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To: Members of the Executive Board

From: The Secretary

Subject: **Financial Sector Assessment Program (FSAP)—Progress Report**

Attached for consideration by the Executive Directors is a paper, prepared jointly by the staffs of the Fund and the World Bank, reviewing progress with the pilot Financial Sector Assessment Program (FSAP) which will be brought to the agenda for discussion on a date to be announced. Issues for discussion appear on page 21. A supplement to this paper describing initial procedural arrangements for the FSAP and the associated Financial Sector Stability Assessments (FSSAs) is being issued together with this paper.

Mr. V. Sundararajan (ext. 38573) and Mr. Leone (ext. 38628) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Financial Sector Assessment Program (FSAP)—Progress Report

Prepared by the Staffs of the International Monetary Fund and the World Bank

Approved by Stefan Ingves and Manuel Conthe

September 13, 1999

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I. BACKGROUND

In May 1999, the managements of the Fund and the Bank decided to launch jointly a Financial Sector Assessment Program (FSAP) on a pilot basis in the context of the Fund's Article IV surveillance. The program is designed to identify financial system strengths and vulnerabilities and to reduce the potential for crisis.¹ A joint program was seen as a vehicle to optimize the use of scarce expert resources by reducing duplication of efforts, and avoiding conflicting advice in financial sector work. The program is responsive to calls by the international community for closer cooperation to reduce the likelihood and/or severity of financial sector crises. The emphasis of the FSAP program is on prevention and mitigation rather than on crisis resolution.²

The FSAP is intended to encourage the early detection of financial system weaknesses and to develop appropriate policy responses, to support a more effective dialogue with national authorities, and to provide both institutions with a common platform for policy advice and technical assistance. The program aims also to identify key priorities for financial sector development and improve the design and delivery of support for strengthening financial systems.

The program has been developed by the Financial Sector (FSEVP) and Poverty Reduction and Economic Management (PREM) Vice Presidencies in the Bank, and the Monetary and Exchange Affairs Department (MAE) in the Fund. In consultation with the Bank's regions and the Fund's area departments, the Bank-Fund Financial Sector Liaison Committee (FSLC) has coordinated the initial development of the program.

The program will operate as a pilot for a one-year period, during which approximately 12 country assessments are expected to be carried out. A report reviewing the experiences and issues arising from the full pilot exercise will be prepared for the consideration of the two Executive Boards by the time of the Interim Committee and the Development Committee meetings next spring.

In response to interest from Directors, this interim report summarizing experiences to date has been prepared. It explains the components and operational procedures as well as the linkages of the FSAP to other activities and pilot programs of

¹ A general description of the FSAP was provided to the Boards of the Bank and the Fund in May 1999 (SecM99-371 and SM/99/116, respectively).

² In their report on strengthening the international financial architecture during their Köln economic summit in June 1999, the G-7 Finance Ministers welcomed the FSAP initiative and called for the breadth and pace of efforts to enhance effective collaboration between the Bank and the Fund in the financial sector area to be increased. The Finance Ministers also called upon the Bank and the Fund to prepare a joint report on their progress and on proposals to meet these objectives by the time of the Annual Meetings in September 1999.

each institution. Issues of outreach and collaboration with a number of national agencies and international bodies as part of the pilot program are also reviewed. The paper describes how FSAP outputs can be of value for the country authorities and also be used in a number of important ways by the Bank and the Fund, summarizes the early lessons from the experience to date, and provides a preliminary review of the resource implications of the program.

