.8**
a. Contractual	5.8	4.7
b. Informational	7.3	8.6
c. Transactional	5.9	6.3
d. Corporate Governance	1.5	1.3
B. Oversight	**55.4**	**57.3**
a. Prudential	50.3	52.2
b. Market performance and Integrity	5.1	5.1
C. Public Policy	**24**	**21.9**
a. General Enabling Policies	14.8	11.4
b. Financial Promotion Policies	9.2	10.5

Source: "The Process of Financial Development: A Statistical View from the FSAP Program" (Ize, Pardo, and Zekri), 2008.

Table 5. FSAP Recommendations by Sector

(*Percentage of overall sector coverage*)

	2002–2004	2005–2007
Banking	42.8	42.6
Insurance	19.2	16.5
Pensions	7.2	9.5
Microfinance	4.8	5.5
Other NBFIs	4.9	4.7
Capital Markets	10.7	9.0
Global Oversight	10.5	12.1

Source: "The Process of Financial Development: A Statistical View from the FSAP Program" (Ize, Pardo, and Zekri), 2008.

26. **The rate at which countries implemented the recommendations in infrastructure, oversight, and public policy has remained relatively constant around 60 percent** (Table 6). In the banking sector, implementation has mainly consisted of increasing bank minimum capital requirements, issuing and implementing loan classification systems, strengthening valuation methodologies for loans and collateral, and introducing regulation on internal controls. The greatest progress was achieved in modernizing legal frameworks for banking, helped in large part by the push in European Union (EU) candidate countries to adopt EU standards. In the payments area, central banks have also implemented the majority of the measures recommended by assessors. Less progress is evident in the supervision and regulation of other sectors of the financial system and on tax, bankruptcy, collateral, and judiciary issues.

The FSAP and the recent crisis

27. **The recent financial crisis was a major test for the FSAP** (see separate background paper). Encouragingly, many of the most vulnerable countries participated, and the program was successful in identifying measures that helped mitigate some of the consequences of the global crisis, especially in emerging economies. In most cases, FSAPs identified correctly the main sources of risk. As the crisis unfolded, FSAP teams were also able to adapt the scope of their assessments to increase the focus on critical issues such as crisis management, liquidity risks, cross-border issues, and cross-sectoral issues.

Table 6. Implementation of FSAP Recommendations by Topic

Recommendations Classified by Topic	Number of Recommendations in the Aide-Mémoire	Percentage of Recommendations Reported as PI or FI 1/ (percent)
A. Infrastructure	**66**	**59**
a. Contractual (insolvency, creditor rights, judiciary)	24	33
b. Informational (accounting, auditing, rating, registries)	12	71
c. Transactional (trading, payment)	27	74
d. Corporate Governance	3	83
B. Oversight	**212**	**60**
a. Prudential	194	61
b. Market performance and integrity (incl. AML/CFT)	18	56
C. Public Policy	**80**	**59**
a. General Enabling Policies (monetary, public debt, tax)	54	57
b. Financial Promotion Policies (public banks, SMEs, housing, etc.)	26	63

Source: World Bank FSAP Management Unit's Database and staff estimates.
1/ PI = Partially implemented; FI = Fully implemented. Percent scores are the average of all FI and half of the PI ratings divided by the total number of ratings in that category.

28. **The study also highlighted the limitations of the FSAP in reducing the likelihood of crises and mitigating their consequences**. In particular:

- The voluntary nature of the FSAP limited the scope for covering countries that might have benefited from an assessment but had not expressed interest. As a result, some systemically important countries had had initial assessments but no update for some time, and a few had not been assessed at all. Resource constraints at both the Fund and the Bank restricted the number of assessments that could be undertaken and limited the frequency of assessments for any given country, even where specific risks had been previously identified.

- The stress tests undertaken were not always able to capture the right risks and exposures. In some cases, the estimated shocks and impact were not sufficiently severe. Sometimes, this reflected the sensitivity of the issues to national authorities; in other cases, it was attributable to shortcomings in the stress tests themselves, for instance when they failed to provide a strong enough test of resilience, to recognize cross-border implications, or to reflect the risk of contagion from abroad.

- One of the FSAP's primary objectives is the assessment of the stability of the financial system as a whole. Therefore, FSAPs have often not focused on individual institutions' vulnerabilities, which can pose risks to the entire system. In some of the pre-crisis countries, greater attention to individual institutions might have uncovered some of vulnerabilities that led to, or facilitated the transmission of the current crisis.

- The assessments centered mostly on home-grown vulnerabilities, even when external factors were considered in stress-testing scenarios. They rarely assessed vulnerabilities originating in other countries or the possible implications of a global crisis.

- The FSAP's focus on identifying underlying vulnerabilities could not, by itself, address them. Identification of vulnerabilities could only lead to a solution if the country authorities decided to implement the recommendations of the FSAP. The study identified a number of cases where the FSAP correctly identified vulnerabilities but no action was taken to forestall the crisis.

Publication and dissemination

29. **FSAPs produce different documents for different audiences, whose dissemination is governed by well-established rules of each institution**. The Aide-Mémoire, produced by the team in the field and revised at headquarters based on the authorities' and peer reviews, is intended for the country authorities, and is not published. Technical Notes, which contain background information or the analysis underlying the Aide-Mémoire, may be published with the authorities' consent. Publication of the two Board documents (the FSA and the FSSA) is governed by each institution's publication policy. Under the Bank's disclosure policy, the FSA

is a country document that requires the authorities' prior agreement before distribution to the Board and publication via the Bank's eBoard. For the Fund, publication of the FSSA and the ROSCs is voluntary. In contrast to Article IV consultation reports, however, there is no presumption of publication. ROSCs may be published even if the FSSA is not published, but not vice versa.

30. **Publication rates are high, with the proportion of FSSAs published generally higher than that for FSAs** (Table 7). This is attributable to the fact that FSSAs include a higher proportion of advanced economies (whose FSAPs are conducted by the Fund alone), which on average tend to publish more of their country documents than emerging and low-income countries.[4] The percentage of Technical Notes published has risen, but this reflects partly the fact that fewer Notes are being prepared with each FSAP update as part of the streamlining and cost reduction effort. The website statistics show that visits to the Fund's external FSAP website have increased by 34 percent since the onset of the crisis (October 2007), with peaks around the Spring and Annual meetings.[5]

Table 7. Publication Trends

(Published documents as a percentage of issued documents)

	2001	2002	2003	2004	2005	2006	2007	2008
FSSAs	65	63	68	74	71	81	61	59
FSAs	50	42	67	64	55	43	33	62
ROSCs	0	0	5	17	50	65	35	74

Source: World Bank and IMF FSAP Databases.

C. Standards Assessments and the FSAP

31. **Detailed assessments of compliance with Standards and Codes have been closely associated with the FSAP** (Table 8). The assessments are essentially an evaluation of a country's regulatory and financial policies and provide ratings against international Standards and Codes developed by the relevant standard-setting bodies. Though not a necessary component of the FSAP, in practice most financial sector standards assessments take place in

[4] The IMF paper "Key Trends in the Implementation of the Fund's Transparency Policy" (http://www.imf.org/external/np/pp/eng/2008/013108.pdf) reports that, while advanced economies publish nearly all their country reports, developing countries publish around 87 percent and while emerging markets around 82 percent.

[5] Data refer to external visits only, excluding visits by Fund staff.

the context of FSAP missions. To complete the assessments, the Bank and the Fund rely on both staff and external experts, particularly from cooperating agencies.[6]

32. **Standards assessments have become more costly, and the average number of ROSCs associated with FSAPs has declined over time**. Standard-setters have been continually updating assessment methodologies, and this process has intensified since the onset of the financial crisis.[7] This has increased the resource cost of full standards assessments and, combined with the resource constraints of the Bank and the Fund, has led to a decline in the number of full standards assessments in FSAPs: the average number of ROSCs has decreased from about five at the height of the first round of FSAPs to around one in FY09 for initial FSAP assessments and less than one for updates (Table 9). Standards-related work continues to be important, but has been increasingly focused in certain areas only—typically those where compliance in the original assessment had been found lacking—and is now often summarized in Technical Notes rather than ROSCs.

33. **Resource constraints also affect the quality of the standards assessments.** An internal Bank-Fund review of the quality and consistency of standards assessments conducted in 2006 identified several weaknesses, including insufficient attention to the actual implementation of the principles by regulatory regimes. The study covered the BCP, IAIS, IOSCO, and FATF's AML/CFT standards and found that, because of time constraints, assessors devoted more time to ensuring formal compliance with the various standards (with a focus on adoption of the required laws, regulations, supervisory policies, and systems) and less to reviewing actual implementation. This trend is likely to be exacerbated by the increasing complexity in financial standards and assessment methodologies.

D. The Views of Country Authorities

34. **In preparation for this review, the Bank and the Fund conducted a survey of country authorities that have participated in the FSAP during the last 10 years** (see separate background document). About 60 countries responded. Their responses complement the evidence presented in the previous sections and the staffs' own views, thus providing a useful perspective to the findings of this review.

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[6] Typically, two banking supervisors ("four eyes" principle) perform the Basel Core Principles assessment. For the securities and other assessments, the FSAP relies on the relevant standard-setter when Fund and Bank staff are not available. Approximately 140 official agencies have provided experts to the FSAP.

[7] For instance, in 2008, the Basel Committee on Banking Supervision announced a comprehensive strategy aimed at reflecting the lessons from the crisis for the regulation, supervision, and risk management of internationally active banks. The changes aim to promote more rigorous supervision and risk management and to focus more squarely on issues such as excessive risk concentration, reputation, funding liquidity risks, and the valuation of financial instruments.

