FOR AGENDA

SM/00/263

November 27, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Financial Sector Assessment Program—A Review—Lessons from the Pilot and Issues Going Forward**

Attached for consideration by the Executive Directors is a paper, prepared jointly by the staffs of the Fund and the World Bank, reviewing experience with the Financial Sector Assessment Program. Issues for discussion appear on pages 35 and 36. This subject, together with a paper on financial system stability assessments and the monitoring of financial systems under Fund surveillance (FO/DIS/00/143, 11/27/00), will be brought to the agenda for discussion on a date to be announced.

It is intended to post this paper on the Fund's external website and to issue a public information notice based on the Chairman's concluding remarks following the Board discussion.

Questions may be referred to Mr. Leone (ext. 38628) and Mr. O'Brien (ext. 34319).

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

THE WORLD BANK

Financial Sector Assessment Program (FSAP)—A Review:

Lessons from the Pilot and Issues Going Forward

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

Approved by Stefan Ingves and Manuel Conthe

November 27, 2000

Contents Page

Text Tables

Boxes

FINANCIAL SECTOR ASSESSMENT PROGRAM—A REVIEW: LESSONS FROM THE PILOT AND ISSUES GOING FORWARD

I. INTRODUCTION

1. The Financial Sector Assessment Program (FSAP) was introduced in the wake of the financial crises of the late 1990s with a view to strengthening the monitoring of financial systems in the context of the Fund's bilateral surveillance and the Bank's financial sector development work. The program seeks to contribute to the ongoing efforts to promote national and international financial stability and growth; it supports consistency of policy advice by the two institutions, fosters accountability, and economizes on scarce expert resources. The program was initially launched in May 1999 on a one-year, twelve country, pilot basis. During the review of progress with the FSAP pilot in the spring of this year, Executive Directors in both institutions welcomed the quality of the work thus far and agreed that the program should be continued, with country coverage being expanded to around 24 members in FY 2001.[1] Bank and Fund staff have been implementing the FSAP drawing on feedback received from previous Board discussions, from national authorities and from various international groups.

2. Several important lessons should be highlighted:

- The program has found strong support in the international community (see Box 1) and in countries that have participated.

- The program has in some cases informed national authorities of emerging problems in their financial systems and has already contributed to national reform efforts as well as to enhancing the surveillance work of the Fund and the financial sector development work of the Bank.

- The value-added of the program derives importantly from its collaborative nature. The joint nature of the program and the expert support it receives from cooperating institutions also enhance its legitimacy. The synergies and efficiencies that arise from combining the perspectives and expertise of the Fund and the Bank to gain a common platform for analysis and policy advice are central to the program.

---

[1]See *IMF-World Bank Financial Sector Assessment Program (FSAP)* (SM/99/116 and SecM99-371) which provides a general description of the FSAP. *Financial Sector Assessment Program Progress Report—Lessons from the Pilot Exercise and Next Steps* (SM/00/54 and SecM2000-130) provides a report on progress with the program and contains some preliminary lessons from the pilot exercise. *Financial Sector Assessment Program—Update* (SM/00/205, SecM2000-541) provides a brief update on the FSAP.

Box 1. International Support for the FSAP

Since its start in 1999, the FSAP has received close international attention. Most recently:

- During the recent Annual Meetings in Prague, the IMFC endorsed the Managing Director's vision of the future role of the IMF, as set out in his address to the Board of Governors of the Fund, in which an expansion of the FSAP plays an important role.[1] The Committee also noted that Fund surveillance should be strengthened further to help the Fund and its members identify vulnerabilities and to anticipate threats to the financial stability of member countries. In this respect, the Committee encouraged members to participate in the FSAP.

- The APEC Finance Ministers during their meeting in Brunei Darussalam in early September 2000 affirmed the importance of, and encouraged participation in, the FSAP in order to strengthen financial systems. Together with the Reports on Observance of Standards and Codes (ROSCs), the FSAP was seen as contributing to adapting the IMF's surveillance role and the World Bank's developmental role. They also noted the importance of basing these assessments on the substantive quality of policies taking account of the circumstances of each economy.[2]

- At their second meeting in Montreal in October 2000, the Finance Ministers and Central Bank Governors of the G-20 reaffirmed their commitment, made at the inaugural meeting of G-20 Ministers and Governors in Berlin in December 1999, for their member countries to participate in the FSAP.[3]

1/ Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Prague, September 24, 2000.
2/ Joint Ministerial Statement, Seventh APEC Finance Ministers Meeting, Bander Seri Begawan, Brunei Darussalam, September 9-10, 2000.
3/ News release from the second Meeting of the Finance Ministers and Central Bank Governors of the G-20, Montreal, October 25, 2000.

- The FSAP requires new analytical techniques, tools, and methodologies, which are evolving as all the parties involved learn from experience.

- The FSAP diagnosis is only one aspect of a broader process. Follow-up technical assistance and other forms of support to countries where vulnerabilities and development needs are identified must be integrated into the ongoing work of the Bank and the Fund.

- Ensuring the necessary quality of assessments on a continuing basis is a challenge. The necessary resources and suitable expertise for both the diagnostic aspects as well as the associated follow-up work must be secured.

3. This paper was requested by the Executive Directors of both institutions at the time of their Spring 2000 review of the FSAP pilot.[2] At that time, Directors welcomed the strengthened collaboration between the Fund and the Bank in the context of the FSAP. They noted that this collaboration was contributing to an effective utilization of scarce expert resources as well as providing a platform for policy responses and technical assistance. They agreed that in-depth assessments of the strengths, weaknesses, risks and vulnerabilities of members' financial systems help to focus national authorities' attention on financial sector issues that might not otherwise have been subject to the same level of scrutiny.

4. Directors also welcomed the participation in FSAP missions of experts from central banks, supervisory agencies, and international standard-setting bodies, who provide an important element of international peer review, especially in the assessments of observance of international standards and codes of good practices. Directors looked forward to the inclusion of experts from a broader range of institutions in future FSAP missions, and encouraged member countries to contribute expert support to the program to the extent feasible.

5. Fund Directors reiterated that assessing the financial sector is an integral part of surveillance. In this regard, many Directors suggested that the FSAP could serve as the primary basis for enhancing the Fund's monitoring of the financial sector in the context of Article IV surveillance.[3] Those Financial System Stability Assessments (FSSAs), derived from FSAP findings, which the Fund's Board had at that stage reviewed were found to have deepened the quality and coverage of financial sector issues in Article IV consultations.

6. Directors in both institutions wished to review further some aspects of the program after the experience with the pilot had been more fully assimilated. Particular issues that were felt to require further review by the Boards of the Bank and the Fund, as relevant, included: the nature of the linkages of the FSAP to Fund surveillance; the role of the FSAP in the work of the Bank; the appropriate scope and country coverage of the FSAP in the future, given resource constraints; circulation and publication policies with regard to FSAP reports, the Fund's FSSAs and the Bank's Financial Sector Assessments (FSAs); and the relationship of the FSAP to other initiatives on the architecture of the international financial system.

7. In July 2000, the Fund's Board supported assessments of Offshore Financial Centers (OFCs) on a three module basis.[4] "Module three" assessments would be similar in scope to

---

[2]See *Concluding Remarks by the Acting Chairman, Financial Sector Assessment Program—Progress Report—Lessons from the Pilot Exercise and Next Steps,* Fund Executive Board Meeting 00/38, April 4, 2000 (BUFF/00/56).

[3]BUFF/00/56.

[4]See *Offshore Financial Centers—The Role of the IMF (*SM/00/136 and BUFF/00/98).

those under the FSAP, and would be comprehensive, covering risks and vulnerabilities, observance or standards and the quality of supervision—including cross border cooperation and information exchange and the extent to which consolidated supervision of on-shore financial institutions effectively covers transactions with off-shore jurisdictions. Decisions with respect to the scope and modality of the FSAP will thus have consequences for the OFC assessments. More recently, some Directors in both institutions have expressed interest in clarifying the role of the Fund and the Bank with respect to financial market integrity issues, covering financial abuse and money laundering. This issue will be addressed in a joint Bank-Fund paper being prepared for Board consideration prior to the Spring Meetings.[5]

8. This paper outlines the experience that has been gained with the FSAP from which Directors may draw more definite conclusions on the appropriate modalities of the program going forward. It also identifies a number of issues on which guidance from the Boards would be useful. Section II discusses experience with the FSAP, drawing on the experience of the staff, feedback received during an outreach meeting held in October 2000, as well as other feedback from the authorities that have participated in the program. Section III provides the staff's view of the program going forward. Section IV presents the issues for the Fund and the Bank on which guidance from the respective Boards is requested.