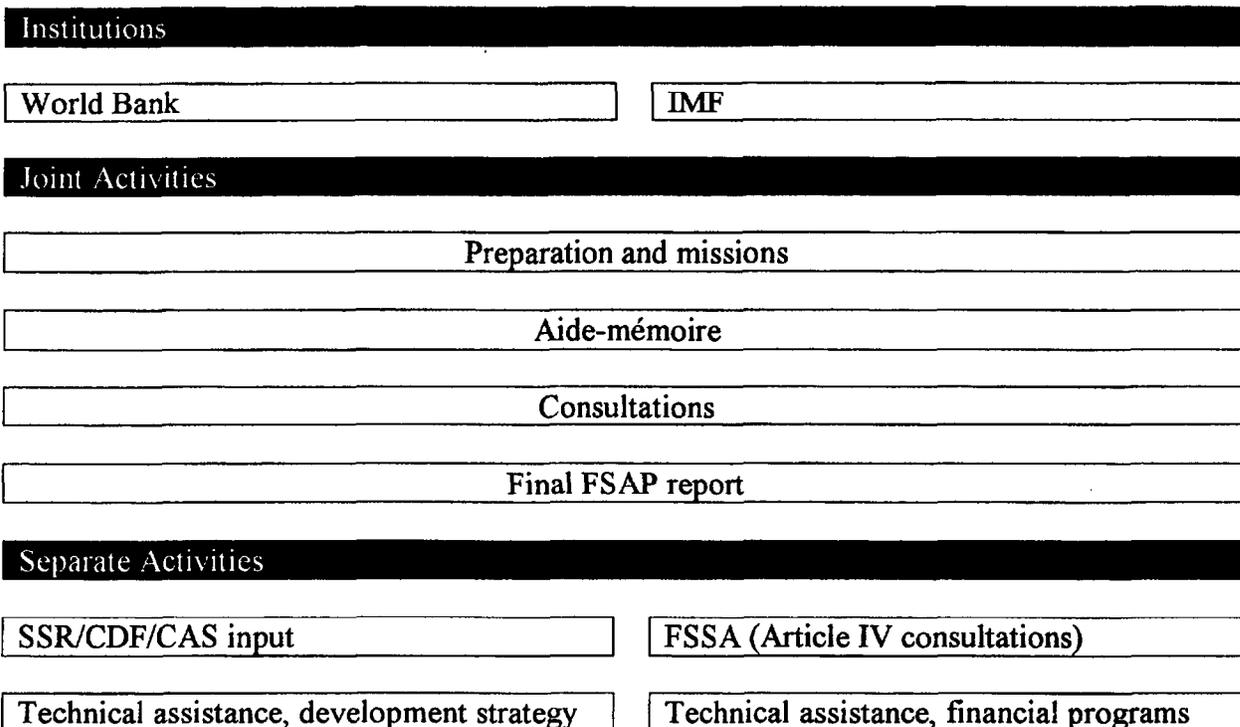
II. OBJECTIVES

The FSAP draws heavily on earlier financial sector work and experience in both the Bank and the Fund. The Fund's involvement has focused especially on the linkages between the soundness and operations of the financial sector and macroeconomic performance and the support of policies that avoid or lessen the likelihood and severity of financial system crises. In the case of the Bank, the focus has been on the importance of the financial sector to development and the reduction of poverty. The objective of the FSAP is to benefit countries by alerting them to likely vulnerabilities within their financial sectors and to assist the Bank and the Fund, and the international community more broadly, in designing appropriate assistance. The FSAP will ensure that financial sector analysis is brought further into the core of economic policy discussions. It is expected that the program will better help countries reduce financial sector vulnerabilities, and therefore the likelihood of crises. It will also provide national authorities with a strategic framework within which to undertake the strengthening of their financial systems.

III. OPERATIONAL PROCEDURES

It is envisaged that a financial sector assessment of a member country carried out as part of the FSAP will cover the most relevant areas of the country's financial system, with the depth of coverage of particular components varying according to country-specific circumstances. A set of operational procedures has been developed for carrying out FSAP missions jointly by the staffs of the Bank and the Fund, including the preparation of FSAP reports, and for the integration of FSAP mission findings into the work of the two institutions. The FSAP process and the associated reports stemming from it are summarized in Box 1.

Box 1. Schematic of the FSAP Process



Key elements of the FSAP process include:

- FSAP missions will take place in the context of the Fund's Article IV process and, therefore, will be organized in coordination with the relevant Fund area departments.
- Preparation for the FSAP missions and the authoring of an FSAP report are to be handled jointly by a Bank-Fund team. Each mission will be headed by a senior staff member from either the Bank or the Fund, with the other institution normally filling the deputy position.³ The mission team will include Fund and Bank staff as well as experts drawn as needed and available from cooperating national central banks, supervisory and financial agencies, and international financial institutions and standard setting bodies.⁴

³ The Fund will be solely responsible for mission leadership in the case of industrialized countries, however the Bank may provide staff to cover specific areas of the mission's work.

⁴ Nonofficial experts (including private consultants) will not be involved in the FSAP.

- The FSAP mission will produce a detailed aide-mémoire which will be left with the authorities. The aide-mémoire will cover the mission's assessment of the strengths, risks and vulnerabilities in the financial systems, including resilience to economic disturbances, and other potential shocks. This will include an assessment of the extent to which a country observes and is progressing towards implementation and observance of relevant internationally accepted standards and good practices throughout the financial sector, **set in the context of broader assessments of vulnerabilities and development needs**. That is, assessments of transparency and compliance issues will be carried out to the extent that they are judged to be key to the FSAP. The judgment will be made based on broader considerations of vulnerability, so that the assessments need not cover all financial system standards comprehensively. The aide-mémoire will identify any priority areas of reform, recommend the design and sequencing of needed reforms, and detail development and technical assistance needs.
- Following review of the aide-mémoire at headquarters and subsequent discussion of its findings with the authorities during the Article IV mission, an FSAP report will be produced as a joint IMF/World Bank staff report to be reviewed by the relevant departments in the Fund and the Bank, cleared by the Director of MAE in the Fund and the Financial Sector Vice President in the Bank, approved by managements of both institutions, and transmitted to the authorities. This will be a confidential report. Fund area department staff will normally participate in the FSAP missions.
- The findings and recommendations from the final FSAP report will be used by Bank and Fund staff in their individual institution's work. As part of the Article IV process, **the Fund staff** will prepare a Financial System Stability Assessment (FSSA) report which will focus on the linkages between financial system developments and macroeconomic outcomes in the context of Fund surveillance, and help contingency planning, program design, and technical assistance. FSSAs will be based on the FSAP reports, but will contain less specific institutional information and will instead focus on financial system issues of significance for macroeconomic performance and policies. The FSSA report will be approved jointly by the directors of the relevant area department and MAE, and will become part of the Fund's staff papers presented for Board discussion. The FSSA report will be a Fund document. **In the Bank**, the analysis and recommendations of the FSAP report will be summarized in a note which is less detailed than the full report and does not contain confidential information. It will also provide the basis for the financial sector component of Social and Structural Reviews (SSRs), and contribute to the Comprehensive Development Framework (CDF) discussions. The FSAP recommendations will thus provide the major input to the Bank's ongoing dialogue with client countries in the financial sector, and the foundation for the formulation of a financial sector development strategy and work program that could include lending in support of policy reforms and/or the provision of analytical and advisory assistance. The financial sector

strategy and work program would be defined in the Country Assistance Strategy (CAS), which will also provide important guidance for the Bank Group in establishing priorities. The FSAP summary note could be attached as an appendix to the CAS.