Table 8. Financial Standards Assessments Completed and Underway
(as of end-December 2008)

Standards Assessed	Completed	Underway
Monetary and Fiscal Policy Transparency	98	1
Banking Supervision	152	9
Securities Regulation	71	2
Insurance Supervision	63	3
Payment Systems	88	2
AML/CTF	72	45
Accounting and Auditing	85	15
Corporate Governance	64	7
Insolvency and Creditor Rights	37	11
Total	730	95

Source: World Bank and IMF ROSC and FSAP Databases.

Table 9. Average Number of Standards Assessments Conducted During FSAP Missions

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Initial assessments	4.1	4.4	4.9	3.9	2.9	2.6	3.0	2.7	1.0
Updates	…	…	…	1.0	0.8	0.3	1.0	1.0	1.0

Source: World Bank and IMF ROSC and FSAP Databases.
Note: Excludes ROSCs undertaken outside FSAP missions.

- ***The survey indicated that countries value the FSAP as an independent assessment of their country's financial sector vulnerabilities and needs***. They found that FSAPs have deepened the discussion of financial sector issues in Article IV consultations and helped formulate a better development agenda. The most appreciated elements of the program were the assessments of financial sector regulatory frameworks and supervisory practices and of financial system stability. The integrated analysis of the financial sector also was highly valued. Regarding analytical components, the assessment of compliance with Standards and Codes, along with stress testing and system level risk modeling were viewed positively by most respondents.

- ***Respondents thought that the FSAP recommendations had been sufficiently clear and candid.*** Of the total number of respondents, almost 90 percent viewed the recommendations as clear and over 80 percent saw them as candid. Where recommendations were not implemented, the most commonly-cited reason was disagreement with specific recommendations. Other reasons included insufficient political support or resources to implement the recommendations.

- ***Around 70 percent considered that the FSAP should continue to be voluntary***. At the same time, they emphasized that the frequency of assessments should be primarily based on the systemic importance of the country. They stressed the need to ensure coverage of the remaining systemically important member countries.

- ***Respondents suggested several areas that require more attention***. Crisis prevention, crisis resolution, and cross-border and regional issues seem to be important preoccupations, as is the integration of the FSAP with other Bank and Fund financial sector work. Respondents stressed the need for future FSAPs to be better adapted to country circumstances, both in terms of the scope of each assessment, and with respect to the team members' knowledge of the country. Several respondents called for greater TA support to ensure that country authorities can assess more independently their own financial sectors, and greater assistance with follow-up actions.

E. The FSAP and Fund Surveillance

35. **Although the FSAP has the potential to provide useful input into Article IV surveillance, it has limitations**. The FSAP was never conceived as a surveillance instrument, and some of its key characteristics limit its versatility in this regard. Its voluntary nature and its status as a joint program with the Bank, notwithstanding their considerable benefits, constrain the scope for prioritization and mean that the assessments are not legally part of the Article IV process. Also, the current requirement that assessments be relatively comprehensive, combined with resource constraints at the Fund, means that FSAP updates take long to prepare and are infrequent. The long time gap between FSAP updates is a major handicap for the analysis of financial sector vulnerabilities and macro-financial linkages, which are the key concerns of the Fund's macrofinancial surveillance.

36. **In addition, the relationship between the FSAP and the Fund's Article IV consultation process implies difficult resource tradeoffs**.

- The Article IV consultation is the main vehicle for *all* bilateral surveillance, but it receives critical support from the FSAP, which provides a more in-depth, but much less frequent, assessment of financial stability. There is, however, a tradeoff between the deployment of financial sector expertise in the Fund for Article IV support, FSAP assessments, as well as support of Fund programs, capacity-building, multilateral surveillance, and methodological development.

- The 2008 *Triennial Surveillance Review* stressed the need to "deploy financial sector expertise strategically, using a risk-based approach, and prioritizing according to the criteria of systemic or regional importance, importance of vulnerabilities, and importance of financial development issues for present or prospective macroeconomic or external stability." However, unlike the Article IV consultation, participation in the FSAP is voluntary. Therefore, the Fund is not always able to direct FSAP resources where the financial sector stability needs are most urgent, and pressure from the Bank to meet FSAP requests from countries where financial development needs are paramount may occasionally require difficult compromises.

F. The FSAP and Bank Support to Financial Sector Development

37. **The FSAP is recognized as a useful instrument for identifying financial sector needs to develop diverse and competitive financial sectors**. The two major reviews undertaken by the independent evaluation offices of the Bank and the Fund and the FSAP stocktaking project (2008) concluded that, in general, the program serves to inform national authorities of emerging problems in their financial systems. It also helps to expand technical capabilities in participating countries and to enhance the understanding of issues, along with the awareness of financial sector vulnerabilities. It provides a valuable independent external assessment of countries' financial systems, encouraging governments to embark on financial sector reforms, and has also provided support to the authorities' policy discussions, including with the legislature and the private sector.

38. **However, follow up on the implementation of FSAP recommendations is uneven across countries**. While the FSAP/ROSC diagnostic tools are used widely in client countries, the coverage of financial sector issues in CASs has been uneven and mostly shallow.[8] A monitoring and evaluation study on the financial sector[9] confirmed that the FSAP and ROSC recommendations remain underutilized in CASs. The absence of financial sector coverage in CASs does not necessarily limit the Bank's capacity to provide assistance in that sector, but this appears to have been the case. Table 10 shows, for projects labeled as "FSAP follow-up," a decrease in the ratio of Bank budget-funded projects to the number of FSAPs since 2004, and diminishing budgetary allocations for FSAP follow-up projects. Beyond financing support, the availability of funding from CMUs plays a crucial role in deepening the dialogue between the Bank and the authorities. It also helps leverage other funds, such as the FIRST Initiative or funds from other donors.

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[8] A review of 38 CASs in FY07-FY08 found that fewer than half contained a comprehensive discussion on the financial sector; the discussion of key financial sector issues is frequently relegated to annexes and not highlighted in the main text.

[9] In 2008, the Bank undertook a study on how to build a results management or monitoring and evaluation framework for the financial sector. Drawing on CASs, the study examined diagnostic and analytical work, as well as lending during FY 2004-08, and proposed a set of comprehensive actions, including the need to (i) enhance the role of the financial sector in CASs (including better use of diagnostic work and financial indicators); and (ii) track more effectively the implementation of FSAP and ROSC recommendations.

Table 10. Bank Budget Support to Post-FSAP Follow-Up Work, FY04–08

FY	Number of Countries for which Bank budget was Made Available	Number of FSAP Assessments	Ratio of Follow-Up Bank budget funded projects to FSAPs (in percent)	Average Value of Initial Bank budget allocation (in $1000)
2004	16	18	89	67,400
2005	7	15	47	48,600
2006	6	15	40	52,900
2007	4	19	21	40,500
2008	6	21	29	41,700

Source: Bank staff estimates.

39. **Successful follow-up depends on the motivation for reform and the country's capability to deliver it**. The FSAP and the ROSC programs have elements of both assessment and advisory work. Successful implementation depends critically on the motivation and capacity of country counterparts and on the political economy context. Motivation factors vary widely, including (e.g., in EU accession countries) peer pressure. And reforms can meet the resistance of vested interests intent on maintaining the status quo.

III. THE NEXT TEN YEARS

A. Old Challenges, New Demands

40. **This FSAP review will need to take into account a range of trends that have been shaping the financial sector environment for some time**.

- ***National financial systems are increasingly important for economic growth and macroeconomic stability***. Financial sectors represent much larger shares of domestic activity. As the recent crisis has illustrated, macro-financial linkages are dense and complex; household and corporate indebtedness may seriously affect financial sector risks, in addition to government indebtedness; and issues of access to financial services and consumer protection have become central to the policy agenda in developing countries.

- ***Financial systems are increasingly sophisticated and integrated across borders***. This change is especially apparent in emerging markets, but cross-border issues, including the possibility of contagion and supervisory cooperation, have become more important in all countries.

41. **At the same time, several of the recommendations of the last FSAP review and subsequent program evaluations remain unfinished business**. As the previous Chapter showed (see Box 1 above), open issues include:

- within the joint and collaborative framework of the program and FSLC, the need for ***greater flexibility in the scope of assessments,*** particularly updates;

- the call to ***deepen and strengthen the analytical toolkit***;

- the need to ***streamline further and contain the costs of the program***, especially FSAP updates; and

- the need to ***integrate the findings of FSAPs more closely with Fund surveillance***, a need that has been emphatically underscored by the G20 and the IMFC following the recent financial crisis, ***as well as with the Bank's financial sector work***.

42. **Last but not least, the recent financial crisis is changing profoundly the environment in which the Bank and the Fund operate and places new demands on the FSAP**. *First*, FSAP assessments will have to incorporate the lessons from the crisis. In some cases, this is just a matter of placing greater emphasis on certain topics that are already covered under the FSAP, such as crisis management; but in others, it requires expanding the scope and changing the modalities of the program. *Second*, in the wake of the crisis, institutions such as the FSB, the G20, and the financial standard-setters are becoming increasingly important, setting the policy agenda at the global level and engaging bilaterally with member countries' financial authorities.

43. **Although the lessons from the crisis are still crystallizing, it is already clear that they will affect the FSAP program in at least four areas**. Some of these lessons have already been incorporated in FSAP assessments that have taken place since the onset of the crisis; for others, further work is needed—in cooperation with other stakeholders—to formulate an adequate response.

- ***Greater emphasis on crisis preparedness and crisis management frameworks and exit strategies***. Although crisis preparedness has always been assessed as part of an FSAP, the crisis has highlighted the need to sharpen the focus and deepen the dialogue with the authorities on this issue in almost all countries. Future FSAPs assessment—like the ones that have taken place in the last year or two—will pay greater attention to central bank liquidity management frameworks, lender-of-last-resort arrangements, stress testing and scenario analysis capabilities of the supervisors, cross-agency coordination arrangements, bank resolution frameworks and tools, and frameworks for debt enforcement and restructuring and corporate insolvency. They would also have to focus on the need for an orderly and coordinated approach to unwinding the unprecedented policy interventions undertaken by countries during the crisis, such as blanket deposit guarantees and other forms of assistance to troubled financial institutions.