[5]In the Fund, the Board will consider the issues in a question and answer session on the paper in January 2001, before a full discussion of the issues in March 2001.

II. Experience to Date

Country coverage

9. The mission work for all 12 FSAP pilot countries was completed by April 2000 (Table 1). For eight of these countries, the Fund's Board has reviewed the related FSSA in conjunction with the corresponding Article IV consultation. The FSSAs for the remaining four countries will be circulated to the Fund's Board in the next few months. All will be discussed by the Board in the context of the corresponding Article IV consultation in the coming months. The Bank's Board has received seven FSAs; two more are expected by year end and FSAs will not be produced for the other three pilot countries.[6]

10. A majority of the 24 countries to be assessed in FY2001 have already been identified by the Bank's regions and the Fund's area departments in close coordination with the Financial Sector Vice-Presidency (FSVP) at the Bank and the Monetary and Exchange Affairs Department (MAE) at the Fund, and supported by the Bank-Fund Financial Sector Liaison Committee (FSLC). As with the pilot, the staff has sought a group of countries representing a reasonable cross section of size and complexity of financial systems and economic development, and a balanced coverage of geographic regions while, at the same time, giving some priority to systemically important countries.

Table 1. Status of the FSAP Pilot

Country	FSAP Mission	FSSA Report	FSA Report
Cameroon	March 2000	FO/DIS/00/66	Expected by year-end
Canada	October 1999	FO/DIS/00/2	
Colombia	July 1999	FO/DIS/99/172	SecM2000-314
El Salvador	April 2000	December 2000	Expected by year-end
Estonia	March 2000	FO/DIS/00/73	SecM2000-559
Hungary	February 2000	Early 2001	SecM2000-478
India	April 2000	December 2000	SecM2000-614
Iran	March 2000	FO/DIS/00/80	SecM2000-534
Ireland	March 2000	FO/DIS/00/88	
Kazakhstan	February 2000	FO/DIS/00/142	SecM2000-601
Lebanon	May 1999	FO/DIS/99/113	
South Africa	October 1999	FO/DIS/00/13	SecM2000-533

[6]FSAs are not prepared for countries that are not the Bank's clients—Canada and Ireland in the case of the FSAP pilot. In addition, no FSA will be delivered for Lebanon, since FSAs had not been envisaged when the FSAP report for Lebanon was prepared.

11. To date, agreement to participate in the program in FY2001 has been formally reached with the authorities of 20 countries and the ECCB area. The target of 24 participants for the year is therefore expected to be met without difficulty. In that regard discussions are also under way with several systemically important countries. Missions have visited 10 of the countries scheduled for FY2001 (Ghana, Armenia, Guatemala, Israel, Peru, Poland, Iceland, Senegal, Yemen, and Slovenia). Commitments to participate in the program beyond the current financial year have been received from a number of countries and discussions are under way regarding possible timing with other countries that have expressed strong interest (Table 2).

Table 2. FSAP: Ongoing Country Participation and Tentative Schedule for Future Participation

Country	Main FSAP Mission[1]
Mission work completed or underway	
Ghana	July 2000
Armenia	September 2000
Guatemala	September 2000
Israel	September 2000
Peru	September 2000
Poland	September 2000
Iceland	November 2000
Senegal	November 2000
Yemen	November 2000
Slovenia	November 2000
Czech Republic	December 2000
ECCB Area[2]	December 2000
Participation confirmed for FY2001 or later[3]	
Argentina, Barbados, Costa Rica, Croatia, Dominican Republic, Finland, Gabon, Georgia, Korea, Latvia, Kyrgyz Republic, New Zealand, Sri Lanka, Sweden, Switzerland, Tunisia, Uganda, United Arab Emirates, United Kingdom and Uruguay.	

1/ In several cases, mission work includes a preparatory staff visit.
2/ The assessments of the six countries in the Eastern Caribbean Central Bank (ECCB) area will be undertaken in a coordinated way, as the shared central bank (which is also the supervisory authority for part of the financial system) implies that the assessments will have many common elements. The countries involved are Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. The ECCB also includes two territories (Anguilla and Montserrat) that are not members of the Fund and the Bank.
3/ Discussions on participation are well advanced with a further six countries.

Methodology: Ensuring consistency and quality of assessments

12. For the FSAP to provide meaningful support to national authorities and help strengthen the financial sector work of the Bank and the Fund, it must achieve a consistently high quality across countries and balance and uniformity in approach, scope and coverage, taking into account country-specific circumstances. Steps have been taken in both institutions to ensure that requirements for this work are clear to mission leaders and that responsibility and accountability, both in the joint FSAP work, as well as for the separate related work in each institution (e.g., monitoring of financial systems under Article IV surveillance in the Fund and developmental work in the Bank), are also clearly defined. Review and clearance procedures that meet the needs of each institution have been developed.[7]

13. The quality of the assessments relies importantly on the analytical capability and judgment of the team members. In carrying out the assessments, the staff draw on their own experience and on that of experts from cooperating central banks, supervisory agencies, standard setting bodies and other international institutions. Outside experts augment the pool of expertise already available in the Bank and the Fund, and provide a valuable element of peer review to the analysis, especially to the assessments of observance of standards and codes. Outside experts' participation has also facilitated more complete feedback to standard setting bodies on improvements to standards and assessment methodologies.

14. FSAP teams rely on certain methodologies or tools that are available or have been developed for this purpose. In particular, the development and use of macroprudential indicators, stress tests and scenario analysis, and improved methods for the assessment of observance of standards and codes have supported and strengthened consistency and quality of analysis across different countries. Some key aspects of the experience to date follow.

Macroprudential indicators

15. Macroprudential analysis aims to highlight the two-way linkages between macroeconomic performance and financial sector soundness. Macroprudential indicators (MPIs) comprise both aggregated microprudential indicators of the health of individual financial institutions (e.g., capital adequacy, earnings and solvency), and macroeconomic variables associated with financial system soundness (e.g., volatility in exchange rates and interest rates). Aggregated microprudential indicators have been found to be primarily contemporaneous or lagging indicators of soundness;[8] macroeconomic variables can signal imbalances that affect financial systems, and so tend to be leading indicators. Financial crises

---

[7]For a description of these procedures, see Annex 2 of the update on the FSAP that was issued in September 2000 (SM/00/205, SecM2000-541).

[8]Observation lags should be short to allow timely monitoring. Stress testing based on these indicators could provide an early warning of possible risks.

usually occur when both types of indicators point to vulnerabilities, that is when financial institutions are weak and face macroeconomic shocks.

16. Experience gained in the course of the FSAP pilot with the use of MPIs is a key input to an ongoing work program in the Fund aimed at developing a core set of MPIs.[9] The range of MPIs reviewed under the FSAP has varied widely depending on the particular country case. On the other hand, the ongoing work program, which has included a survey of countries' practices and aspirations regarding MPIs, will help to provide better data for, and greater systemization of, macroprudential analysis undertaken during an FSAP exercise. There is significant interest in this work internationally, which has been revealed in part by the very good response rate of countries to the MPI survey. The development of robust MPIs would support continuous financial sector monitoring under the FSAP and by national authorities. Progress with the development of MPIs, including the experience gained from the FSAP and the results of the MPI survey, is expected to be reviewed in the Spring of 2001.

Stress tests and scenario analysis

17. Stress tests and scenario analysis, which help in assessing the impact of macroeconomic and other shocks on the profitability and solvency of financial institutions, provide a useful and flexible framework for the identification and analysis of financial sector vulnerabilities and for discussing these findings with country authorities. Under the FSAP, the kinds of tests and models used, and the types of shocks and scenarios considered, vary depending on the level of sophistication and development of the financial system being assessed, the data available, and the areas of the country's financial system on which the authorities wish to focus.