- A set of operational procedures for the FSAP, covering all aspects from the preparatory work through the finalization of reports, is under consideration by the FSLC.

IV. COMPONENTS OF THE FSAP

Some of the individual components of a particular assessment will vary according to the country-specific circumstances.⁵ In all cases, however, an FSAP mission would undertake an assessment of the strengths, risks and vulnerabilities of the financial system, given its structure as well as the macroeconomic environment, and its capacity to absorb shocks. Actions which would strengthen the financial system, together with any needed contingency plans, would be flagged and a detailed evaluation of the monetary and fiscal implications of these actions would also be provided.

Sustained systemic health depends in large part on an adequate regulatory environment and incentive structure. An FSAP assessment will therefore review the legislative underpinnings of the financial sector. Regulatory capacity and practice will be evaluated, including a systematic assessment of compliance with the Basel Core Principles for Effective Banking Supervision, transparency practices in monetary and financial policies, and other standards and sound practices. Other legal and institutional issues that bear on the financial sector may also be reviewed.

Efficient and effective implementation of monetary and exchange policy requires adequate microstructure and regulatory frameworks, supported by well-designed payment systems to manage systemic liquidity and credit risks. The assessment will therefore cover money and foreign exchange markets as well as the analysis of systemic risks in payment systems.

In addition to judging the present economic performance of the system, the authorities' strategic vision for system development may need to be considered. In developing countries, it may be appropriate to devote special attention to the potential development of capital markets, insurance, pension fund and contractual savings, as well as financial services for the underserved, as these areas can contribute to the healthy development of the financial system as a whole.

⁵ The Fund's Monetary and Exchange Affairs Department is developing a handbook which will contain a complete list of the components for the Financial System Stability Assessments.

These various components of an FSAP assessment give rise to the need to examine a broad range of areas. In each of these areas, the assessment will need to take into account the structure of the financial industry in the country being assessed, and draw on international standards, best practices, and accumulated experience of the Bank, the Fund, and other international institutions, as well as market information. While this range of areas is extensive, there is substantial in-house background knowledge in both the Bank and the Fund that permits an ex-ante identification of those issues that are most significant in a given country, so as to focus the work under the FSAP. A summary of the expected coverage of an FSAP report, on the basis of the experiences to date, is provided in Box 2.

V. RELATIONSHIP OF THE FSAP TO OTHER FINANCIAL SECTOR WORK IN THE BANK AND THE FUND

As noted, in the case of the Fund, the final FSAP report will inform the Financial System Stability Assessment (FSSA), which will be a key instrument of Fund surveillance. The Bank for its part will use the report to formulate financial sector development strategies and work programs to be defined in the Country Assistance Strategy (CAS), the Comprehensive Development Framework (CDF), and the Social and Structural Reviews (SSRs).

For both the Bank and the Fund, the FSAP will provide the basis for prioritizing and organizing technical assistance for the financial sector and a platform to coordinate the delivery of technical assistance with other donors. In the same vein, the FSAP permits the Bank and the Fund to coordinate their responses to new mandates from the international community to assess implementation and observance of standards and good practices in supervision, regulation and disclosure. More generally, the data and analysis from the FSAP will support comparative analysis of cross-country experiences, the drawing of lessons for the prevention and mitigation of financial problems, and the design and implementation of corrective practices. The remainder of this section describes in more detail the linkages of the FSAP with the key specific programs of each institution.

Fund surveillance

For some time now, Fund staff have been intensifying their attention on the linkages between the soundness of the banking and financial system and macroeconomic

Box 2. Typical Scope of an FSAP Report

I. Macroeconomic environment

- Identify factors in the macroeconomic environment relevant to the performance of, and their implications for, the financial sector.

II. Financial institutions' structure

- Soundness of financial institutions, both bank and non-bank, including quantification of system portfolio and income statements. For banks and near banks, includes evaluation of developments in prudential indicators relating to solvency, profitability and margins, liquidity and market risk. This includes an analysis of exposures to particular sectors such as property, nonperforming loans and interest margins. This may require the analysis of individual data on systemically important institutions.
- Developments in assessments by supervisors, rating agencies, and analysts.
- Developments in the corporate sector that may flow on to the financial sector, as well as possible asset price bubbles.
- Stress testing and sensitivity analysis of aggregate and disaggregated data on financial institutions and markets to changes in macroeconomic variables and international developments, particularly to asset price collapses and to changes in interest and exchange rates.
- Monetary and fiscal implications of restructuring and reforms that may be needed.