- ***Exploring cross-border linkages***. The FSAP is and will remain essentially an assessment tool for individual country financial sectors and a vehicle for policy dialogue with national authorities, just like the Fund's Article IV consultation. Within this bilateral context, however, the recent crisis has underscored the need to examine more closely cross-border aspects of financial sectors, in particular (i) financial linkages, such as ownership patterns, financing flows, or market links that propagate and amplify the transmission of financial shocks; and (ii) supervisory cooperation arrangements that mitigate these risks. While the latter has for some time been part of the traditional FSAP coverage, more effort needs to be made on both issues.

- ***Developing assessment methodologies for macroprudential risks***. The financial crisis has illustrated how macro-prudential and micro-prudential factors can interact to contribute to market excesses and financial instability. It has also illustrated that risks to financial stability stem not just from illiquidity or insolvency of large financial institutions, but also from the interdependence and interconnectedness between financial institutions and markets. This has brought home the need to expand the FSAP to cover not just micro-prudential supervision and issues, but also to develop new tools and methodologies to enable assessments of macroprudential vulnerabilities and to correspondingly enrich the policy dialogue with authorities on these issues.

- ***Incorporating the lessons being distilled in the area of supervision and regulation of financial institutions***. The crisis has exposed the pitfalls of regulating tightly only deposit-taking institutions, relying excessively on market discipline for prudential purposes, and using procyclical regulatory practices. As a result, standard-setters and national authorities are now re-examining the appropriate perimeter of regulation; the scope for differentiated layers of oversight; requirements for governance, risk management, and disclosure that would directly affect incentives within financial institutions; rules to reduce conflict of interest at rating agencies; and introducing countercyclical capital buffers. As these changes crystallize into formal standards or best practices, they will have to be incorporated into FSAP assessments.

44. **These new demands on the FSAP have to be balanced against abiding needs of member countries…** While the current financial crisis and its implications are attracting most of the attention, the FSAP should not lose sight of enduring financial sector needs of member countries, particularly in the developing world. Many of these developmental financial sector challenges were present before the crisis and will continue long after its impact has passed. In re-setting priorities for the program, the Bank and the Fund should continue to pay due regard to these issues.

45. **… and, at the same time, contend with the reality of available resources**. While expectations are multiplying, resources in both institutions, unless increased, are unlikely to keep pace with new demands for financial sector work. Systemic importance already is one of the criteria used by the Bank and the Fund to prioritize assessments, once these are requested by the member countries. This criterion will henceforth become much more prominent, especially for the Fund. It will inform not only the response to individual requests (whether

and when to conduct an assessment) but also the amount of resources that each institution would dedicate to the assessment. Given the current resource envelope, this implies that, at the Fund, FSAP assessments in non-systemically important countries—including low-income countries—would be given lower priority and fewer resources than those in systemically important countries.

B. An FSAP for the Next Decade

46. **Against this background, the proposed changes to the FSAP have three overarching goals**.

- ***Make the program more flexible and better aligned with country needs, as well as the Bank's and the Fund's financial sector priorities and core responsibilities***. This requires *inter alia*, improving the targeting and timeliness of the outputs; clarifying the relationship of FSAP to other financial sector work in the Bank and the Fund; and simplifying and accelerating internal processes. These efforts would be underpinned by strengthened analytics and continued close coordination of Bank and Fund staff. This is critical for allocating scarce resources in line with a sharper systemic focus —especially at the Fund—and for balancing the new demands on the program with the mandate to serve the entire membership.

- ***Enhance the quality, candor, and comparability of assessments***. This entails developing further tools and methodologies for assessing both the stability and the developmental aspects of financial sectors and their linkages to the rest of the economy; and tackling the new analytical challenges posed by the crisis in the areas of stability analysis, macroprudential risk assessment, and cross-border linkages.

- ***Integrate the FSAP analysis and results into the institutions' evolving mandates***. The key objective for the Fund is to integrate FSAP assessments more closely with surveillance. This would require changes both to the FSAP program and to the conduct of Article IV consultations. For the Bank, the priority is to integrate effectively financial sector analysis and recommendations for reform stemming from the FSAP in the CASs and other financial sector work.

47. **The point of departure in reshaping the FSAP is to preserve and capitalize on the successes and wide acceptance of the program among the membership**. To achieve this, two key aspects of the program are proposed to remain the same.

- ***First, the FSAP would remain a joint Bank-Fund program in developing and emerging market countries (FSAPs in advanced economies would continue to be the sole responsibility of the Fund)***. The joint nature confers important benefits in terms of combining complementary resources, skills, and viewpoints, albeit at some cost in terms of coordinating the internal processes of the Bank and the Fund. At the same time, it complicates the integration of FSAP assessments into Fund surveillance. The increased flexibility within the joint framework described below would provide greater clarity on each institution's distinct contribution while reinforcing the benefits of the joint program.

- ***Second, participation in the FSAP would continue to be voluntary for members***. Since initial assessments have been conducted for most of the membership and—on the basis of the G20 commitment—will soon have been completed for all systemically important countries, the voluntary nature of the program does not leave major gaps in global coverage. Still, it complicates the prioritization of assessments and does not allow the Bank and the Fund to allocate resources where vulnerabilities are most urgent unless the authorities request it. It is also a major obstacle for the integration of the FSAP assessments into the Fund's surveillance.[10] That said, voluntary participation increases ownership by the authorities, as also indicated by the results of the survey of participating countries' views (see Section II.D above and background document). On the assumption that, following the initial assessment, countries undergo FSAP updates regularly, this benefit arguably offsets the costs of voluntary participation. Prioritization of country requests will continue to be based on the criteria established by past Board reviews of the program (see Section II.A).

48. **Beyond these key aspects of the program, staff are proposing a set of complementary changes concentrated in three areas**: (i) sharpening the focus of individual assessments and clarifying the institutional responsibilities of the Fund and the Bank; (ii) making the FSAP more flexible, responsive, and continuous; and (iii) strengthening the analytical content and making assessments more rigorous, candid, and transparent, with a pronounced thematic/regional perspective.

49. **To support these changes, adjustments are also needed in two other areas**: (i) making standards assessments more flexible and targeted; and (ii) improving the management of the joint program, notably through strengthening FSLC and streamlining internal processes.

50. **The experience with the proposed innovations will be subject to an early review by staff and Management**. Given the extent of some of the proposed changes, the operation of the program will be monitored closely and the experience reviewed by staff and Management of the two institutions within two years.

Sharper focus, clear delineation of institutional contributions

51. **FSAPs have always encompassed assessments of both financial sector stability and developmental needs**. As discussed in Chapter II, this has indeed been one of the

[10] As noted above, for the Fund FSAPs are legally a form of technical assistance that is performed at the request of the member. It would be possible for the Fund to make the FSAP exercise a mandatory part of the surveillance process under Article IV, but this would require a number of changes to the Fund's policy framework for surveillance and to Bank policies that would need to be adopted by Executive Board decisions.

strengths of the program: a "holistic" view of the financial sector, benefiting from the comparative advantage and expertise of both institutions, as well as the presence of external assessors, who are often included in the FSAP teams.

52. **Stability and developmental assessments provide distinct and complementary perspectives on the financial sector**. To be sure, the distinction between financial sector "stability" and "development" issues is not clear-cut and differs from country to country; and their sectoral coverage (banking, insurance, pensions, payments systems, etc.) often overlap. Nevertheless, these two distinct perspectives are not always equally important or topical in every country undergoing an assessment. Also—and crucially—the time horizon over which each of these perspectives applies is different: the stability assessment focuses on the near-term horizon, while the developmental assessment is anchored around medium-term issues. Notwithstanding the inevitable areas of overlap, clarifying each institution's principal contribution to the joint program will help make the FSAP more flexible, ensure institutional accountability, and strengthen systemic focus in the allocation of the Bank's and the Fund's resources. It is also a prerequisite for closer integration of the FSAP with IMF surveillance and the Bank's other financial sector work.

53. **Financial stability assessment in the context of an FSAP—the primary responsibility of the Fund—will comprise three elements**: an evaluation of the main risks to macro-financial stability and their potential impact; an assessment of the country's financial stability policy framework; and an assessment of the authorities' capacity to manage and resolve a financial crisis. These assessments would be focused on the near term (1–3 years). These elements would be the core of the Fund's contribution to the joint program, and would in all cases be summarized in an FSSA, which would remain the key FSAP input into IMF surveillance. If needed, they could be accompanied by ROSCs. Box 3 outlines in more detail the content of each of these three elements.

54. **The sectoral coverage of stability assessments would vary according to country circumstances**. It is expected that in all cases the assessment would cover the banking sector, but other sectors (securities, pensions, insurance) or aspects of the financial system (legal framework, payments system) could be covered if (i) they are sources of risks to financial stability, or (ii) their structure or operation impinges on the authorities' crisis management and resolution capabilities.

55. **The financial development assessment in the context of the FSAP—the primary responsibility of the Bank—will cut across different sectors and topics, according to country circumstances** (Box 4). The key output of a "developmental assessment" would be the Aide-Mémoire (AM) delivered to the authorities at the end of the field work and the FSA delivered for information to the Board. The AM will be complemented by technical notes and ROSCs as necessary.

Box 3. The Core Elements of the Stability Assessment

At a minimum, a stability assessment would include three components.

- ***An evaluation of the source, probability, and potential impact of the main risks to macro-financial stability in the near-term***. This involves analyzing the structure and soundness of the financial system; salient trends in both the financial and non-financial sectors; risk transmission channels (macro-financial linkages, cross-border effects, and feedback loops); and features of the overall policy framework that may attenuate or amplify financial stability risks (e.g., exchange rate regime). Both quantitative analysis (Financial Soundness Indicators (FSIs), stress tests) and qualitative assessments would be used to estimate the severity of risks and rank them according to the likelihood of occurrence and the potential impact on financial stability.