18. Meaningful stress testing requires reliable macro and microeconomic data.[10] In some cases, due to the countries' confidentiality laws relating to supervisory information, the FSAP teams were not allowed access to data on individual institutions. In these cases, stress tests and scenario analysis were conducted on the basis of aggregated data for groups of banks, reducing the significance and the robustness of results to some degree. In some other cases where banks had in place stress-testing models as part of their internal risk management and monitoring systems, they were asked to conduct their own stress tests

---

[9]See *Macroprudential Indicators and Data Dissemination—The Role of the Fund*, and *Macroprudential Indicators and Data Dissemination—Background Paper* (SM/99/295 and SM/99/295, Supplement 1, respectively) for a discussion of MPIs. The role of MPIs and other tools used in the FSAP, such as stress testing, was discussed in *Financial Sector Assessment Program—Progress Report—Lessons from the Pilot and Next Steps* (SM/00/54).

[10]See *Bank Soundness and Macroeconomic Policy*, Carl-Johan Lindgren, Gillian Garcia, and Matthew I. Saal, International Monetary Fund (1996), page 10.

(under agreed parameters) and share the results with the FSAP team. In still other cases, data were unavailable or of such poor quality as to be unsuitable for meaningful stress testing or scenario analysis.

19. The experiences with stress testing and scenario analysis in FSAP work have been generally positive. At the outreach meeting in October 2000, several authorities noted that stress testing and scenario analysis helped identify the sensitivity of financial system stability to various potential shocks and provided a useful cross check of the other findings of FSAP teams. Several commented, however, that the assumed scenarios could sometimes be too extreme, and that alternative scenarios may have more realistically highlighted potential risks.

20. Conducting stress tests and scenario analysis in cooperation with authorities has also proven to be valuable in helping to build risk management capacity in member countries and to encourage routine stress-testing by country officials of their financial systems. Closer involvement of country supervisory authorities in stress testing and scenario analysis and ongoing initiatives in the Bank and Fund to improve data reporting and dissemination are expected to help national authorities to further enhance the quality of these techniques in the future. Staff are continuing to improve stress testing techniques and scenario analysis methodologies.[11]

Standards assessments

21. Assessments of observance and implementation of relevant financial sector codes, good practices and standards in the FSAP have served three purposes: (i) to identify gaps in financial sector regulation and transparency practices and hence identify reform and development needs in the area covered by the standard; (ii) to provide input for the overall stability assessment of the financial system; and (iii) to help country authorities to evaluate their own systems against international benchmarks. The assessments have helped countries to focus on operational and supervisory risks and to identify needed corrective actions and institutional strengthening plans. They have also offered country supervisory agencies an opportunity for a professional peer review. At the same time, the FSAP process ensures, *inter alia*, that the assessments of international standards observance are undertaken in the relevant macroprudential and overall policy and institutional context. These assessments are summarized in FSSAs and FSAs. These summaries also become the financial sector modules of the *Reports on Observance of Standards and Codes (ROSCs)*.

22. The standards that have been assessed to date in the context of the FSAP—with country specific prioritization of which standards were most relevant for assessment in each case—have been: the Code of Good Practices on Transparency in Monetary and Financial

---

[11]Research is ongoing in both the Bank and the Fund, in some cases jointly, and elsewhere, on refining the methods for stress testing. Experiences with stress testing techniques will be reviewed in the Spring 2001 Fund Board paper on macroprudential indicators.

Policies (MFP), the Basel Core Principles for Effective Banking Supervision (BCP), the Core Principles for Systemically Important Payment Systems (SIPS), the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation, and the International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP). Table 3 provides information on the standards and codes assessed under the FSAP.

23. The MFP has been assessed for all FSAP countries but its detailed coverage has varied depending on the structure of the financial system. Similarly, in deciding which particular supervisory standards assessments to undertake, FSAP mission teams have first identified which standards are judged to be most relevant in a particular case. The BCP was assessed in all cases, the SIPS in most cases, and the IOSCO and IAIS principles in more than half of the cases. When undertaking the assessments, the focus has been on assessing the quality of compliance and not simply on preparing a checklist of technical compliance. The summaries of the assessments have been prepared in the context of the overall findings of the FSAP team, taking into account, as appropriate, the subsequent Article IV mission discussions.

24. The experience gained to date confirms that standards assessments are an important component of the FSAP. A high degree of observance of relevant standards is necessary for the stability of financial systems that are integrated into global financial markets and face a variety of financial innovations and shocks.[12] Standards assessments are also helpful in identifying and implementing regulatory and operational reforms needed for the development of countries' financial systems over time and their integration into global markets.

25. Standards assessments play a more limited role in identifying immediate financial system vulnerabilities, as these are influenced by a host of macroeconomic and structural factors. At the same time, such assessments need to be combined with a broader range of information and analysis in order to obtain a complete picture of relevant risks and vulnerabilities required for an overall stability assessment, and the identification of development priorities. They are thus an important part of the broader assessment of the macroeconomic and structural risks that affect the financial sector, and of the reform and

[12]Research is ongoing in the Bank and the Fund aimed at assessing and quantifying the links between non-observance of standards and financial sector vulnerability.

Table 3. Standards and Codes Assessed in the FSAP

	Transparency in Monetary and Financial Policies (MFP)	Banking Supervision (BCP)	Securities	Insurance (ICP)	Payment System (SIPS)
FSAP Pilot					
Lebanon	x	x			
Colombia	x	x			
South Africa	x	x	x	x	x
Canada	x	x	x	x	x
Cameroon	x	x		x	x
El Salvador	x	x			
Estonia	x	x	x	x	x
Hungary	x	x	x	x	x
India	x	x	x		x
Iran	x	x			
Ireland	x	x	x	x	x
Kazakhstan	x	x	x	x	x
Post-Pilot					
Ghana	x	x		x	x
Armenia	x	x	x	x	x
Guatemala	x	x			x
Israel	x	x	x	x	x
Peru	x	x			x
Poland	x	x	x	x	x
Yemen	x	x			
Senegal	x	x	x	x	
Iceland	x	x	x	x	x
Slovenia	x	x	x	x	x

development priorities to strengthen the performance of the sector.[13] This view that the FSAP process provides the proper context for assessment of observance of key financial sector standards was echoed by the participants in the recent outreach meeting on the FSAP.

26. Enhancing countries' ownership of assessments will improve the implementation of standards. To that end, countries have been encouraged to undertake self-assessments. This has helped to raise a general awareness and understanding of standards and their objectives and to expedite the FSAP assessment process. Subsequent to the assessments, several countries have undertaken legal, regulatory and institutional reforms to improve their adherence to core principles.

Prioritization of work

27. FSAP teams undertake comprehensive assessments to ensure that major financial system vulnerabilities and development needs are not overlooked. However, resource constraints place a limit on the scope of the work—both for the mission teams and for national authorities. Based on consideration of both cost effectiveness and relevance, FSAP teams need, in conjunction with national authorities, to be selective in the scope of the assessments covering those issues and institutional features which are judged to be most important for financial sector stability and development in the particular country. This selectivity and prioritization allow FSAP mission teams to be kept limited in size and the FSAP process to be cost effective for the Bank and the Fund as well as for national authorities.

28. While staff have experience in the kinds of issues that are most likely to be relevant to FSAP work in different countries, there is still much to learn. The ability to prioritize work more effectively and economize on resources will continue to develop as experience with undertaking FSAP assessments accumulates. In any case, there will always be a need to maintain a fairly broad scope for the work, at least in the initial stages of an assessment, to

---

[13]These findings from the experience with the FSAP confirm the earlier experience with the assessment of the Core Principles for Effective Banking Supervision in a range of contexts as reported in *Experience with Basel Core Principles Assessments* (SM/00/77). A review of experience with assessments of the *Code of Good Practices on Transparency in Monetary and Financial Policies* will be provided to the Fund's Board for information in December 2000. This summary concludes that, overall, the detailed assessments have helped evaluate the role of transparency in policy effectiveness, and have provided guidance in improving the transparency framework especially when carried out within the broader macroeconomic and institutional context. The experience also confirms the need for developing a clear assessment methodology in order to improve the depth and consistency of assessments. Reviews of experience are planned for the assessments of the other standards which are commonly undertaken in the context of the FSAP.

ensure adequate consideration of the particular circumstances of individual countries and to avoid possible "cherry picking" of the various components of an FSAP assessment that would undermine the quality of the assessment as a whole.