III. Financial markets

- Structure and efficiency of organized money and foreign exchange markets, including market segmentation, if any.
- Structure and efficiency of organized markets in debt and equity securities, including existence of market segmentation, if any.
- Structure and efficiency of credit markets, including aspects such as small business finance where appropriate.
- Adequacy of the policy, regulation and supervisory framework for capital markets. Issues relating to transparency, and credit rating agencies.
- Systemic liquidity issues, including developments in the volume, market liquidity, and depth of markets, especially those through which authorities and financial institutions manage their liquidity (money, interbank, foreign exchange, and government securities).
- Aspects of monetary operations, including central bank lending policies and money market interventions from the perspective of liquidity management, and lender-of-last resort and contingency liquidity arrangements.
- Foreign exchange market intervention systems and policies, contingent liabilities, and external debt exposures.

IV. Review and assessment of systemic risks in payment systems, and risk management procedures

- Developments in transactions, instruments and regulations in major domestic payment systems.
- Operation of the clearing and settlement process/settlement accounts.
- Status and developments in risk management and loss sharing arrangements.

V. The legal framework and the system of official oversight, prudential regulations and supervision, including observance of standards, core principles and good practices

- Major developments in bank legislation, regulations and supervisory systems and procedures.
- Compliance with the Basel Core Principles for Effective Banking Supervision.
- Status and major developments in capital market and insurance regulations, as needed.

Box 2. Typical Scope of an FSAP Report (continued)

- Transparency practices in monetary and financial policies.
 - Status and developments in early warning systems, off-site analysis, and external audit arrangements.
 - Compliance and enforcement of accounting, disclosure and reporting standards.
 - Efficient operation of the legal system with respect to financial institutions and transactions, including corporate governance, collateral arrangements and enforcement of financial claims.
- VI. The institutional and legal arrangements for crisis management, financial safety nets, financial institution and corporate intervention and workout mechanisms**
- Bank exit policies and developments in bank resolution and liquidation.
 - Guarantee schemes and deposit insurance—status and developments.
 - Institutional/legal framework for corporate bankruptcy, corporate restructuring, and loan recovery.
 - Corporate governance incentives and practices.
- VII. Key reforms to reduce vulnerabilities in the financial system and to minimize systemic risks**
- Appraisal of key structural vulnerabilities and deviations from best practice.
 - Formulation of a broad action program of financial system reforms.
 - Proposals for sequencing of specific measures to implement the action program.
 - Identification of sector development and technical assistance needs to support reforms.

performance.⁶ Recent experiences, particularly in Asia, reinforced the need for strengthened surveillance over financial systems with a view to supporting systemic stability in the context of globalization, financial market integration, and capital account liberalization. In particular, scrutiny is being intensified where there is a significant possibility that financial system problems could have systemic implications, not only domestically, but also contagion effects on other countries. Fund staff are also monitoring countries' progress regarding the implementation of good practices and core principles in their financial sectors and encouraging them to adopt guidelines and standards being developed by international standard-setting bodies. This experience will also permit the provision of feedback to these bodies on the adequacy and gaps in standards.

To this end, as noted, Fund staff have developed an enhanced monitoring mechanism through in-depth FSSAs which will be based directly on the FSAP reports. The linkages between the FSAP and Fund surveillance will be further strengthened as one or more key FSAP mission members will normally be expected to participate in the

⁶ To strengthen surveillance of financial sectors, MAE prepared a *Guidance Note for the Monitoring of Financial Systems Under Article IV Surveillance* that was issued for information of the Fund's Board in June 1998 (SM/98/151). Complementing the guidance note, a set of related *Tables and Questionnaires* was prepared in November 1998. The guidance note and the accompanying tables and questionnaires were designed to guide the work of Fund missions involved in monitoring financial sectors in the context of Fund surveillance. Work is underway to prepare a handbook to aid in the FSAP/FSSA exercises which would build on the earlier guidance note as well as other work which is ongoing in the Fund to identify indicators of financial system soundness (macroprudential indicators).

associated Article IV mission discussions with the national authorities on financial sector issues, while area department staff would often participate in the FSAP mission itself. Thus, this work feeds into the Article IV process, program design, and technical assistance.

The Bank's sector development strategies and associated sector reports

As part of a commitment to increase its work in the financial sector, the Bank has undertaken to assess more systematically countries' financial systems. The goal is to help client governments identify improvements that increase the robustness of the financial sector, as well as contingency plans in the event of a crisis. In the past the Bank has conducted Financial Sector Reviews periodically in many countries. The FSAP will complement these reviews and other analytical work by the Bank in the financial sector. FSAP reports will target early identification of vulnerabilities, contingency plans for crises, and a strategy for making the financial system more robust and for promoting its sound future development. Moreover, participation of experts from the Fund and various national and international agencies will help make for a thorough identification of reform priorities.

The FSAP recommendations will also provide the foundation for the formulation of a financial sector development strategy and work program that could include lending in support of policy reforms and/or technical assistance as appropriate.

Technical assistance

For an FSAP to be effective, the report will need to identify feasible follow up measures for the authorities. The FSAP reports will provide a common basis on which to develop the financial sector technical assistance programs of the Bank and the Fund in cooperation with country authorities. The Bank and the Fund will coordinate in providing technical assistance to a particular country to implement recommendations in an FSAP report.

The Fund provides technical assistance in its core areas of competency, which include the monetary and financial sectors, to facilitate the design and implementation of structural and institutional reforms. The Fund's technical assistance is generally provided on a limited scale and typically has a high policy content. In countries where an FSAP exercise has been undertaken, the key reforms which are identified as being necessary to strengthen the financial system and foster institutional development will provide the basis for the design of the Fund's technical assistance program.