- ***An assessment of the country's financial stability policy framework***. This involves an evaluation of the effectiveness of financial sector supervision; the quality of financial stability analysis and reports; the role of and coordination between the various institutions involved in financial stability policy (with special emphasis on the central bank); and the effectiveness of monetary policy.

- ***An assessment of the authorities' capacity to manage and resolve a financial crisis should the risks materialize.*** This involves an overview of the country's liquidity management framework (instruments, collateral policies); financial safety nets (deposit insurance, lender-of-last-resort arrangements); crisis preparedness and crisis resolution frameworks (bank resolution); and the possible spillovers from the financial sector onto the sovereign balance sheet.

To preserve the integrity of the program, these three elements would be the minimum required for a stability assessment in the context of the FSAP. All three elements are required for a well-rounded assessment of near-term financial vulnerabilities, and would be expected to be covered in all FSSAs. To be sure, focused missions by specialist staff—either as part of Article IV surveillance or technical assistance—could cover some of these elements (e.g., stress testing, institutional structure of financial supervision, central bank liquidity management, etc.), as at present. But unless all three elements are covered, these focused missions will not be done under the FSAP (though their findings could, of course, be an input to future stability assessments) and will not generate an FSSA. Of course, stability assessments in individual cases could cover additional areas, if needed, and could also be accompanied by detailed assessments of compliance with Standards and Codes.

56. **As with the stability assessments, the sectoral coverage of developmental assessments would also vary**. They would cover all sectors that are currently or potentially important for growth and development (e.g., banking, securities, pensions and insurance), with a particular emphasis on the structural or policy-related impediments that hold back the contribution of the financial system to economic growth and development. In developing countries, in particular, these aspects also have important implications for financial sector soundness.

57. **Developmental assessments play a particularly critical role in low-income countries (LICs)**. For many LICs, shallow financial markets and limited access to financial services constrain growth and can exacerbate poverty. These impediments also make these markets less resilient to shocks and constrain the ability of authorities to undertake countercyclical policies. Thinness of markets limits financial institutions' ability to manage

portfolios, leaving them vulnerable to shocks. More generally, the lack of reliable and comprehensive data coverage in most LICs hinders analysis and benchmarking.

Box 4. Elements of the Development Assessment

Developmental assessments would tend to focus on the medium- to long-term needs for the deepening and strengthening of the financial sector, addressing major weaknesses affecting the sector's efficiency, soundness, and contribution to long-term growth and social development. They will encompass a combination, based on the relevance of each topic for the country assessed, of some of the following elements:

- ***An assessment and identification of development needs for the financial sector infrastructure, that includes***: (i) a set of rules regarding property rights, including those governing proprietary security; (ii) general rules on corporate governance; (iii) a basic framework to collect, organize, store and communicate information; and (iv) an infrastructure to facilitate the trading and settlement of contracts.

- ***An evaluation of financial sector oversight to ensure that***: (i) financial systems remain sound; (ii) financial intermediation becomes as competitive and efficient as possible; and (iii) consumers are adequately protected and markets retain their integrity.

- ***An assessment of public policy that can affect financial sector activity by***: (i) managing general enabling policies that have an important bearing on financial development; or (ii) by managing public financial institutions or seeking to influence the activities of private financial intermediaries through targeted financial promotion policies.

- ***An assessment of the impact of an underdeveloped financial sector on financial stability in low-income countries***, and identification of the long-term financial sector reforms that would enhance the capacity of the financial sector and the economy as a whole to absorb shocks and improve the effectiveness of economic policies.

Development assessments could also be accompanied by detailed assessments of compliance with Standards and Codes.

Flexibility, responsiveness, systemic focus, and continuity

58. **The limited progress toward streamlining and focusing FSAP updates since the last review has resulted in long lags between updates**. One difficulty has been the expectation that FSAP updates would be comprehensive in all cases, regardless of country circumstances. This has resulted in updates that often were less focused and more cumbersome than they could be. Large teams and long lead-times, combined with the tightening resource constraints—especially at the Fund—have kept the average time lag between updates to about six years. Although this was consistent with the directions given by the last Board review,[11]

[11] The Board had concluded at the time of the last review that "an average frequency of FSAP updates of about five years seems reasonable" (http://www.imf.org/external/np/sec/pn/2005/pn0547.htm).

the experience of the recent financial crisis has shown that long lags between updates, especially for the stability assessment component, weaken the effectiveness of the FSAP. [12]

59. **"Modular" FSAP updates would introduce a degree of flexibility and continuity in the program**. The modular approach would essentially introduce the option, under FSLC guidance, to conduct an FSAP update through separate, smaller, more focused missions concentrating on stability or developmental needs, with the Fund and Bank taking the lead respectively. This option would eliminate the rigidity inherent in the current "one-size-update-fits-all" approach and allow both institutions to respond more flexibly to country circumstances—as well as their own priorities—without abandoning the joint nature of the program. By allowing greater flexibility with respect to the scope and focus of updates, it would facilitate a more strategic focus in allocating scarce resources among countries requesting updates. Last but not least, the option for modules would facilitate an increase in the frequency of stability assessments when necessary, as frequently as every 3-4 years for systemically important and vulnerable countries, provided there is demand and subject to resources. Box 5 illustrates how the modular approach would work.

60. **Risk-focused ROSCs would also enhance the flexibility and transparency of the program**. At present, ROSCs—be they initial assessments or updates—must be based on a comprehensive detailed assessment of all principles. As Chapter II documented, this has resulted in the number of ROSCs declining from almost five per initial FSAP in the early years to about one now. Instead, staff is producing more focused Technical Notes on selected principles, which are arguably less effective (full ROSCs have been found to spur authorities to take remedial action) and less transparent (Technical Notes are not, as a rule, issued to the Board). The proposal thus is to modify the existing requirement so that, following the initial comprehensive assessment, staff could have the option to undertake a risk-focused partial ROSC update.[13] This proposal is developed in detail in a separate paper (*Revised Approach to Financial Sector Standards Assessments in FSAP Updates*), which describes the basis on which the principles that would be re-assessed in a partial ROSC would be determined.

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[12] The accompanying background paper shows that, in the recent crisis, the more dated the FSAP assessment, the less accurate the diagnosis of financial vulnerabilities and the less apt the policy recommendations on how to address them.

[13] This option would not apply to AML/CFT standards, which would continue to be assessed in their entirety. Moreover, initial FSAPs and full FSAP updates would continue to incorporate a full AML/CFT assessment, consistent with existing IMF Board guidance (see http://www.imf.org/external/np/sec/pn/2006/pn0672.htm which also provides for flexibility in the timing of the AML/CFT assessment). When FSAP modules are conducted separately in-between "full" updates, on the other hand, it may or may not be appropriate or necessary to incorporate a full AML/CFT assessment. The relationship of AML/CFT assessments to the FSAP program more broadly will be addressed in a forthcoming Board paper on the AML/CFT program.

Box 5. The Option for FSAP Modules

The modular option introduces flexibility in the choice of vehicles for FSAP updates. The standard, joint Bank-Fund assessment mission would remain the norm for initial assessments and for "full" updates in developing and emerging market countries (and similarly, the standard Fund-only mission in advanced countries). This reflects the overlap between stability and development issues and the recognition that the distinction between them is not always clear-cut. But when, for example, a rapid update of the stability assessment is required for surveillance purposes or requested by the authorities, the Fund would lead a stand-alone stability assessment, focused on the core topics outlined in the previous section (Box 3). Similarly, when it is important for the reform process or requested by the authorities, a Bank-led development module could conduct stand-alone, focused assessments of developmental needs (Box 4). Although each institution would take the lead for its module, staff from both institutions would normally participate in both.

The modular approach would allow scheduling and tailoring the modules more closely to the needs of the country and to each institution's priorities and resources. The output of a Fund-led stability module would in all cases be an FSSA, just as with the joint "full" FSAP update missions. The output of a Bank-led development module would be an Aide-Mémoire left with the authorities at the end of the mission, and technical notes, ROSCs, and an FSA, as appropriate. The output of separate modules would be shared between (and reviewed by) the staff of the two institutions.

Modules would complement but not replace the "full" FSAP updates. A "full" update would still require both stability and development perspectives to provide a "holistic" view of the country financial sector, while tailored to country circumstances; but modules would provide the flexibility to address specific country needs and circumstances between full updates. To preserve the FSAP brand, the outputs of the stability and development modules (Aide-Mémoire and FSSA/FSA), when conducted separately, would be clearly labeled as such. Joint "full" FSAP update missions would still be undertaken periodically, as at present. Their frequency would depend on country circumstances and the systemic prioritization of allocating Bank and Fund FSAP resources.

Strengthened mechanisms for quality control and inter-institutional coordination would be a crucial part of the modules. A number of reforms, discussed in more detail in the following sections, would ensure the continued integrity of the FSAP product. These include (i) a more systematic prioritization exercise; (ii) an upgraded role for FSLC in deciding the modalities of FSAP updates (joint "full" update missions or modular assessments) taking into account the authorities' preferences, country circumstances, and the need to ensure that both stability and developmental aspects of the financial sector are appropriately covered over time; and (iii) enhanced off-site financial sector monitoring by both institutions.

61. **Enhanced off-site monitoring and analysis would improve the continuity of monitoring and policy dialogue**. Combined with the option for modular assessments, it would help plug the gaps that the current model leaves in financial sector surveillance, highlighted by the experience with the recent crisis (see background document). Two recently-launched Bank and Fund initiatives are first steps in this direction.