29. One area where selectivity and prioritization is essential is in the assessments of observance of standards. As noted, they play an important role in identifying medium-term development needs, but their contribution to identifying immediate risks and vulnerabilities is limited. Further, their cost is high, both in terms of the staff and expert resources of FSAP missions as well as in terms of time devoted by country officials, relative to other aspects of an FSAP mission team's work. For example, two FSAP team members are needed just for the assessment of observance of the Basel Core Principles for Effective Banking Supervision and detailed assessments of all five of the standards which typically have been assessed under the FSAP to date could require at least six staff, or about half of the typical mission team, with corresponding involvement of country officials.

Overall experience

30. The program affords an opportunity to provide authorities with a thorough, objective, outside review and analysis of their financial sectors. By combining the results of macroprudential analysis, stress tests and scenario analysis, assessments of standards' observance, and other information on institutional setting and diversity of the financial system, FSAP team members have been able to identify and analyze a range of issues relating to strengths, risks, vulnerabilities and weaknesses of the financial sector.

31. Even in instances where the financial system was judged to be basically sound, FSAP teams have found areas, particularly with respect to regulation and supervision generally and supervision of nonbank financial institutions or of securities markets specifically, where authorities could take steps to strengthen their systems. National authorities have acted rapidly to follow up on the recommendations made either by FSAP teams, or in subsequent consultations, to address immediate systemic vulnerabilities as well as medium-term development needs.

32. While the specific findings of the FSAP assessments have been conveyed to Directors of the Fund and the Bank in FSSAs and FSAs, respectively, the following are a few examples of common themes with respect to findings and responses:

- Macroeconomic volatility and distortions introduced in the economy by external shocks or poor management are placing stress on financial intermediaries in some countries. These problems have resulted in severe vulnerabilities in environments where the quality and consistency of supervisory enforcement is weak. In one case, the linkages between high interest rates and nonperforming loans and banks' capital were highlighted; this allowed a more considered analysis of the sustainability of high interest rates and the need for other policy measures.

- In many countries, FSAP assessments have highlighted the need for strengthening the framework for banking supervision in order to enhance financial system stability. In some of these countries, following FSAP recommendations, authorities have taken steps to improve the country's adherence to international supervisory standards or have requested technical assistance to build institutional capacity for effective supervision.

- Public sector banks have often been identified as over-exposed to credit risk or requiring recapitalization. Follow up work with respect to addressing banking sector vulnerabilities has ranged from assisting with the design of a deposit insurance scheme to longer-term efforts such as the development of credit registries.

- Analyses of securities markets have revealed important deficiencies. Weaknesses tend to be concentrated in supervision, settlement systems, corporate governance and sovereign debt management. Accordingly, follow up action to date has focused on building securities market infrastructure and institutional capacity. As a consequence of FSAP recommendations, in one country, technical assistance on sovereign debt management was provided jointly by the Bank and the Fund. In another country, the Bank is providing authorities with a Financial Infrastructure Development Loan focusing on securities market development.

- Judicial reform has been identified as a key developmental priority, particularly with respect to facilitating access to credit, enacting collateral law and speeding up debt recovery. In one instance, technical assistance to undertake legal reform has been incorporated in an existing Bank loan. In other instances, FSAP team members have been providing guidance and comments on draft legislation being prepared by authorities.

33. As noted, the experience with the use of various analytical and quantitative tools is still developing. The Financial Sector Liaison Committee (FSLC) sponsors joint Bank-Fund meetings for staff who have participated in the program to provide a forum for capturing and applying the lessons of experience. Experience with the production of reports, which in some cases have been very long, is also developing. Work is under way to improve the quality and focus of reports. These efforts will contribute to further strengthening the program in the future.

Feedback from national authorities and cooperating institutions

34. National authorities have been supportive of the program. The vast majority of those who have participated in the FSAP have acknowledged its value in informing domestic policy making, by providing a thorough, objective assessment of their financial sectors. Several commented that they found the program beneficial in providing a comprehensive framework within which to review financial sector stability issues and development needs. The linkage of the FSAP to the Article IV consultation process was also found to be helpful.

The "peer review" aspect of the program—using experts from cooperating institutions—was considered an important value added, as was the incentive the program gave national authorities to conduct self-assessments.

35. Under the aegis of the FSLC, an outreach meeting was held in Washington in October 2000 to elicit feedback from the participants in the FSAP on how to improve the quality, comparability across countries, and procedural aspects of the program. Officials from those countries for which FSAP missions had been completed by September 2000, as well as of experts from cooperating institutions and concerned staff, were invited to the meeting.[14] Comments made during the outreach meeting are summarized in Box 2 and are reflected throughout this paper.

36. In addition to the outreach meeting, staff have been soliciting feedback from participants since the outset of the program. More recently, a short standardized questionnaire has been prepared that is sent, with the final FSAP report, to all participating countries.

Follow-up to FSAPs: Relationship of the FSAP to other work in the Bank and the Fund

Linkage to lending and non-lending services in the Bank

37. Assessments conducted under the FSAP are diagnostic tools, not ends in themselves. The results of this diagnosis must be integrated into the other work of the Bank and the Fund. From the Bank's perspective, the assessments should be seen as informing the ongoing policy dialogue between Bank staff and national authorities. Specifically, the diagnostic work of the FSAP provides a comprehensive assessment of a country's financial sector, which serves as a foundation for setting priorities for technical assistance and other forms of support. The collaboration between the financial sector specialists and the country teams offers Bank staff a new opportunity for harnessing recommendations for the financial sector to larger country strategies, as embodied in Country Assistance Strategies (CAS). The analysis should be integrated with other Economic and Sector work and reflected in other documents, including the Social and Structural Reviews (SSR) and the Poverty Reduction Strategy Papers (PRSP), and in the provision of technical assistance.

38. The Bank's Executive Directors have an opportunity to discuss the issues raised in the assessments in the context of Board discussions of CASs, SSRs, and particular loans. Separately, to inform Bank Directors of the financial sector work that is conducted under the program, Bank staff prepares FSAs to distribute to Executive Directors, for their information.

---

[14]Thirty representatives from 15 countries, representatives from three standard-setting bodies (the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, and the International Association of Insurance Supervisors), and experts from cooperating institutions, who helped conduct the assessments, attended the outreach meeting.

Box 2. Comments from the FSAP Outreach Meeting in October 2000

Linkages between macroeconomic developments and the financial sector

- Participants felt that linkages between macroeconomic developments and the financial sector have been sufficiently well identified. However, they suggested that more attention be paid to the implications of missing, incomplete, or informal markets for the stability and the development of a diversified financial sector.
- Some participants felt that more attention could be paid to identifying vulnerabilities that result from maintaining the status quo in certain areas of the financial system.
- Stress-testing provided useful insights into the linkages between macroeconomic developments and the soundness of the banking system, and raised awareness of risk identification and management. However, the uneven quality and availability of data used in stress testing in different countries raised some concerns.

Standards assessments

- Standards assessments provided an important input to the overall stability assessment when undertaken in a broad macroeconomic and institutional context.
- Undertaking self assessments, despite the flaws therein, helped prepare some countries for interaction with FSAP teams and enhance country ownership of the ongoing monitoring of their financial sectors.
- Assessment of standards should be comprehensive—not narrowly technical and yielding "pass-fail" scores.
- Participants supported the current approach of setting country-specific priorities—in consultation with national authorities—on which standards to assess, and for assessing interrelated sectors together in order to ensure an integrated approach.
- The FSAP provided an important source of feedback to standard setters in designing assessment methodologies and identifying which standards are in need of refinement or improvement.

Analysis of overall stability, and of key financial sector structural and developmental needs and priorities

- Most participants felt that the scope of the FSAP was appropriate and was balanced in the treatment of banking and nonbanking issues.
- Participants wanted more attention paid to the legal framework. This should include the analysis of enforcement capabilities as well as regional circumstances where many aspects of the infrastructure are integrated (such as the French Franc zone) or in countries where the major banks are foreign.
- More attention should be paid to the role of the informal sector where it is significant.
- Realistic timeframes should be set for implementing recommendations, in particular for structural issues; sequencing is an important consideration that should link stability with development issues; stability concerns should then be discussed during Article IV consultations.
- The lack of consistency across countries of treatment of nonperforming loans (NPLs) represented an important gap in standards which the development of the MPIs should help to address.

