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To: Members of the Executive Board

From: The Acting Secretary

Subject: **IMF-World Bank Financial Sector Assessment Program (FSAP)**

Attached for the information of the Executive Directors is a note on the IMF-World Bank Financial Sector Assessment Program (FSAP). A similar note is being circulated to the World Bank's Executive Board.

Mr. V. Sundararajan (ext. 38573) or Mr. Lindgren (ext. 37151) is available to answer questions relating to this note.

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INTERNATIONAL MONETARY FUND

IMF-World Bank Financial Sector Assessment Program (FSAP)

Prepared by the Monetary and Exchange Affairs Department
(In consultation with Fund Departments and the World Bank)

Approved by Stefan Ingves

May 20, 1999

The purpose of this note is to inform Executive Board members of a new Financial Sector Assessment Program (FSAP) that the managements of the Fund and the Bank have agreed upon to be undertaken jointly on a pilot basis. The program has been developed by the Monetary and Exchange Affairs Department (MAE) of the Fund and the Financial Sector Practice (Financial Operations Vice Presidency and regional financial sector units) of the Bank, in consultation with other departments/regions, and coordinated by the joint Financial Sector Liaison Committee (see also *SM/99/89*, p. 4). The objective is to provide better coverage and analysis of member countries' financial systems through closer collaboration between the two institutions and a better utilization of limited expert resources.

Background: Financial Sector Work in the Fund and the Bank

The new program draws heavily on earlier experiences in both institutions. For the last 20 years, the Fund has done diagnostic studies of aspects of member countries' financial systems in the context of MAE technical assistance. In recent years, as the importance of the linkages between financial system soundness and macroeconomic policy have become clearer, these diagnostic studies have become broader in coverage. The Fund has also been paying increasing attention to financial sector issues in the course of Article IV and multilateral surveillance, adjustment programs, and a wider range of technical assistance. The focus has been on the soundness of the banking sector, large-value payment systems, money, foreign exchange and short-term government debt markets, and on the regulatory and institutional framework for prudential control, emphasizing the linkages between soundness in those areas *and macroeconomic policy in general, and monetary and fiscal policy in particular*. In addition, in recent years, the need to identify near-term vulnerabilities and prevent crises has become evident. While Article IV missions have sought to focus on these issues, it is not feasible to expect them to do the broad and in-depth assessments that will increasingly be needed. MAE has recently developed a format for Financial System Stability Assessments (FSSAs) based on the *Guidance Note for the Monitoring of Financial Systems under Article IV Surveillance* that was issued to the IMF Board in June of last year (*SM/98/151*).

Meanwhile, the Bank also has been conducting broad-based financial sector reviews (FSRs) in many of its client countries to lay the basis for its lending and medium- and long-term sector development programs. While the breadth and depth of coverage of these assessments have varied, most have included substantial focus on macrofinancial and banking sector issues, with coverage of other elements of the sector (non-banks, capital and insurance markets, pension funds, small and medium enterprise (SME), micro and rural credit arrangements, etc.), depending on country circumstances. FSRs have contributed importantly to the Bank's country-specific knowledge base and have provided a basis for the Bank's financial sector lending. As the effectiveness of the Bank's activity depends on the quality of the FSRs, the Bank has also recently taken measures to improve the quality and consistency of this work.

Despite the different needs of the two institutions, there is a need to join forces and reduce duplication of efforts to upgrade the coverage and methodology for financial system assessments. The case for close cooperation is reinforced by the need to optimize the use of scarce financial sector specialist resources and to respond to the calls by the international community for a well structured response to identify and deal with financial system vulnerabilities and reduce the potential for crisis. The recent crises in the financial sectors of many emerging markets have further highlighted the devastating effects of financial system failures on macroeconomic stability, growth and welfare, and strengthened the case for coordinated action by the Fund and the Bank.

The Financial Sector Assessment Program (FSAP)

The managements of the two institutions, therefore, have agreed to launch a joint program to consistently assess and monitor the financial systems of member countries, with the aim of developing strategies and policies for strengthening these systems, as needed. The FSAP format will be used in all countries, and will be a joint exercise in all countries, except in industrialized countries, where the Fund will be solely responsible. In countries where both institutions are active, the FSAP calls for each institution to designate a team leader or a deputy team leader from a pool of their most experienced financial sector experts, with leadership and deputy leadership divided between Bank and Fund staff. The teams will include staff and consultants with relevant expertise from both institutions and staff from the Fund's area departments, as well as outside experts from central banks and other relevant national authorities, and other international financial institutions and regulatory bodies, as called for.