These reforms will also provide inputs for the Technical Consultations (TCs) and Technical Cooperation Action Plans (TCAPs), which are being developed on a pilot basis.⁷ Technical consultations are to be undertaken as part of Article IV consultations to

⁷ Undertaken in response to a recommendation contained in the recent review of the Fund's technical assistance by the Office of Internal Audit. See *Review of Fund Technical Assistance*, EBAP/99/59, May 17, 1999.

review the scope of past and prospective technical assistance activities of the Fund and their effectiveness. This could include follow-up discussions based on FSAP work or other financial system work already completed. TCAPs involve an in-depth review of vulnerabilities, strengths, implementation and observance of standards, and reform needs, leading to an action plan for reforms supported by Fund technical assistance, and as such will be able to build directly on the FSAP in matters relating to financial sector issues.

On the Bank's side, key recommendations in an FSAP report to strengthen the financial system and foster institutional development will provide the basis for the Bank's country directors, together with financial sector staff and the country counterparts, to develop a technical assistance program.

The Bank has a number of modalities through which technical assistance for financial sector reforms can be provided, but there is scope for enhancing these mechanisms. These modalities include:

- **Technical assistance directly provided by Bank staff.** In many instances, the expertise required to assist national financial authorities can be found within the Bank, and it may be efficient for Bank staff that have helped identify assistance needs to carry out the follow-up work. Funding for these activities from the Bank's budget could be usefully supplemented by trust funds, if possible.
- **Technical assistance provided through lending.** The Bank can arrange expert assistance from private and official sources through technical assistance lending, either in conjunction with an FSAL or independently. Technical assistance loans have been used effectively in helping finance technical assistance to the Asian crisis countries. *More extensive use of loans for this purpose will depend on borrowers determining that financial sector reforms warrant sufficiently high enough priority to justify borrowing to finance the technical assistance.*
- **Technical assistance provided through trust funds.** Trust funds provided by donors specifically for financial sector advisory services are an important modality for financing technical assistance to implement the recommendations of FSAPs. Trust funds have also been a significant component of the Bank's assistance programs in the Asian crisis countries. These funds can provide assistance effectively to complement, or substitute for, technical assistance loans. To support the ability to deliver technical assistance, the Bank will seek trust fund support specifically for the FSAP program.

Compliance with standards

The FSAP will permit the Bank and the Fund to coordinate their work as regards assessments of implementation and observance of standards and good practices. In particular, the FSAP would have a close connection with the Fund's proposed *Reports on*

Implementation of Standards and Codes (RISCs),⁸ which are intended to monitor compliance with and implementation of a range of international standards and good practices, including in the financial sector.

A comprehensive financial sector assessment would need to take account of transparency and compliance issues as regards the financial sector (including compliance with a broader range of standards than are envisaged to be covered by RISCs).⁹ It may therefore often be possible and appropriate for the financial sector components of a RISC to be produced as part of an FSAP exercise. This would be consistent with a modular approach for the RISCs, in terms of which assessment of different standards could be carried out at different times.¹⁰

There is also a need to develop, compile and disseminate key financial sector statistics that would facilitate regular and continued monitoring of the financial sector. In the Fund, efforts are underway to integrate the data form and standards of the SDDS/GDDS and the technical assistance provided by the Fund's Statistics Department within the FSSA process, including the identification of relevant macroprudential indicators.

At the request of the Basle Committee, the Bank and the Fund are also undertaking assessments of countries' compliance with Basel Core Principles for Effective Banking Supervision (BCPs). An FSAP report would normally include an assessment of financial supervision and regulation, based on the Core Principles, so that a compliance assessment could be produced by the FSAP mission team. However, because of the limited number of FSAP assessments, at least in the pilot phase, the Bank and the Fund are also undertaking these BCP assessments in separate missions, or as part of technical assistance and other missions. These stand-alone Core Principles assessments would be an input to any future FSAP reports.

⁸ See *International Standards and Fund Surveillance—Progress and Issues*, EBS/99/158, August 17, 1999.

⁹ FSAP reports would normally contain a full analysis of implementation and compliance with the *Basel Core Principles for Effective Banking Supervision* and of transparency issues related to monetary and financial policies, based on the *Code of Good Practices on Transparency in Monetary and Financial Policies*.

¹⁰ The RISC project is still in a pilot stage, and the proper way to produce RISCs (when on a stand-alone basis and when as a part of a broader assessment) still remains to be decided.

VI. EXPERIENCE TO DATE

The FSAP is only a few months old. To date, 5 of the 12 assessments envisaged for the pilot have been scheduled. Of these, one (Lebanon)¹¹ has been completed and another (Colombia) is close to completion. Preparatory work for the assessments for South Africa, Canada, and Iran is well advanced. Discussions within the Bank and the Fund, and informal contacts with national authorities, are underway to complete the list of countries for the pilot exercise.

While the FSAP is still in its early stages, experiences gained from the missions which have taken place, and the preparatory work which has been undertaken for the other country cases as well as the program as a whole, can already be usefully summarized regarding: (a) the allocation of responsibilities for specific work areas between the Bank and the Fund, as well as the use of experts from collaborating official agencies in member countries; (b) the selection of countries and communications with national authorities regarding the program; (c) several confidentiality issues; (d) the linkages between the FSAP and other work related to assessment of implementation and compliance with standards and good practices; and (e) the resource implications.