Procedural issues

- Assessments should be carried out over a sufficient period of time to enable early involvement of experts from institutions, to ensure adequate preparation time by all parties, and to help organization generally.
- The purpose of the requests made to authorities of participating countries should be clear (data requirements, schedule of meetings, and envisaged outputs).
- Reports should be finalized within a reasonable short timeframe, so as to sustain the momentum that the FSAP engenders.
- While some authorities felt that mission sizes should be reduced, others thought that they had been appropriate to the range and complexity of the issues that were covered.
- Periodic meetings of experts that have participated in the FSAP would help to ensure consistency of assessments and strengthen the peer review process.

Publication issues,

- Participants noted that FSAP reports need to be candid and may include confidential material, so it may not be desirable that these be published. Nevertheless, many participants strongly supported publication of FSSAs on a *voluntary basis* and the need to develop mechanisms for the periodic updating of published assessments.

The FSAs summarize the main points identified in the assessments and the key recommendations made, with emphasis on those related to developing and strengthening institution building in a country's financial system.

Linkage to the Fund's bilateral surveillance

39. In the Fund, the diagnosis of vulnerabilities and development needs, which the FSAP provides, is used to enhance the identification and analysis of financial system stability issues relevant to Fund surveillance traditionally undertaken as part of the Article IV process. The FSSAs are prepared by Fund staff drawing on the FSAP mission work as well as on the discussions of financial sector issues during the subsequent Article IV mission.[15] FSSAs focus on strengths, risks and vulnerabilities in the financial system in a broader macroeconomic and macroprudential context than has traditionally been the case. They are circulated to the Fund's Board as part of the documentation for the Article IV consultations and thus are the link between the FSAP and the monitoring of financial systems under Fund surveillance.

40. Linkages between macroeconomic developments and financial sector soundness and risks, as well as major factors affecting the overall stability of the financial system, are highlighted in FSSAs using as input the FSAP team's work on MPIs, stress tests and scenario analysis, the assessments of observance of standards, and the examination of the institutional setting and the depth and diversity of the financial system.[16] Such analysis serves, among other things, to focus on the likely consequences of alternative macroeconomic policy mixes and exogenous shocks, and the possible implications of broader policy and regulatory reforms, for financial sector profitability, solvency, and liquidity. FSSAs place particular emphasis on systemic liquidity issues, and on sources of liquidity risks in financial institutions and markets that give rise to overall stability concerns. Specifically, the environment for liquidity management by financial institutions, and the factors affecting liquidity of money, exchange, and government securities markets are reviewed. These factors include market structures, lender of last resort facilities, and payment system arrangements.

41. FSSAs also provide a vehicle to highlight the impact of observance and implementation of financial sector standards on overall financial system stability, by considering the range of key factors affecting the vulnerabilities and risks in the financial

---

[15]Initial procedural arrangements for FSSAs were presented to the Fund's Executive Board in *Financial Sector Assessment Program (FSAP) and Financial System Stability Assessments (FSSAs)—Initial Procedural Arrangements in the Fund* (SM/99/226, Supplement 1). These procedures, approved by the Board, have proven effective in supporting financial sector monitoring under Fund surveillance.

[16]A summary of surveillance issues highlighted in individual FSSAs is provided in a background paper.

system, and highlighting the contribution of standards observance to containing these risks and thereby fostering stability. In order to bring out the relationship between risks, stability, and standards observance, the summary assessments of standards are analyzed in the broad institutional and macroprudential framework of the FSSA (and are presented in Section II of the FSSA).[17]

42. Within this overall framework, the scope of FSSAs needs to extend beyond domestic stability considerations to encompass possible cross-border effects and consideration of international repercussions while maintaining its country specific focus. This is particularly important for the assessments of countries with significant offshore financial centers.

43. A strength of FSSAs is the use of a broad range of information and analysis, drawn both from the FSAP as well as from the further analysis undertaken in the context of the Article IV mission, on which they are based. FSSAs thus can provide a more accurate assessment of stability issues than would otherwise be the case. For example, as noted above, one purpose of the detailed assessments of international standards and codes that are undertaken as part of an FSAP exercise is to provide an input to formulate an overall stability assessment in the FSSA. The experience with the preparation of FSSAs to date, however, indicates that the relationship between observance of standards and financial system stability is complex and some area departments question the value of standards assessments, especially if they are excessively detailed. In some countries a high degree of compliance with financial system standards has helped to contribute to addressing risks and to a generally sound and stable financial system. In other countries, weak observance of standards has aggravated risks and systemic vulnerabilities. In some countries departures from standards were found to have limited connection with the financial risks and vulnerabilities and did not pose a threat to immediate stability. The experience to date is therefore that standards assessments can contribute to a robust overall stability assessment only when they are combined with other analysis and information. A similar conclusion applies to the other analytical tools and information, if used in isolation, on which FSSAs are based.

44. FSSAs have also provided a framework to present broad priorities and sequencing of specific reforms and development actions in a structured and comprehensive way in order to foster stability in the course of financial sector reform. This framework allows short-term risks to be highlighted and medium-term risks to financial stability, such as those that could emerge from the liberalization and development of financial systems, to be identified and thereby helps to formulate measures to address these risks.

45. Experience so far indicates that the FSSA findings and recommendations have provided a useful input to Article IV missions' discussions of financial sector issues with national authorities, have helped to deepen the quality and coverage of financial sector issues in Article IV consultations, and have been incorporated in the Fund's staff reports for

[17]These summary assessments are also issued as financial sector modules of ROSCs.

Article IV consultations. Producing FSSAs is still a relatively new activity for the Fund. Further evolution and improvement is envisaged as more experience is gained, both with the information base as well as with the analytical techniques and the process of identifying key vulnerabilities with potential systemic stability implications.

FSAP follow-up

46. The follow-up to FSAP recommendations is critical for effectively helping countries strengthen their financial systems. An underlying objective of the FSAP is that national authorities implement measures to redress the identified vulnerabilities and development needs. In that context, the Bank and the Fund should seek to ensure that the strategic components of the assessment are reflected in other aspects of country programming, and that appropriate technical assistance and other support is provided to national authorities that request it. While financial authorities will in some instances be able to take steps on their own to implement policy recommendations, in other cases the authorities are likely to request that the Bank or the Fund arrange technical assistance to help them in implementing these recommendations.

47. Even though the FSAP was initiated relatively recently, it has already had a noticeable impact on financial sector policies in many of the pilot countries. As noted above, national authorities (including in the two pilot industrial countries) have acted upon the findings and recommendations of FSAP teams or, where appropriate, have requested technical assistance to aid them in doing so. Moreover, additional requests are expected to arise in a range of financial sector areas including: sequencing of financial sector reforms; design of early warning systems; banking supervision; deposit insurance; microfinance design; pension reform; foreign exchange market reform; debt management; debt and securities markets development; legislative and judicial reform and payment systems. In a few instances, countries have requested follow-up missions, usually joint between the Bank and the Fund, to assess the progress made since their assessments, to extend the scope of the original FSAP assessment or, generally, to continue the dialogue between the team and the authorities on technical issues.

Resource costs

48. The broad scope of the assessments provided under the FSAP requires high quality teams with technical expertise in a number of financial sector areas. These include: macroprudential analysis; financial analysis; financial legislation; financial sector standards, codes and good practices; supervision and prudential regulation of financial sector institutions and markets, including banks, securities and insurance firms and other non-banks; payment and settlement systems; corporate finance and bankruptcy; microfinance in various aspects; and pension systems. Teams must also include individuals able to implement the methodologies for assessing compliance with various international standards and codes.

49. Since the inception of the program, experience with all aspects of the assessment process has been developing and efforts have been made to ascertain those issues that are likely to be significant in differing circumstances. In this early stage, the size of FSAP missions has tended to be large. On average, the core mission has consisted of about 12 people, provided roughly equally by Bank and the Fund, except for industrial countries where the Fund takes the main responsibility for the FSAP and the mission staffing.[18]

50. Budgeted costs of the FSAP for FY2001 were based on estimates derived from the early FSAP pilot cases. At the time of the Spring 2000 review of progress with the pilot, it was estimated that assessments of larger countries and/or those with more regional systemic importance would require almost two staff years on average.[19] Assessments of smaller, less systemically important countries were estimated to have a lower resource requirement, so that the total staff requirement for the program in FY 2001 would be about 45 staff years. The Fund's share of this staffing would be greater than half, given the Fund's predominant role in the FSAP for industrial countries, and the costs of producing FSSAs (which are included in these cost estimates). Total dollar costs for each assessment, on average, were expected to be about $500,000 for both the pilot cases as well as the 24 countries to be assessed in FY2001. Follow-up work in subsequent years (linked to the Article IV process in the Fund and the various work activities in the Bank) would give rise to additional resource costs.