A key objective of the FSAP is to develop an approach to financial system assessment that is broadly consistent across countries, while allowing for differences in emphasis to reflect different country circumstances. To accomplish this, Bank and Fund staff are developing a common template for FSAP assessments that covers all of the important subsectors and issues from both near-term vulnerability and long-term developmental perspectives. However, not every element of the template will be assessed in every case, nor will any of the elements be applied mechanically. FSAP teams will begin with the generic template, but will develop a

narrower country-specific focus depending on the structure of the country's financial system and an evaluation of priorities for both system stability and sector development.

An important part of FSAP assessment is an evaluation of the extent to which countries have adopted and implemented internationally recognized standards, best principles, codes, practices and norms in the areas of financial (bank and non-bank) sector regulation and supervision, bank exit and resolution, payments and settlements, accounting, transparency, bankruptcy and corporate governance. These parts of the assessments will feed into the Fund's broader transparency reports. Fund and Bank staff have been substantially involved in helping international standard-setting bodies develop best practices and are expected to monitor and encourage their adoption and implementation.

FSAP reports

The FSAP team will prepare a detailed draft report, which will be discussed with the authorities during the subsequent Article IV mission. On completion of the Article IV mission, in which a member of the FSAP team will participate, the FSAP team will complete a comprehensive final FSAP report with an assessment of the country's financial system and infrastructure, and recommended corrective policy and developmental measures; this report would contain information on individual institutions, and would (like technical assistance reports) be kept confidential. Based on the FSAP report, the Fund and the Bank will prepare separate reports for their own institutional needs: Fund staff will prepare a Financial System Stability Assessment (see below) report, while Bank staff will prepare medium- and long-term sector development strategies and associated sector reports.

Financial System Stability Assessment (FSSA) reports

Based on the financial sector analysis contained in the FSAP report, Fund staff will prepare an FSSA report, which will be part of the Article IV documentation distributed to the Board and the conclusions of which would be included in the staff report. The FSSA report will identify key structural components and vulnerabilities of the financial system, and assess their impact on macroeconomic stability and policy formulation. Coverage would include: (i) prudential regulation and supervision of bank and other financial intermediaries, including compliance with international standards, core principles, and good practices; (ii) financial policies, instruments, and market arrangements for liquidity management; (iii) systemic risks in payment systems; (iv) arrangements for crisis management, such as financial safety nets, frameworks for bank and corporate restructuring and bankruptcy; (v) maturity of market infrastructure, including disclosure and transparency practices; and (vi) vulnerabilities in financial institutions and markets to macroeconomic shocks, contagion, and consequences of financial vulnerabilities and reforms (possibly including stress testing and simulations).

Country selection

The combined resources of the Bank and Fund, even when leveraged with outside expertise, are insufficient to carry out FSAP assessments in a large number of countries. Present plans, therefore, call for a limited set of pilot countries to be selected based on priorities expressed by area departments in the Fund and the regions in the Bank, and in agreement with the authorities of the countries concerned. Crisis countries would normally not be subject to FSAP missions, because in those countries financial system vulnerabilities typically already are apparent and programs often are in place to deal with them. Present plans call for coverage of some 12 countries representing all regions over the next 12 months. Assuming that full assessments normally would not need to be repeated more often than, say, every four to five years, and that resources would be available, some 50 countries could be covered over a five-year period.

Resource implications and follow-up

The present pilot FSAP will enable an assessment of both content and resource implications. Initially, the intention in the Fund is to absorb the FSAP costs within the budget of MAE, while the Bank has made a dedicated budget allocation for this program. This activity will stretch MAE's resources as it is additional to intensified participation in (i) Article IV missions; (ii) crisis and intensive program countries; (iii) stand-alone transparency assessments; and (iv) Basle core principles assessments. Management will present a progress report to the Board on the FSAP before the Annual Meetings, and a more elaborate report dealing with the full resource implications before next year's budget discussion. After review of experiences and resource implications, the program may later be stepped up to cover a broader group of countries.