- ***FSI databases***. During the recent crisis, the standard FSIs that were used in surveillance did not provide sufficiently early warning of the turmoil. MCM is revising the list of core and encouraged FSIs for commercial banks, expanding them to include systemically important nonbank financial institutions, and broadening their coverage of sectoral risk exposures (e.g., to cover CDS spreads, distance to default, size of ABS markets and performance of MBS/ABS securities). Work is also underway to develop FSIs for non-financial corporations and households. In addition, the Bank is expanding the range of development and business indicators for the financial sector.

- ***FSAP recommendations database***. The Bank has compiled a database of FSAP recommendations since the start of the program as part of its stock-taking exercise. Recommendations were classified based on the grid described in Appendix II. This effort will now be continued, with the maintenance of a permanent database of FSAP recommendations; and enhanced, with the introduction of a tool to measure the degree of implementation. This would allow a more systematic follow-up of the implementation of FSAP recommendations, provide greater continuity, and help anchor the FSAP more effectively in the other financial sector work of the Bank and the Fund. It would also help reduce somewhat resource demands on mission teams.

These initiatives notwithstanding, increased off-site monitoring and analysis are neither easy nor costless. They have implications for staffing and may require a careful look at organizational aspects in both institutions.

62. **The incorporation of offshore financial center (OFC) assessments into the FSAP has also helped streamline and facilitate the systemic focus of the program**. The integration of the program in the FSAP last year has enabled a more uniform and risk-based approach to financial sector surveillance and improved the coordination of Fund analysis across jurisdictions. It has also allowed a better allocation of Fund resources, focusing on those OFCs that account for the largest share of offshore activity and could pose systemic risks.

Stronger analytical content, candor, transparency, and regional/thematic perspectives

63. **Improving the analytical tools used for stability assessments in the FSAPs is a major priority**. The Fund has already invested heavily in developing more advanced quantitative models and market-based indicators for gauging financial vulnerability and its potential impact on the real economy. Since these tools are not unique to the FSAP, a fuller discussion may be found in the paper *Financial Sector Work and Bilateral Surveillance—Toward Further Integration*. These efforts will concentrate in four areas:

- ***Macro stress testing***. This includes refinements to meet bilateral surveillance needs arising from FSAP and Article IV work, including shedding greater light on macro-financial linkages and their feedback effects to the real economy. Refinements will cover the methodology itself, as well as quality control, training, and dissemination of tools within and outside the Fund.

- ***Risk modeling.*** The Fund is working to refine macro-financial models, including better integration of credit, market, and liquidity risk, and the incorporation of second-round effects in the models.

- ***High frequency monitoring and risk assessment tools, including for early warning purposes***. A variety of system-wide risk indicators are being developed to meet the expanding bilateral and multilateral financial surveillance requirements. These include daily computations of CDS spreads for major banks and insurance companies, an emerging market bond spread indicator, and an Excel-based risk management tool to assess sovereign debt-related vulnerabilities and risks. These tools will continue to be expanded and disseminated to both FSAP and Area Department teams.

- ***Contingent Claims-based Approach (CCA)***. The Fund has developed a Contingent Claims utility that facilitates calibrating risk-adjusted balance sheets for sovereign, financial, and non-financial corporate sectors. Use of this facility will now be gradually extended to advanced country and emerging market FSAPs, provided the required data are available.

64. **Stress tests in FSAPs have become more sophisticated over time, but the recent financial crisis has prompted a critical re-assessment of stress testing tools and methodologies**. Some of the stress tests performed in the run-up to the crisis missed important sources of instability, such as exposures to liquidity risk, concentration of exposures in the real estate market, and exposures to off-balance sheet vehicles. The crisis also illustrated rather dramatically the strength of contagion, both domestically and across borders. An internal Fund evaluation of how stress tests performed during the crisis, presented in a separate background document, has proposed a number of improvements in the stress testing methodologies based on this experience. Chief among them will be efforts to obtain adequate data for the tests, covering both on- and off-balance sheet exposures—which requires the full cooperation of the authorities—and, when there are gaps, communicating these, and associated simplifying assumptions, clearly; paying greater attention to the possibility of cross-border contagion and to liquidity risk; design scenarios that combine solvency risk with liquidity risk; and running stress tests regularly, and harmonizing methodologies for peer groups of countries.

65. **The crisis has also created demands for methodological development in new areas, notably the assessment of macroprudential risks**. Analytical work in this area, both in the Fund and more broadly, has gained impetus since the crisis. The emerging lessons will be distilled and used in stability assessments, in particular as regards (i) the identification and monitoring of systemic risk by developing tools to monitor large exposures (e.g., to sub-prime mortgages) across firms and markets, rather than only at the level of individual firms; focusing on the role of systemically important financial institutions; and analyzing possible spillovers between financial firms; (ii) risk management or regulatory gaps that could increase systemic risk, such as deficiencies in risk-management practices, broad-based increases in financial leverage, and deficiencies in regulations, e.g., procyclicality; and (iii) developing a system-

wide approach to regulation and clarifying institutional responsibilities of the central banks and other supervisory agencies.

66. **In addition to improving the analytical toolkit, the introduction of a *Risk Assessment Matrix* will make stability assessments more candid and transparent**. While there is a limit to how far assessments can be standardized without losing depth and nuance, the Fund, largely based on an approach pioneered by the Bank of England and others, last year developed and piloted on an experimental basis a *Risk Assessment Matrix* (RAM) designed to help organize the analysis and presentation of FSAP stability assessments and—as important—to facilitate their integration in both bilateral and multilateral Fund surveillance. RAMs combine the identified major sources of risks (e.g., over-indebted households, undercapitalized banks), possible triggers (e.g., a severe macroeconomic downturn, a failure of a systemically important institution), and transmission mechanisms, with the assessment of regulatory, supervisory, and crisis management frameworks and the results of stress tests to arrive at qualitative assessments of (i) the probability of risk triggers being activated (low, medium, high); and (ii) the potential impact on financial stability and on the broader economy were those events to materialize. Appendix IV presents a sample RAM. Based on a review of the pilot uses, guidelines for the use of RAMs are being prepared with a view to mainstream its use in all stability assessments in the context of FSAPs by year-end.

67. **On the Bank side, analytical tools are also being enhanced to assess more effectively the developmental aspects of a country's financial system**. The areas assessed by the Bank are wide and varied, including analysis of sectors and markets (banking, pensions, insurance, housing finance and capital markets), financial infrastructure issues (payment and settlement systems, credit reporting systems), and topics that cut across sectors and markets (access to finance, market competition, governance, transparency and disclosure, legal basis). Several efforts are underway to enhance analytical tools used in these areas.

- ***Benchmarking financial development.*** A Financial Indicator Benchmarking Project that is currently underway aims to produce and annually update a core set of cross-country financial sector indicators (both on intermediate outcomes and on the enabling environment). The Bank also launched recently a Global Payments System Survey with responses by 142 countries over a range of issues (legal and regulatory framework, large value payments, retail payments, foreign exchange settlement, remittances and other cross-border payments, securities settlement, oversight). These new tools can be used to benchmark and assess financial development progress in the context of the FSAP.

- ***Creation of new assessment tools.*** The Bank's FSAP stock-taking exercise included the production of guidance notes in several areas (including access to finance, credit reporting, and pensions). In addition, new approaches and lessons learned are being applied to areas that have been increasingly important in FSAP assessments (such as competition issues, housing finance, etc.). The Bank has also produced a legal technical note providing a comprehensive overview of the legal issues underpinning, affecting, and enabling financial sector development.

- ***Contribution to standard-setting efforts***. In addition to the Bank's and Fund's close collaboration with standard-setters (BIS, CPSS, FATF, IASB, IFAC, IOSCO, IAIS, and OECD), the Bank is adapting tools and creating new standards. The Bank developed a guidance note for the FSAP to help evaluate the legal framework that governs insolvency and creditor rights. The Bank is also leading an international effort to define guidelines and standards in the area of credit reporting. Also, the Bank has been advocating that the Financial Action Task Force (FATF) devise a policy note on the specific challenges of implementing AML/CFT standards in countries with low supervisory and enforcement capacities. The Bank is participating in the Global Corporate Governance Forum to incorporate lessons learned in this area and continue ongoing efforts for their implementation. Finally, the Bank has developed a set of "Good Practices in Consumer Protection and Financial Literacy" for financial sector areas including banking, securities, insurance, private pensions, non-bank credit institutions, and credit reporting.

- ***Incorporating lessons from the crisis for financial sector strengthening*.** The crisis has also highlighted the importance of a sound financial infrastructure, and challenged perceptions of "best practice" for creating sound financial systems. Where financial markets are underdeveloped, shallow, and inefficient, financial institutions will be less resilient to shocks and policy less effective at addressing market imbalances. Analytical work on the lessons from the crisis is being incorporated into developmental assessments, in particular as regards (i) tools to measure better the incentive structures and resulting risks being taken by individual financial institutions; (ii) governance structures, and their ability to measure and mitigate risk; and (iii) the appropriateness of government policies for supervision and regulation, including the roles played by the central banks and other supervisory agencies.

68. **Within the limitations of the FSAP, assessments would be enriched by a stronger regional/thematic perspective**. The FSAP is a tool for assessing vulnerabilities and development needs of national financial sectors and a vehicle for policy dialogue with supervisors and policy-makers, whose authority is predominantly defined by national borders. As such, it is essentially—and will remain—a bilateral instrument. It will nevertheless need to adapt to the reality of an increasingly interconnected global financial market by enhancing cross-border perspectives in its analysis. Specifically, FSAPs would focus more squarely on cross-border financial linkages that propagate and amplify the transmission of financial shocks (cross-border capital flows and ownership, global liquidity conditions, global investor bases and risk management practices, spillover effects from global or regional systemically important countries). And more will be done to incorporate into FSAP assessments the findings and policy recommendations from regional and multilateral financial sector analyses, such as the GFSR, the WEO, vulnerability exercise, and the early warning exercise (EWE).