51. Analysis of the pilot cases indicates that the FY2001 budget estimates are broadly on track.[20] While costs of assessments in some larger countries are somewhat lower than had been expected, resource savings that were thought possible in the smaller country cases, e.g., as regards assessments of systemic vulnerabilities, have not been fully realized and have tended to be offset by there being greater resource requirements for assessing development needs. The scope of the assessments in smaller economies is one area that requires further consideration.

---

[18]For the purposes of these calculations, experts from cooperating institutions are counted as participants from the Fund or the Bank depending on which of the two institutions has funded them.

[19]This includes preparation time and post-mission work preparing and reviewing reports. See SM/00/54 and SecM2000-130, page 30.

[20]As only a few of the FY2001 assessments are complete, it is difficult to comment in detail on the actual budget outcome at this stage.

Involvement of outside experts

52. The wide range of expertise required for the FSAP, especially with regard to assessments of observance of standards, has necessitated the use of experts from cooperating institutions. A substantial number of central banks, supervisory agencies, standard setting agencies and other international institutions have agreed to contribute experts to the FSAP. As reported to the two Executive Boards in the update on the FSAP in September, the number of such institutions now exceeds 50 (see Table 4 for a listing).

53. These experts have made important contributions to the program. The majority have helped to prepare the assessments of observance of the Basel Core Principles for Effective Banking Supervision and in some cases to assist also in stress testing. Central banks have also provided payment systems experts, who have assessed observance of the Core Principles for Systemically Important Payment Systems and helped in addressing payment systems risks and vulnerabilities. IAIS and IOSCO have supported the FSAP by helping to identify insurance and securities market regulators to participate in several of the missions that undertook assessments of observance of the core principles for those sectors. Many of the assessments of observance of these latter two standards have, however, been undertaken by Bank staff. Finally, several multilateral development banks have offered to send their staff on FSAP missions; the IADB has already participated in one.

54. The Bank and the Fund are fully responsible and accountable for the contributions made by cooperating central banks, supervisory agencies and other international institutions. So far, this seems to be working well, with the contributions from these experts being of a high standard.

55. When experts are from countries that have participated in the FSAP, or where countries being assessed have previously provided FSAP mission members, the staff and the national authorities benefit from their experience and familiarity with the FSAP. Participation of a range of experts in FSAP missions has also facilitated feedback to standard-setting bodies regarding the review and refinement of new and evolving assessment methodologies. Experts from cooperating central banks who participated in the outreach meeting noted that the synergy derived from the peer review process—in terms of gaining better understanding of the assessment methodologies and their application to country specific circumstances—was significant. They indicated that this process can be further improved through periodic coordination meetings of experts.

56. The staff will continue to examine ways to strengthen the framework and procedures in place to ensure consistency of approaches and quality of work by experts from different institutions. This will partly be achieved through stronger coordination of experts and specific guidance on assessment methodologies. It will also be supported by further refinements to assessment methodologies that the staff will actively promote.

Table 4. Institutions Cooperating in the FSAP
(Current and Prospective)

Central Banks and Supervisory Agencies

Central Bank of Argentina
Reserve Bank of Australia
Australian Prudential Regulatory Authority
Austrian National Bank
National Bank of Belgium
Banking and Finance Commission, Belgium
Central Bank of Brazil
Bank of Canada
Office of the Superintendent of Financial Institutions, Canada
Banking Commission of the Central African States
Bank of Central African States (BEAC)
Central Bank of Chile
Superintendency of Banks and Financial Institutions, Chile
Hong Kong Monetary Authority
Czech National Bank
National Bank of Denmark
Financial Supervisory Authority, Denmark
European Central Bank
Bank of Finland
Financial Supervision Authority, Finland
Bank of France
Deutsche Bundesbank
Financial Supervisory Authority, Hungary
National Bank of Hungary
Reserve Bank of India
Central Bank of Ireland
Bank of Israel
Bank of Italy
Bank of Japan
Financial Services Agency, Japan
Bank Negara Malaysia
Bank of Mexico
Netherlands Bank
Reserve Bank of New Zealand
New Zealand Securities Commission
Central Bank of Norway
Banking, Insurance and Securities Commission, Norway
Central Reserve Bank of Peru
National Bank of Poland
Bank of Portugal
Saudi Arabian Monetary Agency
Monetary Authority of Singapore
Reserve Bank of South Africa
Bank of Spain
Bank of Sweden
Financial Supervisory Authority, Sweden
Swiss National Bank
Central Bank of Tunisia
Central Bank of the Republic of Turkey
Bank of England
U.K. Financial Services Authority
U.S. Federal Reserve System
U.S. Federal Deposit Insurance Corporation
U.S. Office of the Comptroller of the Currency
Banking Commission of West African States
Central Bank of West African States (BCEAO)

Other Institutions

African Development Bank
Bank for International Settlements
Inter-American Development Bank

International Standards Setting Bodies[1/]

Basel Committee on Banking Supervision (BCBS)
International Association of Insurance Supervisors (IAIS)
International Accounting Standards Committee (IAS)
International Organization of Securities Commissions (IOSCO)
Committee on Payment and Settlement Systems (CPSS)

1/ These institutions support the FSAP by, inter alia, helping as needed to identify experts, and by sharing information on assessment methodologies.

57. Several of the cooperating institutions have already indicated that while they support the FSAP fully, their ability to release staff for missions is limited due to their own work commitments. Accordingly, the staff intend to involve additional cooperating institutions. As well as sharing the costs of supplying experts over a greater number of institutions, this would, in particular, support assessments of OFCs as well as any increase in the number of FSAP exercises per year. In addition, this will enable experts from more institutions to benefit from exposure to the program and the associated assessment methodologies.

Confidentiality issues

58. The importance of adequate procedures to handle sensitive information in the course of FSAP work has been stressed in previous Board discussions. The confidentiality procedures that staff, as well as outside experts, are required to follow have been found to be sufficient in ensuring that the confidentiality of information that is obtained during an FSAP mission is adequately protected.[21] The application of these procedures in the case of mission participation of experts from cooperating institutions has worked well, and the authorities have been willing to provide requested information, if available, to FSAP missions.

[21]In May 2000 both managements circulated a Confidentiality Protocol to all staff, which outlined the specific rules that are in place in each institution. The Protocol was circulated to the two Boards as an attachment to the report on further progress with the FSAP, *Financial Sector Assessment Program (FSAP)—Lessons From the Pilot Exercise and Next Steps* (SecM2000-130 and SM/00/54), which they reviewed in Spring 2000. Prior to participating in missions experts are informed that they are required to maintain the same confidentiality of information as Bank and Fund staff. They are required to read the Confidentiality Protocol and to sign a declaration that they have been informed of and understand these requirements. These experts are generally financial market supervisors and regulators and are by profession well aware of the need to protect information provided on a confidential basis.

III. Issues Going Forward

59. Based on the experience to date, it is the staff's view that the FSAP has strengthened the monitoring of financial systems under Fund surveillance and the financial sector development work by the Bank. Utilizing the combined expertise of the two institutions and that of cooperating official institutions, FSAP teams have been able to provide a comprehensive picture of financial sector strengths, weaknesses and development needs in the participating countries. This common platform for diagnosis by both institutions supports consistency in policy advice and future work programs, avoids duplication of work, and helps to ensure that the follow-up technical assistance provided by both institutions is properly targeted in a coordinated manner. It also allows both institutions to undertake their subsequent separate financial sector work in a manner that permits clear and separate accountability within a common framework that enhances dialogue.

60. The program is still relatively young. Lessons from the initial phase are being continuously incorporated and the program will continue to evolve as further experience is gained. At this time, guidance from Executive Directors is needed regarding the linkages of the FSAP to Fund surveillance, the appropriate country coverage and pace of the program going forward, the linkages to the Bank's development work, and publication issues.

