

**EXECUTIVE
BOARD
MEETING**

SM/21/52
Correction 1

May 11, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **2021 Financial Sector Assessment Program Review—Towards a More Stable and Sustainable Financial System**

Board Action: The attached corrections to SM/21/52 (4/16/21) have been provided by the staff:

Evident Ambiguity **Pages 33, 47, 48**

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views **Pages 34, 38, 42, 60**

Typographical Errors **Page 70**

Questions: Mr. Haksar, MCM (ext. 37157)
Ms. Oura, MCM (ext. 38166)

- **New process for early engagement in the review of Article IV policy note:** In collaboration with SPR, the FSAP team and MCM could be more closely involved in the early stages of the Article IV policy note review process. The details are discussed in the CSR paper.

65. To support Board engagement with the FSSA, staff will be ready to offer an optional technical seminar to Directors on the FSSA ahead of the joint Article IV-FSSA Board discussion. Based on the stakeholder surveys and previous engagements, there is support for having opportunities for the Board to be informed in greater depth of technical findings of FSAPs.

C. Integration with the GFSR and TA

66. Analytical approaches are being shared between the FSAP and the GFSR. While the FSAP primarily informs Article IV consultations, and the GFSR is focused on multilateral surveillance, there is frequent cross-fertilization between the two products on key policy and analytical topics and tools. A good example is the 2019 France FSAP that followed up on the issue of banks' U.S. dollar funding in the April 2019 GFSR. In turn, the corporate vulnerability analysis of the 2019 France FSAP was followed up in the 2019 October GFSR. Another example is that FSAP assessments and the GFSR have begun using GaR, which approximate financial stability risk in terms of the downside risk to growth. The 2019 Canada FSAP used GaR analysis as a tool to frame the analysis of macrofinancial vulnerabilities.

67. The FSAP plays an important role in framing subsequent TA. There are many examples of FSAPs leading to useful TA engagements (e.g., [2017 China](#), [2014 Moldova](#), and [2016 Morocco](#), among others). An FSAP provides a comprehensive approach to financial sector recommendations, including a recommended sequencing of policy reforms. This approach is especially useful in countries with Fund-supported programs where TA is often tied to structural benchmarks.

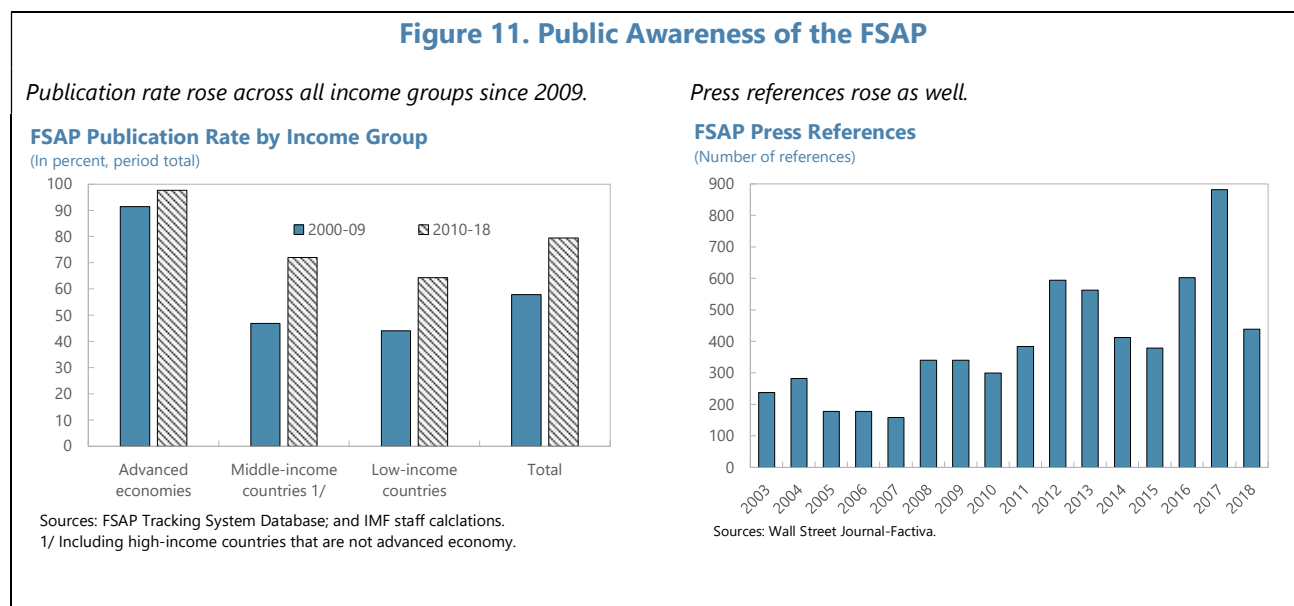
D. Traction with the Public

68. Publication rates of FSAP documents have increased in the past decade, especially for emerging markets and developing countries (Figure 11). This has been accompanied by an increase in press references.