69. **Finally, the reach and impact of FSAP assessments can be enhanced by a more open publication policy**. At present, the Aide-Mémoires produced by FSAP teams are confidential documents, while Technical Notes, FSSAs, and FSAs may be published with the consent of the authorities. There is merit in the status of keeping Aide-Mémoires unchanged: these documents often contain market-sensitive information, data on individual institutions, or detailed assessments of compliance with international standards. They should thus continue to be a vehicle for transmitting this valuable information to the authorities in a secure and confidential manner. FSSAs, however, are the main input into the Fund's surveillance, and there is a strong argument to treat them in the same way as Article IV consultation reports, i.e., apply also to them the presumption of publication. This proposal will be considered in the forthcoming review of the Fund's transparency policy. On the Bank side, there is also a strong case for publication of FSAs but as country documents, their publication will still require approval by country authorities.

Effective Bank-Fund coordination and management of the joint program

70. **The aforementioned changes would be underpinned by a strengthened FSLC**. Since its creation in 1999, the FSLC has had the mandate to coordinate the two institutions' financial sector agendas, focusing on the FSAP and financial sector technical assistance. However, its structure, activities, and mandate set out at its creation (see Guidelines for FSLC, 1999)[14] have become ill-suited to the rapidly changing global financial environment.

71. **An enhanced FSLC will ensure that the FSAP is targeted and focused and that the proposed changes improve the quality of the program**. This would involve

- setting country priorities, reflected in a memo sent to the top management of both institutions prior to Spring and Annual Meetings;
- providing guidance on the analytical and policy framework for the program;
- reviewing FSAP requests from countries and, for updates, approve the proposed modality (joint "full" missions or separate modular assessments);
- providing guidance regarding the scope and composition of assessment teams;
- serving as a vehicle for systematic information-sharing of results from stability and development modules; and
- playing a key role in forming the strategy and overseeing the implementation of the off-site framework that will provide continuity to the program.

[14] Guidelines for Bank-Fund Collaboration in the Financial Sector. Developed by the Financial Sector Liaison Committee of World Bank and IMF, 1999. http://finsec.worldbank.org/assets/images/Guidelines_for_Collaboration.pdf

New FSLC terms of reference and procedures have been prepared to ensure an effective implementation of its enhanced role. (See Appendix V).

72. **The FSLC will continue to coordinate the financial sector activities undertaken by both institutions outside the FSAP**. In a more continuous and flexible framework, it will be more important than ever to strengthen this function to ensure effective coordination of policy. To this end, FSLC will facilitate regular meetings between Bank and Fund teams to discuss TA follow-up for countries that have recently completed an FSAP and will oversee TA coordination.

73. **At the same time, the strengthening of FSLC aims to improve decision-making without creating an additional layer of bureaucracy**. The existing FSAP Secretariats in each institution will take the general guidance of FSLC forward in developing plans for assessments with staff and country authorities. Existing arrangements for scheduling, staffing and budgeting by FSAP Secretariats in each institution will be maintained. Processes will be reviewed to consider what is best decided at a FSLC level and what could be addressed in a FSLC sub-committee or at the FSAP Secretariat level. FSLC would meet regularly, with many decisions made on a lapse-of-time basis, and with disagreements promptly referred to management. FSLC will continue to elevate some meetings per year to the level of the Fund MCM director and Bank FPD vice president. Also FSLC may establish, as needed, subcommittees to review financial sector policies and practices, similar to the subcommittee created for the preparation of this review paper.

C. Integration of the FSAP with Other Bank Financial Sector Work and Fund Surveillance

74. **A critical priority in the proposed revisions of the FSAP is linking the assessments more closely to follow-up technical assistance to support countries willing to implement FSAP recommendations**. The FSAP provides a valuable independent external assessment, informs national authorities about vulnerabilities and challenges, and opens a window for further engagement with the Bank and Fund. However, this window does not automatically lead to engagement and technical assistance; and as demonstrated by the Bank's declining budget spent on follow-up to FSAPs in FY04–FY08, efforts to use the assessment as a springboard for technical assistance have been shrinking year after year. Review of the history of follow-up efforts in recent years suggests that client ownership of the process, engagement with reform-minded counterparts in the countries, and continuity of communication with clients are key for more substantive follow-up technical assistance.

75. **The revised program will emphasize continuous engagement with countries**. The program will develop an off-site component that maintains communication with country authorities about the status of financial sector development, tracking improvements, and channeling the information to possible sources of technical assistance within the Bank and Fund. FSAP assessments will place greater emphasis on communicating messages effectively,

raising countries' awareness about potential opportunities for learning and technical assistance. Greater flexibility would also help respond more rapidly to country needs for assessment in particular sub-sectors in a less rigid format. Through these efforts, the program aims to strengthen the ongoing relationship with countries, and link its assessments more effectively with technical assistance, advisory work, and lending offered by the Bank and Fund.

76. **Financial sector standards assessments will continue to be closely linked with the FSAP, but greater use outside the FSAP could be considered**. These standards assessments have typically been performed in the context of the FSAP to take advantage of the synergies between a detailed consideration of the strengths of prudential and regulatory arrangements and stability and developmental considerations. However, full standards assessments are expensive, time-consuming for the authorities, and occasionally divert attention from a more holistic discussion of the financial sector to a principle-by-principle box-checking exercise. The proposed risk-focused ROSCs would introduce greater flexibility to tailor standards assessments and help arrest the reduced emphasis that these have received as part of the FSAP. Moreover, given the increasing emphasis on standards assessments by the FSB and others, consideration may need to be given to expanding the use of stand-alone (full or risk-focused) ROSCs separate from the FSAP, although the resource implications of this would need also to be addressed.

77. **Two of the proposed changes above are critical for improving the integration of the FSAP with other Bank financial sector work**:

- ***The development of an off-site component***. Building up the off-site work would be a way to enhance the effectiveness of on-site reviews and leverage the Bank's contribution as regards its cross-country experience. The off-site work will be aimed at maintaining a more regular contact with country authorities. Building on the summary of findings and recommendations, an information system could be developed in which all actors (including country authorities) could input and retrieve data on a continuous and flexible basis. In addition to facilitating coordination, this system could also become a key element of the Bank's monitoring and evaluation (M&E) system for the financial sector development.

- ***Linking FSAPs assessments more efficiently to follow-up technical assistance***. The FSAP management unit will actively facilitate the ongoing dialogue about technical assistance and follow-up work between regional and anchor staff, the FSLC, FIRST Initiative and client counterparts. In this respect, the FSLC will play a larger role to bring stakeholders together and make decisions. The FSAP management unit will liaise with FPD sector managers and support them with background information and recommendations to help in discussions of CAS. In addition, the unit will liaise closely with FIRST Initiative to ramp up efforts to connect assessment recommendations with efforts to provide follow-up technical assistance. The goal is to ensure a more continuous approach to diagnosing vulnerabilities and weaknesses in countries' financial sectors, and getting the right resources and tools lined up to help.

78. **Last but not least, the proposed changes outlined in the foregoing sections will allow the Fund to meet the challenge set out by the IMFC and the G20 to integrate the program more closely with surveillance**. The existence of the FSAP as a distinct instrument from the Article IV consultation, which also—and increasingly—covers financial sector issues, creates difficult tradeoffs for the Fund's financial sector expert resources. Nevertheless, the proposed changes will help shrink that gap.

79. **Three of the proposed changes in this paper are critical for improving the integration of the FSAP with Fund surveillance**.

- ***The definition of the core elements of the stability assessment, the Fund's main contribution to the FSAP*** (Box 3) would clarify expectations about what the FSAP can in turn contribute to the Article IV process. An assessment that covers these elements, whether conducted in a joint Bank-Fund mission or as a stand-alone stability module, would always be summarized in an FSSA and be associated with an Article IV consultation, as at present. More limited assessments of particular vulnerabilities or aspects of a country's financial stability policy framework could still be conducted in separate missions or as part of the Article IV consultation.

- ***The greater flexibility afforded by the option of modular assessments*** would allow the Fund—resources permitting—to address a major shortcoming of the current FSAP: the relatively low frequency between updates. Stability assessments would henceforth not need to wait for a comprehensive FSAP update mission to take place but could be mounted quickly and flexibly on a stand-alone basis.

- ***Some of the new analytical tools for the FSAP being developed in response to the crisis*** would enhance the quality of macrofinancial surveillance by allowing a better assessment of financial vulnerabilities and more candid and comparable assessments across countries. By providing input that could be readily used by the WEO and GFSR, these would also help bridge the gap between bilateral and multilateral surveillance.

80. **Better integration of the FSAP with surveillance would also require changes in the Article IV process**. This paper has described a set of proposed changes that would make the output of the FSAP more easily incorporated into surveillance. But for these to yield maximum benefit, the Article IV process also needs to adapt. The 2008 Triennial Surveillance Review discussed a number of improvements, underway or planned, that would improve the coverage and depth of analysis of financial sector issues in Article IV consultations. A separate paper (*Financial Sector Work and Bilateral Surveillance: Toward Further Integration*) follows up on that discussion and puts forward a number of proposals that

complement and dovetail with the proposed changes to the FSAP, with a view to making the integration as seamless as possible, given the limitations.

D. Resource Implications and Tradeoffs

81. **Meeting the new expectations and additional demands placed on the FSAP would require additional resources**. Other things being equal, additional resources will be needed to (i) exploit the flexibility provided by the modular option to increase the frequency of assessments—particularly stability assessments—and facilitate better follow-up through more in-depth development assessments; (ii) expand the coverage and analytical content of the program to new areas, such as macroprudential risks and policies; (iii) adapt the existing toolkit and assessment methodologies to the lessons learned from the crisis; and (iv) enhance the continuity of the program through off-site monitoring of financial sectors and policies. Moreover, at least in the near term, additional resources would be needed to meet the recent G20 commitment to FSAP assessments, as well as possible demands associated with FSB peer reviews that may use the FSAP as a vehicle.