The FSAP/FSSA process and Fund surveillance

61. The need for strengthened financial sector monitoring and assessments under Fund surveillance and the analysis of interlinkages between financial system stability and macroeconomic performance are now well recognized.[22] In parallel with the rapid integration of international financial markets, increased emphasis has been placed on financial sector and capital account issues in Fund surveillance and work on these topics has intensified. In this regard, the FSAP/FSSA process is proving to be a valuable tool for identifying strengths, as well as risks and vulnerabilities, and needs for institutional development in the financial systems in member countries. These issues are then included in the surveillance dialogue with members, during staff discussions with national authorities as well as discussions at the Fund Board.

62. Drawing on collected factual information, in-depth assessments conducted jointly with the World Bank, and subsequent discussions with the authorities in the context of the Article IV consultations, the Fund staff prepare the FSSAs. They focus on the interlinkages between the soundness and operations of the financial system and macroeconomic

---

[22]Earlier this year, the Executive Board has confirmed this in the Summing Up by the Acting Chairman, *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision* (SUR/00/32). Also, at the last FSAP review, Directors "reiterated that assessing the financial sector is an integral part of Fund surveillance," see *Concluding Remarks by the Acting Chairman, Financial Sector Assessment Program—Progress Report—Lessons from the Pilot Exercise and Next Steps* (BUFF/0056).

performance and are provided to the Fund's Executive Board as part of the supporting documentation for countries' Article IV consultation discussions. Issues of particular significance for surveillance are highlighted in the Article IV consultation staff reports.

63. Given the advantages of regular comprehensive assessments (as discussed above), Fund staff consider the FSAP/FSSA process, out of which the FSSA is the immediate product for the Fund Board, as the preferred model for the monitoring of financial systems under Fund surveillance. In the staff's view, the FSAP/FSSA process provides the best framework within which to deepen the quality and coverage of the analysis of financial sector issues in the context of Fund surveillance, by providing comprehensive assessments of vulnerabilities and priorities for strengthening institutions and markets, using the best expertise available and with clear accountability and responsibility for the work. Staff believe that Fund surveillance would be significantly strengthened if all members were to participate in the FSAP. FSAP participation is, however, voluntary and the frequency of assessments is limited by resource constraints.

64. With the number of assessments that can be undertaken in any year being limited, there may be a gap of at least several years before a country that has participated in the program can undergo another comprehensive financial sector assessment under the FSAP. To ensure continuity, there is a need to develop a mechanism for regular updates of the assessments of financial sector risks, vulnerabilities and institutional conditions by the Bank and the Fund in the course of their ongoing work following the initial round of assessments. This will be particularly important for countries identified as vulnerable or systemically important, and those whose financial systems are evolving at a rapid pace.

65. For surveillance purposes, focused updates of FSSA findings could be undertaken by Fund staff in the context of subsequent Article IV consultations. These updates will cover key issues of systemic relevance identified during previous FSAP work, and revise assessments of standards as relevant, so as to take account of recent developments and new measures adopted by the authorities. These updates could be reported to the Fund's Board as separate supplements to Article IV staff reports with key issues and conclusions summarized in the staff reports.

66. In respect of countries with systemic issues that have volunteered to participate in the FSAP, and that cannot be accommodated by the program immediately, a targeted assessment of the most relevant issues could be undertaken in the context of Article IV consultations and the findings would be reported to the Board, as appropriate.[23] In order to avoid a situation that such targeted assessments substitute for the FSAP, it could be envisaged that at the

[23]Targeted assessments will focus on vulnerabilities with likely macroeconomic implications and key prudential or supervisory issues.

earliest opportunity, after the assessment of all other financial sector issues considered relevant, the FSAP report would be completed and an FSSA report issued for a subsequent Article IV consultation.

67. There is also a need to consider how to strengthen financial sector monitoring under Fund surveillance in countries that have not volunteered for the FSAP. A country's choice whether or not to participate in the FSAP does not alter the Fund's responsibility to conduct financial sector monitoring. To the extent that an assessment of the financial sector is a necessary element of an Article IV consultation, but the country chooses not to participate in the FSAP, the Article IV team can be reinforced with financial sector expertise and conduct the necessary assessments. The staff's view is that a full exercise would still be the preferred vehicle for conducting financial sector assessments as input to Fund surveillance. Accordingly, the staff could recommend (in the staff appraisal in the Article IV staff report) that the country participate in the FSAP. The Fund's conduct of surveillance will be further considered in the context of the follow-up of the surveillance review, which is expected to take place in the first half of 2001.

Country coverage of the FSAP

68. The view that country participation in the FSAP would be voluntary but that, over time, all countries would choose to participate is consistent with the proposed structure of the FSAP that was reviewed by the two Boards in the spring of 2000. At that time, most Directors saw merit in maintaining a broad country coverage. Some Directors felt that the FSAP should be targeted to systemically significant market economies. However, some Directors noted that countries that are not systemically important in international markets should also have the opportunity to participate in the program to help them strengthen and develop their financial sectors, avoid costly financial crises and, where relevant, prepare the ground for market liberalization and greater access to the international capital markets.

69. In its Communiqué at the time of the 2000 Annual Meetings, the IMFC reiterated the Fund's central role in "helping to ensure that all countries can benefit from globalization" and, in this context, noted that the Fund must sharpen the focus of the work in its core areas of responsibility including "financial sector issues, especially systemic issues relating to the functioning of domestic and international financial markets."[24] The Development Committee noted the Bank's valuable role, in partnership with the Fund and other international agencies,

[24]Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Prague, September 24, 2000.

in strengthening the international financial architecture, including "in areas that are important to financial resilience and integration into the global financial system, and assisting countries to strengthen their related institutions and policies."[25]

70. Against this background, actual and planned participation in the FSAP has reflected a very diverse and balanced set of countries. However, a sharper focus on systemic stability issues would require the program to proceed more rapidly with regard to systemically important countries. It may thus be appropriate that the criteria for scheduling participation in the FSAP be somewhat more focused on these countries. At the same time, we would maintain the goal of achieving a balanced mix of countries in any given year, thus enabling all countries to benefit from the FSAP, including those that are planning on implementing significant financial sector reforms and liberalization with the view to attaining greater reliance on global financial markets, those that are less active in international financial markets as well as a number of countries with offshore financial activities.

71. The group of systemically important countries that would be given higher priority includes both countries whose capital markets intermediate the bulk of global financial transactions, and emerging economies whose financial systems have the potential to cause, or be subject to, undue volatility in cross border flows and financial system contagion. The proposed expansion of the FSAP, which is discussed in the next section of the paper, would provide additional scope for including a greater number of such countries in the program, while still enabling full scope for other countries to participate. Flexibility in scheduling countries' FSAP participation would, of course, be needed so as to respond to unforeseen developments including urgent requests for FSAP participation.

Pace of the program

72. Decisions on the precise amount of resources to be allocated to the FSAP and related work, and therefore the scale of the program for FY2002 and beyond, will be undertaken in each institution in the context of their separate annual budget discussions. However, some increase in the annual number of FSAP assessments from the 24 in FY2001 seems justified. This would be consistent with the FSAP being the main vehicle for strengthening the financial sector work of the Bank and the Fund and would support an increased focus on systemically important countries while enabling a range of countries to participate. Further, an increase in the annual number of FSAP assessments would facilitate the inclusion of countries with OFCs in the program. Finally, authorities in some of the countries that have already been assessed have indicated that they would like comprehensive follow-up

[25]Communiqué of the Development Committee of the Boards of Governors of the Bank and the Fund, Prague, September 25, 2000.

assessments in order to disclose the reforms undertaken. This would likely not be possible to achieve in a reasonable time frame if assessments were undertaken at a rate of 24 annually.

73. Undertaking 24 assessments per year would enable the entire membership to be covered in about eight years. Assessments at the rate of about 30 per year would cover the entire membership in about a six-year cycle, while 36 assessments per year would support a five-year cycle. Given that the program is still relatively new, it would be difficult for the staff to implement a large increase in the number of assessments, especially given the logistical issues of organizing first-time assessments in countries that are not familiar with the process, as well as the need to further build up skills and assessment techniques.