69. FSSAs are about as readable as financial stability reports (FSRs) produced by national authorities, but more outreach efforts are needed. The average technical complexities of FSSAs and FSRs are similar, as measured by the Flesch-Kincaid Grade Level.²⁰ In an effort to modernize FSAP outputs and make them more accessible, staff introduced in 2019 new word limits on FSAP documents (aligned with Article IV staff reports) and a "Key Issues" box on the cover of FSSAs to better highlight the FSAP's findings and policy recommendations. In cases where the FSSA is

²⁰ The Flesch-Kincaid Grade Level is derived from numbers of syllables, words, and sentences and interpreted as the number of years of education generally required to understand a text. It has been used in education and other fields. Across FSSAs, the Flesch-Kincaid Grade Level varies from 14 to 18 (standard deviation: 0.5). The average Flesch-Kincaid Grade Level for FSSAs declined from an average of 16.1 before 2015 to an average of 15.7 since 2015. The average Flesch-Kincaid Grade Level across central banks' FSRs is 16, as is the average across GFSRs.

published, staff aim to produce shorter, easier-to-read outputs—such as country focus articles and blog posts—to disseminate FSAP messages to broader audiences.



E. Proposals to Increase Traction

70. The analysis and survey results lead to proposals increase traction (Table 3).

Table 3. Aim III: Proposals to Increase Traction

#	Proposal
III-1	The FSSA to include a short section summarizing the authorities' views.
III-2	Article IV mission chief participation in the FSAP concluding mission.
III-3	Develop stability risk analysis tools for use in bilateral surveillance.
III-4	Early engagement in the preparation of Article IV consultations (see CSR Main Paper ¶17).

AIM IV: COUNTRY PARTICIPATION

A. Overall Considerations

71. The FSAP has broad global coverage, focusing on jurisdictions that are systemic for global financial stability. Altogether, Fund staff had completed 373 assessments by end-2020 (excluding World Bank-only FSAPs). Since the 2014 FSAP Review, there have been 710 completed assessments, including 398 (54 percent) voluntary assessments. A total of 157 member countries, accounting for 99.7 percent of global financial assets, have been assessed at least once (Figure 12).²¹ Of these, 112 member countries accounting for 98.8 percent of the world's financial system have

²¹ One hundred and fifty-seven "Fund member countries" exclude jurisdictions such as Hong Kong SAR and overseas territories (e.g., British Virgin Island) but include countries covered only by the World Bank and regional FSAPs.

15 jurisdictions, which fall between the two tolerance levels under this methodology, would be subject to mandatory FSAs every ten years. Overall, 47 jurisdictions, including more EMDEs, would be subject to mandatory FSAs. Reducing overall risk tolerance would ensure that mandatory FSAs cover jurisdictions with lower size-weighted interconnectedness that could affect many other jurisdictions. The lower size-weighted interconnectedness of the newly added jurisdictions (relative to the new proposed S-32) motivates the lower frequency of assessments.

Table 4. Jurisdictions with Mandatory Assessments—S47

Five-year cycle (32)		Ten-year cycle (15)
Australia	Japan	Argentina
Austria	Korea	Chile
Belgium	Luxembourg	Colombia
Brazil	Mexico	Czech Republic
Canada	Netherlands	Hungary
China	Norway	Malaysia
Denmark Hong Kong SAR	Portugal	New Zealand
Finland Denmark	Russia	Peru
France Finland	Saudi Arabia	Philippines
Germany France	Singapore	Poland
Greece Germany	Spain	Romania
Hong Kong SAR Greece	Sweden	Slovakia
India	Switzerland	South Africa
Indonesia	Turkey	Thailand
Ireland	United Kingdom	United Arab Emirates
Italy	United States	

Note: Bolded names = new addition compared to current S29. Green names = jurisdictions that have already been participating in FSAPs every five years due to their G20 commitment. Orange names = jurisdictions that have not participated in FSAP for more than ten years. Poland's assessment frequency is reduced from five years to ten years.