Allocation of responsibilities, staffing of FSAP missions, and cooperating institutions

Table 1 provides a breakdown of the staffing of the FSAP missions which have been scheduled to date, by area of expertise. Typically, these missions consist of 9 to 13 professional staff, plus one or two support staff as needed. As noted, each mission is headed by a senior staff member from either the Bank or the Fund with the other institution normally filling the deputy position (the exception being Canada which, as an industrial country, requires less World Bank involvement). The allocation of responsibilities between the Bank and the Fund in each case reflects each institution's areas of expertise.¹²

FSAP assessments provide a comprehensive coverage of financial sector components and therefore would normally require a team with a broad range of expertise, capable of providing consistent assessments and advice and giving added credibility to the process. To respond to the necessary resource requirements, it is essential to utilize expertise from elsewhere to complement the staff specialists from the Bank and the Fund. For this purpose, in a similar manner to that used by the Fund in its ongoing arrangements with cooperating institutions for the provision of technical assistance,

¹¹ The Fund's Executive Board reviewed the FSSA report for Lebanon (SM/99/200) in early September in the context of the Article IV Executive Board discussion for this country.

¹² This allocation is in accordance with the agreed division of responsibilities between the Bank and the Fund in financial sector work. See *Review of Bank-Fund Collaboration in Strengthening Financial Systems*, SecM98/732 and SM/98/224.

**Table 1. FSAP Missions:
Subject Specialties and Cooperating Institutions**

Team Leaders/Subject	Lebanon	Colombia	South Africa	Iran	Canada
Mission leader	WB	IMF	IMF	IMF	IMF
Deputy leader	IMF	WB	WB	WB	IMF
Assessment of strengths, risks and vulnerabilities	IMF/WB	IMF/WB	IMF/WB	IMF/WB	IMF
Banking supervision, assessment of implementation and observance of Core Principles for Effective Banking Supervision	IMF and Banque de France	WB and Superintendency of Banks of Chile	IMF and OFSI (Canada)	WB and Financial Services Authority (UK)	U.S. Federal Reserve Board, Deutsche Bundesbank, and Central Bank of Brazil
Legislative framework	WB	WB	WB	WB	
Transparency issues in monetary and financial policies	IMF	IMF	IMF	IMF	IMF
Money and exchange markets	IMF	IMF	IMF Central Bank of Ireland	IMF	IMF
Debt and equity securities	IMF	WB	WB	WB	WB and Australian Securities and Investment Commission
Payment system		IMF and Reserve Bank of Australia	WB		Sveriges Riksbank
Capital markets, insurance, pension funds, and contractual savings	WB	IMF/WB	WB	IMF/WB	WB, Australian Securities and Investment Commission
Other	WB (Corporate governance, accounting, disclosure and information management)	WB (Public banks' resolution)	WB (Small business finance)		
Total mission members (excluding support staff)	9	13	11	10	12

additional expert support for the FSAP pilot has been sought from some 30 national agencies (central banks and supervisory authorities of selected OECD and emerging market countries), standards-setting bodies, and other international agencies. The response from these institutions has been highly positive and, as noted in Table 1, experts from them are participating in the FSAP missions.

Selection of countries for the pilot

To gain the maximum benefit from the pilot, the intention has been to undertake assessments of the financial sector in a group of around 12 countries, with a wide geographic spread and with differing financial system characteristics. Participation in the pilot is voluntary.

As a first step in the country selection process, the Fund's area departments and the Bank's regions, in consultation with MAE and the Financial Sector Vice Presidency, identified a sample of important countries covering all regions, and representing different types of financial sectors, for which it was felt that assessments would be useful. In addition, some countries which had indicated interest in being subject to these assessments were included in the pool of possible candidates for the pilot. This process was coordinated by the Bank-Fund Financial Sector Liaison Committee (FSLC). In line with the focus of the FSAP on prevention and mitigation rather than on crisis resolution, countries that were experiencing a financial crisis, or where their financial sector weaknesses were already well understood, were excluded from consideration. Discussions were then initiated with individual country authorities as regards potential participation.

It was found that the national authorities in some countries that had been identified by the Bank and Fund staff as potential candidates for the pilot were unwilling to participate. In a couple of cases, the countries approached had recently experienced or anticipated major changes in government and other tasks were deemed of higher priority. In one case, however, it was felt that participation might signal to the markets a concern by the Bank and the Fund that major problems existed, and thereby result in a loss of confidence in the financial system. In another case, the authorities felt that they would have difficulty with the increased workload that was involved (including the gathering of necessary information and the completion of questionnaires), especially if an FSAP mission occurred concurrently with the Article IV consultation mission.