82. **These implications will affect both institutions**. The tradeoffs are stark for the Fund: *first*, many of these demands fall in areas that are the Fund's primary responsibility; *second*, they affect largely—though by no means exclusively—advanced economies, for which FSAPs are conducted by the Fund alone; and *third*, they come at the heels of the recent downsizing. The Bank is also faced with additional demands, especially given the importance of meeting the needs of countries facing persistent financial sector developmental challenges and the need for more in-depth assessments to better facilitate follow-up. Given the different focus and areas of expertise of the two institutions, the room for substitutability between Fund and Bank resources within the program is limited.

83. **The shift in focus towards systemically important or highly vulnerable countries risks diverting resources from low-income countries that face profound developmental challenges, as well as stability and soundness issues, and for which the FSAP remains an important and valued program.** Many of these demands fall in areas that are the Bank's primary responsibility, and the two institutions (through FSLC) need to reflect on the appropriate scope for these FSAPs and the relative contributions of Bank and Fund staff.

84. **Recent and proposed measures will yield some efficiency gains**. In particular, the option to conduct modular assessments; the recent integration of the OFC assessment program into the FSAP; and the greater emphasis on systemic focus provide greater scope to prioritize missions and allocate resources in a more effective manner. Moreover, efforts will continue to be made in the areas of containing the size of missions; avoiding duplication in analytical work and methodological development across the two institutions; and simplifying internal processes (e.g., consolidating pre-mission Scoping Notes and Terms of Reference, accelerating the post-mission review of the Aide-Mémoire, and eliminating unnecessary revisions and meetings).

85. **Nonetheless, these gains would be modest, and the tradeoffs can be illustrated with two scenarios assuming an unchanged budget envelope.** Given the uncertainty regarding the long-term impact of the new demands on the FSAP and the asymmetric impact these are likely to have on the two institutions, and since the Bank's and the Fund's budgetary processes and timetables are different, a detailed budgetary proposal is beyond the scope of this joint staff paper. It is nonetheless crucial to ground the proposals for the reshaped FSAP on resource realities. To illustrate the tradeoffs, this paper uses the default assumption of an unchanged resource envelope, i.e., that the current combined resources for the Bank and Fund are maintained at roughly US$11–16 million annually.

- If joint assessments continued to be the norm, the two institutions could continue to deliver around 20 FSAP assessments per year—depending on the countries involved and the mix between initial assessments and updates. As the number of countries that have undergone initial FSAPs increases, however, the average time gap between full updates would gradually rise.

- Modules could increase the assessment frequency for some, but at the cost of longer gaps between full updates, especially for non-systemically important countries. In particular, although the stand-alone Fund-led stability modules are expected to be streamlined, covering the three core elements would still require a minimum of 3-4 staff (more in advanced economies). With an unchanged resource envelope, these modules, while in principle available to all members, would have to be limited to systemically important and vulnerable countries (assuming steady demand for FSAP updates and/or modules on behalf of these countries). This would imply that Fund participation in FSAPs in small emerging and developing countries would have to be scaled back. Although higher participation of Bank staff could partly fill the gap, the coverage of financial stability issues in these countries would decline, with the average time between assessments lengthening well beyond the current six years. The impact on small industrial countries, where FSAPs are conducted by the Fund alone, would be even starker (Box 6 provides an illustration). Also, without an increased resource envelope there will be no room for more in-depth development-oriented modules.

Box 6. Resource Tradeoffs

Although the precise resource impact of new demands on the FSAP is uncertain, it is possible to quantify with reasonable precision the resource tradeoffs in one area: the frequency of stability assessments in FSAP updates. This would help illustrate the implications of the assumption of a broadly unchanged resource envelope on the FSAP program.

Under the staff proposals presented above, comprehensive stability assessments would henceforth be conducted in the context of either (i) full FSAP updates (Fund-only for advanced countries or joint Bank-Fund missions for the rest) or (ii) focused Fund-led stability modules. This would provide the flexibility to increase the frequency of stability assessments, when appropriate. To be sure, selected aspects of financial sector soundness could be assessed in the context of Bank-led development modules (if they have important developmental implications) or indeed outside the FSAP program altogether, e.g., in Article IV consultations; but these assessments would be partial (they would not cover all three core elements discussed in Box 3) and would not generate an FSSA report to the Fund Board.

With unchanged resources, more frequent stability assessments would by necessity be limited to systemically important and vulnerable countries, and come at the expense of less frequent assessments in the rest of the membership. This is illustrated in the Table below.

- The first column presents the average of initial assessments and FSAP updates in recent years, implying an average gap between updates of about 6 years. Going forward with this model and unchanged resources would have implied fewer initial assessments and more updates but, as the number of countries participating in the FSAP also increases, the average gap between updates would tend to rise (second column).
- The flexibility to conduct stability modules would allow higher frequency updates of stability assessments; but under unchanged resources, these would need to be prioritized. Assuming that high-frequency stability modules are targeted to about 30 systemically important and vulnerable countries would imply that the rest of the membership would be limited to regular "full" FSAP updates. But the Fund's resource constraint would mean that the frequency of these updates—and associated coverage of stability issues in these countries—would decline substantially from the present level (third column).

Resource Tradeoffs at the Fund: An Illustration

	Actual average FY07-09	Steady state, full updates only	Steady state with stability modules
Initial FSAP assessments	7.0	4	4
Stability assessment updates			
In full FSAP updates (Fund-only or joint Bank-Fund missions)	12.3	16	10
In Fund-led high-frequency stability modules	--	--	8
Avg. time between stability assessment updates, in years	5-6	6-7	
Systemically important countries[1]	…	…	3-4
Non-systemically important countries	…	…	8-9

Source: Fund staff estimates.

[1] For the purposes of this calculation, it is assumed that (i) the systemically important group includes the G20 countries plus 8-10 non-G20 vulnerable or otherwise high priority cases; and (ii) Fund-led high-frequency stability modules are focused exclusively on these systemically important countries, while the rest continue to be serviced by regular FSAP updates.

86. **These tensions remain unresolved and will need to be revisited in light of the experience with the new features of the FSAP**. The tradeoffs described above, while illustrative, highlight tensions that cannot be resolved at this stage. Their severity will depend crucially on the steady-state level of demand for updates by systemically important countries, notably the G20, which will become manifest only over time. Also, as the Bank and the Fund gain experience with the implementation of the proposed changes, their precise resource impact will become clearer. Resource implications will therefore need to be re-assessed again in this light.

IV. Issues for Discussion

- Do Directors agree with the characterization in Chapter II of the FSAP since its inception, and the results of the survey of country authorities? What are Directors' views about the evolution of the program, including its integration with Bank and Fund operational work, and the response to the recent global financial crisis?

- What are Directors' views about the proposals that have been put forward in Chapter III for improving the focus, flexibility, analytical content, and administration of the program? Do Directors have other suggestions for improving the effectiveness of the program?

- Do Directors agree with the assessment of the advantages and disadvantages of the voluntary nature of the program? Do Directors agree that FSAP participation should remain voluntary?

- What are Directors' views about the resource issues flagged in Section III.D, in particular the caution that absent additional resources allocated to the program, it would be difficult to avoid stricter prioritization of assessments for non-systemically important countries, would limit the depth of assessments and follow-up, and would constrain the scope for significant increases in the analytical toolkit and off-site analysis?

APPENDIX I: COUNTRY PARTICIPATION IN THE FSAP

Overview of Country Participation in the FSAP

(As of end-July, 2009)

Completed 1/			Underway	Future Participation Confirmed
Albania	Ireland 2/	Slovak Republic	Burundi	Angola
Algeria	Israel	Slovenia	Cote d'Ivoire	Benin
Armenia	Italy	South Africa 2/	Cyprus	Cambodia
Australia	Jamaica	Spain	Fiji 6/	Chad
Austria	Japan	Sri Lanka	**Total: 4**	China
Azerbaijan	Jordan	Sudan		Equatorial Guinea
Bahrain	Kazakhstan 2/	Sweden		Guinea
Bangladesh	Kenya	Switzerland		Indonesia
Barbados	Korea	Syrian Arab Republic		Papua New Guinea
Belarus	Kuwait	Tajikistan		Republic of Congo
Belgium	Kyrgyz Republic	Thailand		San Marino
Bolivia	Latvia	Tanzania		United States
Bosnia and Herzegovina	Lebanon 2/	Trinidad and Tobago		**Total: 12**
Botswana	Lithuania	Tunisia		
Brazil	Luxembourg	Turkey		
Bulgaria	Macedonia, FYR	Uganda		
Burkina Faso	Madagascar	Ukraine		
Cameroon 2/	Malawi	United Arab Emirates		
Canada 2/	Mali	United Kingdom		
Cape Verde	Malta	Uruguay		
CEMAC 3/	Mauritania	WAEMU 5/		
Central African Republic	Mauritius	Yemen		
Chile	Mexico	Zambia		
Colombia 2/	Moldova	**Total: 125**		
Costa Rica	Mongolia			
Croatia	Montenegro			
Czech Republic	Morocco			
Denmark	Mozambique			
Djibouti	Namibia			
Dominican Republic	Netherlands			
ECCU 4/	New Zealand			
Ecuador	Nicaragua			
Egypt	Niger			
El Salvador 2/	Nigeria			
Estonia 2/	Norway			
Finland	Oman			
France	Pakistan			
Gabon	Paraguay			
Georgia	Peru			
Germany	Philippines			
Ghana	Poland			
Greece	Portugal			
Guatemala	Qatar			
Guyana	Romania			
Haiti	Russia			
Honduras	Rwanda			
Hong Kong SAR	Saudi Arabia			
Hungary 2/	Senegal			
Iceland	Serbia			
India 2/	Sierre Leone			
Iran 2/	Singapore			

1/ Defined as cases where the FSSA has been discussed by the Fund's Executive Board.
2/ The initial assessment was a part of the pilot program.
3/ The Central African Economic and Monetary Community (CEMAC) comprises Cameroon, Central African Republic, Congo, Gabon, Equatorial Guinea and Chad.
4/ The ECCU FSAP covered the ECCU member countries: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.
5/ The West African Economic and Monetary Union (WAEMU) comprises Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.
6/ Board discussion postponed due to delayed completion of Article IV.