Source: Staff calculations.

79. Staff consider the above proposal can make mandatory FSAs even more risk-based.

Jurisdictions with relatively more systemically important financial sectors would participate in FSAs more frequently. This approach goes in the direction recommended in the evaluation of financial surveillance by the IMF's IEO (IEO, 2019 and Caprio, 2019) by making the frequency of assessments more closely linked to the systemic importance of the relevant financial sectors. This approach would also be consistent with making overall Fund surveillance more risk-based (IMF 2018b). The mandatory frequencies are minimums and allow for flexibility to undertake assessments earlier if warranted.²⁷ For instance, G20 members that have committed to participate in FSAP every five years but that are not on the S29 list (Indonesia, Saudi Arabia, and South Africa) have been participating in

²⁷ In deciding whether an earlier assessment is warranted, the Fund would take into account, inter alia, a jurisdiction's requests and availability of resources. Such requests would be prioritized according to the criteria for voluntary assessments (Figure 13).

E. Proposals on Participation

84. The analysis and the feedback from the survey lead to proposals on participation in the program (Table 5):

#	Proposal
IV-1	Adopt methodological improvements in the identification of SIFS (notably, using averages over a period of time and dropping derivatives weights).
IV-2	Strengthen the risk-based approach to surveillance by adding an additional level of risk tolerance to identify additional jurisdictions assessed at a lower frequency.
IV-3	Use the flexibility within the mandatory framework to conduct assessments before the mandatory deadline when warranted.
IV-4	Increase the precision of the criteria for voluntary assessments as proposed in P8.12 .
IV-5	Where members subject to mandatory assessments delegate financial sector policies to a supra-national entity, there will be an assessment at the supra-national level focused on these policies. Assessments with suitable modalities should continue for the members subject to mandatory assessments.
IV-6	Conduct regional exercises on thematic topics subject to resource constraints.

AIM V: RESOURCES

A. Analysis

85. Costs of FSAs have been broadly stable over time, reflecting the risk-based prioritization of topics under the three-pillar framework. Fund-wide direct spending on FSAs under the FSAP has been about 2½–3 percent of total Fund-wide direct spending (Figure 14). As pointed out by the IEO (2019), the budgetary envelope for financial surveillance has increased somewhat since the 2012 Financial Surveillance Strategy was launched. Still, the budgetary envelope for both financial surveillance and FSAPs is largely around the levels of the mid-2000s before the GFC.

86. Costs vary widely across individual assessments, reflecting the size and complexity of different financial sectors (Figure 15). The size of the financial system explains most of the cross-country variation (Figure 16). Complexity—of the financial system and the policy framework—is another significant contributing factor. For example, FSAPs in jurisdictions with multiple supervisory agencies are costlier than those in jurisdictions with single supervisory agencies. Beyond size and complexity, some of the variations in costs can be attributed to the number of formal, graded standard assessments (DARs),³⁰ FSAP vintage (follow-up FSAPs being less expensive than first-round FSAPs), World Bank participation (which is associated with relatively lower IMF costs), language

³⁰ The IMF and World Bank have recognized international financial sector standards in the areas of banking supervision, securities regulation, insurance supervision, deposit insurance, financial market infrastructures, and resolution regimes for banks. On average, recent FSAPs have contained about one full graded assessment (Figure 2). In addition, FSAPs occasionally assess other standards concerned with market integrity, such as corporate governance, accounting, auditing, and insolvency and creditor rights, led by the World Bank.

B. Implications for the Fund’s Risk Profile

92. **Overall, the proposals are expected to improve the Fund’s risk profile by mitigating surveillance risks.** Residual risks in surveillance could remain, in particular, due to data constraints, as well as residual risks in the areas of medium-term and human capital, which are crucial for supporting surveillance. Key risk areas that may be impacted by the proposals are:

- **Strategic Direction and Reputation:** Expanding mandatory financial stability assessments to more countries and strengthening integration with Article IV consultations would help better align surveillance priorities with the membership’s interests, thereby sustaining their support for the Fund’s strategic agenda and mitigating reputational risks.
- **Surveillance:** The proposals would mitigate risks to different aspects of surveillance. Combining flexibility in scoping with risk-based prioritization reduces the risk that new and important risks would be missed. Strengthening quantitative analysis would improve risk identification and spillover analysis, though data constraints may limit staff’s ability to conduct the best possible analysis. The proposal to add a short section to the FSSA on authorities’ views, and inviting the Article IV mission chief to participate in the FSAP mission, supplemented by readiness to offer an [optional](#) technical seminar on the FSSA, would reduce risks to traction by strengthening engagement with the authorities, the Board, and the Article IV consultation. Expanding mandatory financial stability assessments using a risk-based approach would help reduce the risk of missing financial sector problems that could affect other jurisdictions.
- **Medium-term Budget:** One proposal—the expansion of the list of systemically important financial sectors, for which financial stability assessments are mandatory—could imply increased demand on the Fund’s budget, since the additional FSAPs will require more staffing. However, since the additional staffing requirement is small compared to MCM’s overall budget, it is expected to be accommodated by reprioritization within MCM resources.
- **Human Capital:** Capturing new topics in FSAPs, deepening quantitative analysis, and developing financial stability tools for use in Article IV consultations would require more staff with appropriate skill sets. Management’s proposal to augment the structural budget in some of these areas (notably climate change, digitalization, and macrofinancial surveillance in Article IV consultations) provide mitigation opportunities. In the meantime, greater collaboration with external experts on new topics could help reduce the challenge from insufficient expertise.

ISSUES FOR DISCUSSION

- Do Directors agree with the proposals to further strengthen the risk-focused approach to scoping FSAs, making even greater use of flexibility within the three-pillar framework to customize scope in light of the evolving financial challenges facing member countries, including the impact of the Covid-19 crisis?
- Do Directors agree with the proposals to strengthen quantitative analysis in FSAPs, in particular, to improve the modeling of interconnectedness, nonbanks, and macrofinancial feedback effects, the analysis of new issues—such as climate risk, cyber, and fintech—and the calibration of macroprudential policies?
- Do Directors agree with the operational proposals to increase traction by better integration with Article IV reports and increasing optional Board engagement?
- Do Directors agree with the proposal to strengthen the risk-based approach to mandatory assessments by adding an additional level of risk tolerance to identify additional jurisdictions assessed at a lower frequency?
- Do Directors agree with the proposal to clarify expectations for supra-national authorities' participation in assessments?

lead to significant spillovers. Applying the 2013 approach to defining the list of jurisdictions with SIFS to the latest available data (end-2019) yields similar results to the current list, and changes seem reasonable. Given that the architecture of the global financial system and its interconnections have evolved gradually, it is reassuring to see the 2013 approach selects similar lists of jurisdictions over time.

Appendix V. Table 1. 2013 List of Jurisdictions with Mandatory Assessments (S29)

Australia	Hong Kong SAR Germany	Poland
Austria	India	Russia
Belgium	Ireland	Singapore
Brazil	Italy	Spain
Canada	Japan	Sweden
China	Korea	Switzerland
Denmark Hong Kong SAR	Luxembourg	Turkey
Finland Denmark	Mexico	United Kingdom
France Finland	Netherlands	United States
Germany France	Norway	

Source: Staff calculations.

5. Approaches to measuring systemic risk for individual financial institutions using only market prices are less appropriate to measuring country-level systemic importance.

Since the GFC, several approaches have been developed to identify systemic financial institutions.⁶ These provide useful insights but have their drawbacks when it comes to measuring jurisdiction-level systemic importance. For one, they primarily rely on equity prices, which often deviate from other financial indicators such as credit risk (e.g., credit default swap, CDS). Also, relying only on equity prices could provide noisy indicators of cross-country financial linkages since equity price co-movements could represent linkages other than financial interconnectedness (such as synchronized real business cycles). Finally, the Basel Committee does not use such measures to identify G-SIBs. On balance, staff view the 2013 methodology as continuing to provide a reasonable basis for identifying SIFS.

⁶ Examples include Diebold and Yilmaz (2014), who used equity volatility data, the CoVaR developed by Adrian and Brunnermeier (2016) that applies value-at-risk (VaR) models, the systemic contingent claims analysis (CCA) measuring default dependence using equity price and debt ratio, and the expected shortfall approach by Acharya and others (2017).

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- _____. 2020a. [Supervisory Actions and Priorities in Response to the COVID-19 Pandemic Crisis](#). IMF, MCM Special COVID-19 Note.
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