Confidentiality issues

Confidentiality issues arise in connection with the FSAP for several reasons. Most important are: (i) FSAP missions may well need to have access to market sensitive information on specific institutions; (ii) official sector experts from outside the Bank and the Fund may participate in some FSAP mission teams; (iii) sections of the FSAP report may be useful to individual agencies within the country being assessed, but other sections may not be and may contain sensitive information; and (iv) key FSAP findings may need to be appropriately incorporated in less confidential reports prepared by the Bank and the

Fund. The Bank-Fund Financial Sector Liaison Committee is formulating a protocol to address these confidentiality issues.¹³

Implementation and observance of standards

The experience to date shows that a comprehensive assessment of implementation and observance of standards is facilitated if it is undertaken as part of a broader assessment of vulnerabilities, risks, and development needs (e.g., as part of FSAP missions, multi-topic technical assistance missions—including future TCAP missions, and sometimes as part of Article IV missions when they seek to address specific vulnerabilities). Moreover, these assessments cannot be limited to a simple checklist, and require specialized expertise. In this connection, there is necessarily a trade-off—given limited resources—between the extent to which staff and experts spend time reviewing and assessing a standard in a particular policy area comprehensively and in detail, and the extent to which they focus on analysis of specific vulnerabilities and risks of macroeconomic significance, with only a selective look at specific elements of a standard, as needed. While, at one level, this is an issue of making efficient use of resources for the Bank and the Fund, it is also a matter of setting appropriate priorities at the country level so as not to overburden the authorities (whose time is a scarce resource). **It would therefore seem appropriate that FSAP team leaders, in consultation with Fund area departments and Bank regions, make a judgement in the preparatory stages for an FSAP as to which transparency and compliance issues, if any, are key and focus primarily on those.**

This said, it should be underscored that vulnerability can arise even if all international standards are adhered to, and that the FSAP cannot serve as a fool-proof early warning system or replace the countries' own diligence in ensuring the soundness of the financial system. Moreover, in encouraging implementation of and adherence to international standards, it should be noted that the application of minimum standards may not be feasible or sufficient in some countries, given the structure and level of risks faced by financial institutions, and that there are many areas related to financial system soundness where standards need still to be developed.

As regards the *Basel Core Principles for Effective Banking Supervision*, a full assessment may reveal various weaknesses and gaps in the supervisory framework, but this assessment should be set in a proper macroeconomic and institutional context in order to identify the relative priorities to be attached to specific gaps, and develop an appropriate focus for supervisory and regulatory reforms. A similar conclusion also applies to assessment of observance of the Code of Good Practices on Transparency in Monetary and Financial Policies.

¹³ Under existing confidentiality rules, experts hired by the Bank and the Fund are subject to the same confidentiality standards as Bank and Fund staff. Nevertheless, an explicit protocol as regards the standards expected of experts hired in connection with the FSAP would serve to allay any concerns by national authorities.

Resource implications

Experience with the budgetary implications of the FSAP is limited as the mission work has been completed for only two countries (Lebanon and Colombia) to date.¹⁴ Moreover, the staff time taken at headquarters, both prior to and after the missions, may be greater for the initial exercises than might ultimately be the case because many of the procedures are still under development. More generally, the program is still at an early stage and so the staff are in a learning phase. Estimates of resource implications at this stage should therefore be considered preliminary, with a full assessment of the resource implications of the FSAP being possible only towards the end of the pilot period.

Irrespective of these provisos, it is clear that the resource implications of the program are significant. The mission teams are necessarily large and some mission members also participate in the Fund's associated Article IV missions. In addition, extensive preparation before missions, and work at headquarters after missions to finalize reports (including supervisory and coordination work) are required. Finally, there are indirect implications arising from the necessary follow-up work, including technical assistance.

Table 2 presents estimates of the staff resources, in staff weeks, involved in the FSAP for Lebanon (report finalized) and Colombia (report in process). These estimates include work carried out by all mission members and support staff, including experts.

As the table shows, the two assessments have each required the equivalent of about 1.5 effective staff years (to which travel costs must be added). One of the objectives of the FSAP is to make more efficient use of Bank and Fund budgetary resources. Plans for accomplishing this, though not without some cost of their own, include making better use of off-site analysis and monitoring as well as more consistent information sharing. Overall, should the FSAP be implemented on a permanent basis, the program will imply substantial additional resource costs to both the Bank and the Fund. The resource requirements for the FSAP will limit the number of assessments that can be carried out each year.

At the same time, the evolving nature of financial systems, and the rapid pace with which problems can develop, mean that it would be desirable to carry out follow-up assessments perhaps with four-five year intervals. Doing this for the entire membership would be quite costly. One solution to be explored could be to identify a group of key countries which would be subject to assessments on a four-five year cycle. This group could include countries judged to be systemically important in their region or internationally.

¹⁴ The estimation of budgetary implications of the FSAP is complicated by the differing approaches to budgeting in the Bank (dollar based) and the Fund (manpower based).

**Table 2. Staff Resources Involved in the FSAP
(Staff Weeks)¹⁵**

	IMF		Total	World Bank	Other ¹⁸	Total
	MAE ¹⁶	Area Departments and others ¹⁷				
Lebanon	30	6	36	21	7	64
Colombia	29	6	35	27	4	66

Issues relating to the resource costs of the FSAP, including the appropriate mode and frequency of assessments will be reviewed in detail at the end of the pilot period, based on the experiences with a full range of countries and types of financial systems. At this stage, however, it is clear that whatever modalities are followed, undertaking the FSAP on a permanent basis would result in a substantial budgetary cost. Based on the results for the assessments to date, and assuming that the workload will be split evenly between the Bank and the Fund, undertaking only 12 full country assessments per year would seem to imply a need for about 8-10 staff years of resources from each institution.¹⁹ To undertake the FSAP with the depth and coverage called for by the G-7 would imply undertaking 25-30 assessments per year.