APPENDIX II: THE GRID FOR CLASSIFYING FSAP RECOMMENDATIONS

87. The FSAP recommendations are classified according to a logical grid that closely adheres to the foundations of financial contracting and the different ways in which the state can help support it:

- To facilitate the leap of faith involved in inter-temporal contracting, financial contracts must be supported by a proper underlying *infrastructure* that includes: (i) a set of rules regarding property rights; (ii) general rules on corporate governance; (iii) a basic framework to collect, organize, store, and communicate information; and (iv) an infrastructure to facilitate the trading and settlement of contracts.
- In addition to providing (and enforcing) basic rules of the game, states also need to exert a proper *oversight* to ensure that: (i) financial systems remain sound and the failures of financial intermediaries, when they occur, are dealt with swiftly and efficiently; (ii) financial intermediation remains as competitive and efficient as possible; and (iii) consumers are protected and markets retain their integrity.
- Finally, states can also affect financial activity by directly influencing the way the game is played or by being part of the game, namely by: (i) managing *general enabling policies* that have an important bearing on financial development (monetary policy, public debt policy, tax policy); or (ii) more directly, by managing public financial institutions or seeking to influence the activities of private financial intermediaries through targeted *financial promotion policies*.

88. The policy universe is thus first broken down into three main headings: (i) infrastructure; (ii) oversight; and (iii) public policies. A second tier further deconstructs these by broad areas:

- infrastructure into: (a) contractual, (b) informational, (c) transactional, and (d) corporate governance;
- oversight into: (a) prudential and (b) market performance and integrity; and
- public policy into (a) general enabling policies and (b) financial promotion policy.

89. A third tier is introduced by themes along logical lines. For example, the contractual framework is divided between main rules (insolvency and creditor rights) and enforcement (the judiciary). The informational framework is organized according to the way information is presented (accounting), reviewed (auditing), disclosed (disclosure and reporting), assessed (rating), or stored for consultation (registries). The transactional framework distinguishes between trading and payment. Prudential oversight reflects the four logically different stages of oversight: (i) the underlying legal and organizational framework, (ii) the regulatory framework, (iii) the supervisory framework, and (iv) crisis management. Financial promotion policy distinguishes between areas where the state: (i) is directly involved in intermediation, (ii) seeks to influence the orientation of intermediation in favor of certain segments of society through subsidies, guarantees, or regulations, or (iii) seeks to promote market development in a neutral yet pro-active fashion.

90. The grid is completed with a fourth and fifth tier reflecting more specialized themes or different sectors of intermediation. For example, the judiciary distinguishes between procedures, transparency, enforcement, capacity building, specialized courts, and extra-judicial arrangements. The recommendations that relate to the oversight of the financial system as a whole (unified or coordinated oversight, consolidated supervision) or that cut across national boundaries (cross-borders) are placed into a "global oversight" bucket.

Table 11. Basic Classification of Recommendations

A. Infrastructure
a. Contractual
i. Creditor Rights
ii. Insolvency
iii. Judiciary
b. Informational
i. Accounting
ii. Auditing
iii. Disclosure & Reporting
iv. Rating
v. Registries
c. Transactional
i. Trading
ii. Paying
d. Corporate Governance
B. Oversight
a. Prudential
i. Legal & organizational framework
ii. Regulation
iii. Supervision
iv. Crisis management
b. Market performance & integrity
i. Market competition
ii. Consumer protection
iii. Anti-Money Laundering
C. Public Policy
a. General enabling policies
i. Monetary & Foreign Exchange Management
ii. Debt Management
iii. Tax Management
iv. Fiscal & public sector management
b. Financial promotion policy
i. Direct intervention
ii. Indirect intervention
iii. Pro-market Activism

APPENDIX III: FINANCIAL STABILITY FORUM STANDARDS [15]

Area	Standard	Issuing Body
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard General Data Dissemination System	IMF
Institutional and Market Infrastructure		
Insolvency	Insolvency and Creditor Rights	World Bank/ UNCITRAL
Corporate governance	Principles of Governance	OECD
Accounting	International Accounting Standards (IAIS)	IASB
Auditing	International Standards on Auditing	IFAC
Payment and settlement	Core Principles for Systemically Important Payment Systems	CPSS CPSS/IOSCO
Market integrity	The Forty Recommendations of the Financial Action Task Force/9 Special Recommendations Against Terrorist Financing	FATF
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Core Principles	IAIS

[15] From the FSB website.

APPENDIX IV: FINANCIAL RISK ASSESSMENT MATRIX: AN ILLUSTRATION

Country X	**Overall Level of Concern**[16]	
Nature/Source of Main Threats	**Likelihood of severe realization of threat sometime in the next 3 years**	**Expected impact on financial stability if threat is realized**
High credit growth in recent years, in part externally funded, may have compromised loan quality, thus increasing credit risk vulnerabilities	***Staff assessment: medium*** • Spreads on sovereign bonds and CDS have started to widen in the last few months, well above the movement seen for countries in the peer group. Given shallow domestic markets, the room for countercyclical fiscal policies appears increasingly constrained. • Enforcement of regulatory standards has been uneven, which has left some banks more room for aggressive risk taking, particularly the funding of the real estate sector and margin share purchases. • However, distance-to-default measures for the domestic banks traded in the local stock exchange remain close to historical highs.	***Staff assessment: high*** • A sharp retrenchment in bank credit via de-leveraging—to restore compliance with capital requirements—would have a sizable impact on economic activity, particularly on the construction sector. • Stress test results suggest that banks holding around 40–50 percent of system's assets could see their capital fall below minimum in the event of a severe downturn. • There is significant potential for cross-border spillovers to country Y given the significant presence of that country's banks in the local market. • The crisis management framework has some important shortcomings, not least an inadequate remedial actions regime.
In recent years, banks have become increasingly dependent on foreign sources and local institutional investors to fund the rapid expansion of their balance sheets, thus increasing funding risk vulnerabilities	***Staff assessment: low (but rising)*** • Deterioration in global liquidity conditions would negatively impact the terms and extent of access of country X and its peers. This will impact the funding of country Y banks operating in X. Foreign funding to the private sector in country X is mostly intermediated through its banking system. • Liquidity ratios remain high (relative to peers) but have been falling. • Although mostly carrying floating rates, the average maturity of loans is rising, with rising maturity mismatches at the short-end of the spectrum.	***Staff assessment: medium*** • Two small domestic banks have a limited stock of CB-eligible collateral, thus leaving them particularly vulnerable to liquidity shocks. This assessment is confirmed in liquidity stress simulating a run on deposits. Confidence effects could spread the impact. • The interbank market is relatively underdeveloped, thus providing limited opportunities to buffer an idiosyncratic shock (e.g., single/few rating downgrade). • By the same token bank interconnectedness via interbank market is limited, thus limiting the scope for direct contagion. • Central Bank LOLR facilities are adequate and well structured.

[16] *Use dual metrics**: likelihood** of threat crystallizing, and potential **impact** of the threat if it does crystallize; either one being high, medium or low.*

APPENDIX V: FSLC PRINCIPLES AND PROCEDURES

91. **The FSLC was created in 1998 with the purpose to coordinate Bank and Fund financial sector activities; facilitate compilation of standards, guidelines, and good practices; and resolve differences of view on recommendations or approaches in areas of overlapping interest**. This broad mandate has been confirmed on numerous occasions, most importantly in the Malan Report in 2007 and the Joint Management Action Plan (JMAP) launched as a result of that report. Yet the core of FSLC's work has been, and will remain, the facilitation and administration of the FSAP program.

92. **The proposals outlined in this report require a strengthened FSLC, with improved governance and transparency to ensure a strong and accountable decision-making framework**. The key elements of the strengthened FSLC, which would ensure that the principles underpinning the FSAP and summarized in this report are effectively implemented, will include:

- A streamlined mandate, in which FSLC provides a platform for sharing information and operational experience about financial sector issues of common concern; and continues to administer the joint FSAP program in keeping with the Boards' call for it to remain joint, voluntary, and focused on providing a comprehensive assessment of the financial systems of member countries. Information-sharing about follow-up technical assistance to the FSAP would remain an important role for FSLC, with the Committee providing guidance but without a decision-making capacity.

- Maintenance of the FSLC Secretariat with representative membership at the appropriate level so as to be effective. This would include regular meetings of the full Committee, with streamlined procedures for additional meetings when required by pressing client demands. Accountability would be enhanced by strong regional representation in the committee and on working groups, and elevation of certain meetings to Fund MCM Director and Bank FPD Vice President level.

- Establishment of working groups that would report to FSLC on critical issues. The focus and composition of these groups would be determined by FSLC, with reference to three issues in particular highlighted in this report: (i) FSAP coordination; (ii) TA issues and coordination, particularly as it relates to FSAP follow-up; and (iii) the special challenges faced by low income countries.

- Regular reporting to senior management on prioritization, decisions and outcomes.

- Prioritization and decision-making about undertaking FSAPs, as before. Proposals for FSAPs, FSAP updates, and modules would be brought to FSLC for review. FSLC approval would be by consensus and the outcome would guide mission chiefs in carrying out the assessments. Issues that cannot be resolved in FSLC would be promptly escalated, as has been the practice in the past, to senior management of both institutions.