¹⁵This does not include the travel costs.

¹⁶ Includes MAE review and senior staff time (4.5 weeks for Lebanon and 3 weeks assumed for Colombia).

¹⁷ Includes area department senior staff and review time (2 weeks per country), and review time by other departments (1 week per country).

¹⁸ Includes work by outside experts. For Lebanon this comprises one MAE-financed short-term expert and services provided by a local legal firm hired by the Bank. For Colombia, this comprises two MAE-financed short-term experts.

¹⁹ It should be noted that the Bank has assigned a dollar allocation from its budget for the pilot, while the cost to the Fund has been absorbed within MAE's existing staffing budget.

VII. CONCLUDING REMARKS

Though the experience to date is limited, a number of tentative conclusions can be drawn from the development of the FSAP. There are also some issues that will require further consideration in the envisaged remaining pilot cases. Most important are the following:

- By strengthening coordination in financial sector work by the Bank and the Fund and gathering expertise from cooperating institutions, the FSAP contributes to improved analysis of strengths, risks, and vulnerabilities of financial systems and consistent advise on the design of necessary reforms.
- The FSAP has significant potential value to countries in addressing financial sector vulnerabilities.
- It is clear that the FSAP can contribute to strengthening the monitoring of financial systems in the context of Article IV consultations, by providing for mobilization of in-depth expert assessments and by facilitating the integration of these findings in the Article IV process. In order to maximize the impact of the FSAP, these assessments will be carried out in the context of the Article IV consultation and in close coordination with area departments.
- The pilot FSAP has, so far, involved voluntary participation by countries. The issue of whether it should become a fixed part of the Article IV process will need to be considered at the time of completion of the pilot stage.
- The outputs from the FSAP will be used in a number of ways of importance for the country authorities as well as for both the Bank and the Fund. These include inputs for the Fund's Financial System Stability Assessments and for the financial sector components of the Bank's Social and Structural Reviews. Moreover, the FSAP provides inputs for the Fund's technical assistance work on financial sector issues as well as Technical Consultations and Technical Cooperation Action Plans, and the Bank's technical assistance programs for financial sector reforms. The FSAP outputs will also feed into the work of the Bank and the Fund in assessing implementation and observance of standards, codes and good practices in the financial sector, including the Fund's proposed RISCs.
- *There would seem to be a need for a better explanation to country authorities by the staffs, as well as by Executive Directors, of the purpose and structure of the FSAP and its potential value in prevention and mitigation of problems in the financial sector that may have significant macroeconomic implications.*
- There is a need to determine whether the Bank and the Fund have adequate resources to transfer FSAP recommendations into actions.
- The FSAP raises issues regarding the trade-offs between confidentiality and transparency. The FSAP report is envisaged to be confidential. However,

consideration should be given to cases of members wishing to make this report public. There is also a question on whether the FSSA report will be a separate or an integral part of the Fund's staff papers presented for Board discussion, when the question of public release of the Article IV staff report and accompanying documents is addressed. Also, a number of countries may not be willing to participate until there are clear understandings on confidentiality issues. These issues will be further analyzed at the time of completion of the pilot.

- There is a wide range of financial sector issues which could be addressed in a specific country in the context of an FSAP. However, the Bank and the Fund, in addition to making most effective use of their own limited resources, need to be sensitive to the burden that is placed on national authorities. Therefore, the financial sector issues which are felt to be of primary importance for an individual country need to be identified and prioritized before the visit to this country takes place. This necessitates careful and substantive preparatory work to gain an initial view on the strengths, risks and vulnerabilities of a country's financial system. Also, to alleviate the workload on the part of the authorities it seems appropriate to schedule the FSAP mission in advance of the Article IV mission.
- At the same time, the coverage of the FSAP should not be too narrowly defined as inter-sector linkages mean that fragilities arising in one area can have implications for other parts of the financial system. The FSAP needs therefore to cover the financial sector in the broad sense, including capital markets, the insurance sector, securities exchanges, and accounting and legal issues pertaining to the financial sector. Trade-offs will therefore have to be found elsewhere. For example, although the assessments of implementation and observance of standards provided a useful tool in organizing the discussions on policy practices during the missions to date, and such assessments were facilitated by the missions' focus on underlying policy practices and quality elements, there is a trade-off between resources needed for comprehensively assessing compliance with standards and those needed for redressing vulnerabilities, with selective focus on key aspects of standards.
- The FSAP will demand significant additional staff resources for both the Bank and the Fund if assessments are regularly undertaken for all member countries.

VIII. ISSUES FOR DISCUSSION

The issues arising from the pilot FSAP will be reviewed in detail in a report for the Boards of the Bank and the Fund at the end of the pilot period. At the present time, however, the views of the Executives Directors would be particularly welcomed on the following issues in order to guide the work during the remainder of the pilot:

- (a) *Do Directors consider that the objectives and components of the FSAP are appropriate?*
- (b) *What are Directors' views regarding the trade-off between assessments of financial system strengths and vulnerabilities and assessments of implementation and observance of standards and good practices?*
- (c) *Do Directors agree with the approach taken to involve experts from central banks, supervisory agencies, and other international bodies in the FSAP?*
- (d) *What are Directors' views concerning the initial assessment of the resource implications of the FSAP that is provided in the paper?*