74. On balance, these considerations suggest that it would be desirable to increase the number of assessments to an annual rate of up to 30 in FY2002 and beyond.[26] An increase in the number of assessments from 24 to 30 would likely involve a 25 percent increase in resource costs, although the staff anticipates realizing some efficiency gains. Moreover, follow-up costs will grow as the number of completed assessments increases. On the Fund's side, there are also resource implications from work relating to the enhancement of financial sector surveillance that is not part of the FSAP. This includes work in the context of the Article IV process on countries where financial sector issues are emerging rapidly and where it is not possible to undertake a full FSAP assessment in the short-term, as well as for countries that have not volunteered for the FSAP. There would also be resource implications for the Fund if a greater number of industrialized countries were to participate, given the Fund's predominant share of the costs in these cases. The additional resource needs in the Fund might be met in part through reprioritization, but they might also entail either cuts in technical assistance, or some additional budgetary allocations to preserve the volume of technical assistance. In the Bank, resources will be needed for follow up and technical assistance and Economic and Sector Work (other than that of the FSAP) that focuses on particular aspects of financial sector development and supports Bank lending operations and provision of non-lending services. The overall commitment of resources to the FSAP and related work in the Fund and the Bank will be addressed in the context of each institution's FY2002 budget discussions.

[26]For FY2002, 30 assessments might include 4–5 industrialized countries and 3–4 countries with OFCs.

75. The resource costs discussed here refer only to the resources of the Bank and the Fund. It is recognized that the FSAP also imposes a burden on national authorities. The staff are sensitive to that burden and are working on ways to reduce it, for example by assisting in self-assessments of standards ahead of FSAP participation and through more focused coverage of issues.

Linkage to the development work of the Bank

76. As noted above, the analysis and recommendation in the FSAP assessments are integrated into the work of the Bank and are reflected in CASs and other documents. More generally, the assessments will inform the dialogue among national authorities and various elements of the Bank Group, the Fund, and the broader international community. Only through such a dialogue can appropriate priorities be established with respect to capacity building and institutional reform and corresponding international support.

77. Experience to date has shown that this process already has begun, but on a somewhat ad hoc basis. Going forward, it may be desirable to consider more systematic means to ensure that, where appropriate, support from the Bank Groups is forthcoming, and—consistent with the Bank's mandate to support institutional capacity building—that the Bank plays a constructive role in catalyzing international support.

78. The funding for follow-up work by the Bank, including technical assistance that is requested as a consequence of the FSAP recommendations, will be considered in the context of the Bank's overall budget and the associated determination of priorities. In the broader context, Bank staff are exploring means to enhance the Bank's catalytic role, including through the possible use of trust fund resources from bilateral donors under a multi-stakeholder partnership arrangement.

Publication and distribution issues

FSAP reports

79. The policy so far has been that publication of FSAP reports by the Fund, the Bank or national authorities is not authorized by Fund and Bank managements. The view from the outset of the program has been that these reports generally contain highly confidential information and need to be candid. Therefore, FSAP reports are prepared by the staff as confidential documents for national authorities. They are not circulated to the Boards, and receive only limited circulation among Fund and Bank staff.

80. Experience to date has shown that, to formulate a comprehensive analysis of financial system strengths and vulnerabilities including carrying out stress tests and other diagnostic exercises, it is desirable that FSAP missions have access to highly confidential information,

especially data related to individual financial institutions.[27] The inclusion of the results of analysis of such data in an FSAP report facilitates the review of financial system issues with the authorities. It would seem appropriate for the managements of the two institutions to continue not to authorize the publication of the main volume of an FSAP report or associated confidential documents. These documents would continue to be circulated on only a limited basis within the Fund and the Bank.

81. However, other components of a typical FSAP report are self-contained and not normally regarded as highly sensitive; publication of those parts is less problematic. In particular, the detailed assessments of observance of standards and codes that is included as a subsidiary volume to main FSAP reports would most obviously fall into this category. While they contribute to the wider financial sector work of the Bank and the Fund in the context of the FSAP, they may also inform outside observers. It is, therefore, appropriate to allow wider circulation and even publication by national authorities of the detailed technical assessments of observance of standards and codes. This would be consistent with the recent practice in the Fund that the detailed assessments that are carried out in the context of technical assistance may be circulated more widely by national authorities if they wish, subject to management consent.[28]

82. Voluntary publication of the detailed standards assessments would be consistent with the approach that is envisaged with the publication of assessments of observance of standards and codes by OFCs. It would also enable European Union (EU) accession countries to provide the EU with the detailed assessments done under the FSAP as part of their accession requests. It is important to note, however, that a decision to allow the publication of detailed assessments of observance of standards would not serve as a replacement for ROSCs.[29]

---

[27]Access to such information may not be possible when national authorities are legally prohibited from providing such information, unless the financial institutions themselves are willing to do so.

[28]In many cases authorities wish to publish or widely discuss such assessments to build momentum for reforms and to justify the substantial resource costs involved, and it would be appropriate for the Fund and the Bank to support such transparency initiatives. Requests by the Brazilian and Albanian authorities to be authorized to publish the assessments of the observance of the Basel Core Principles for Effective Banking Supervision and the Code of Good Practices on Transparency in Monetary and Financial Policies, respectively, which were carried out by Fund staff in the context of technical assistance were recently granted by Fund management. These detailed standards assessments have been circulated to the Fund's Board for information.

[29]The role of ROSCs, as well as their preparation, is explored in *Assessing the Implementation of Standards: A Review of Experience* (forthcoming).

FSSAs and FSAs

83. Publication policies for FSSAs and FSAs should be consistent. The current policy, which applied to the FSAP pilot, is not to permit publication of FSSAs and FSAs (by the Fund or the Bank, as appropriate, or national authorities). These documents have also received only limited circulation within the Fund and the Bank and have not been circulated to outside agencies. However, national authorities may elect—on a voluntary basis—to publish the summary assessments that form Part II of the FSSAs, as they are issued as ROSC modules.

84. It is the Fund staff's view that experience with the pilot indicates that it has been possible to include in FSSAs a full picture of the findings of the FSAP teams relevant to systemic stability issues without including, for example, highly market sensitive information on individual financial institutions. Furthermore, while some national authorities have indicated that they would not wish to publish their FSSAs, others have requested that the Fund allow publication, as it has been felt by them that this would enhance transparency as well as their reform agendas, not to mention potential value to market participants in formulating investment decisions.

85. FSSAs also convey the broader context in which to interpret the assessments of standards and this would improve the information content of the ROSCs that are published. Finally, FSSA findings are referred to in Article IV staff reports, which may be published. When this has occurred there have been no apparent negative reactions from markets.

86. Therefore, the Fund staff recommends that FSSAs be treated the same as staff reports for Article IV consultations for publications purposes. Publication of FSSAs could be permitted on a voluntary basis at the conclusion of the FSAP process subject to the same deletions policy regarding market sensitive information that pertains to staff reports.[30] Although FSSAs and the associated Article IV staff reports would be complementary, publication of FSSAs would be permitted even if national authorities did not wish to publish the staff reports. The staff propose that FSSA reports be given the same internal distribution and circulation to outside agencies as the staff reports for Article IV consultations.[31]

87. From the Bank's perspective, disclosure of FSAs would increase awareness of development needs and could help to generate a consensus for addressing those needs. At the same time, the willingness of authorities to make FSAs public might be seen as a signal of a

---

[30]The FSAP process is concluded when the FSSA is distributed to the Fund's Board and the associated Article IV consultation has been concluded, the FSA (for non-industrial countries) is distributed to the Bank's Board, and the final FSAP report is transmitted to the authorities.

[31]The European Commission, for example, has expressed interest in receiving the FSSAs for countries seeking accession to the European Union.

serious intention to address their problems and so might induce financial and other support from the private sector. Therefore, the Bank staff recommends that publication of FSAs could be permitted on a voluntary basis at the conclusion of the FSAP process.

88. It is proposed that the new policy for voluntary publication would not apply to initial assessments of the 12 pilot countries. These countries could, however, on a voluntary basis, publish a subsequent FSSA or FSA in the context of updates of the assessments undertaken by the Fund and the Bank in the course of their ongoing activities.

IV. Issues for Discussion

Issues for both the Bank and the Fund

- *Do Executive Directors agree that the FSAP process is providing a coherent framework to identify vulnerabilities and strengthen the analysis of domestic macroeconomic and financial stability issues, to identify development needs and priorities, and to help authorities develop appropriate policy responses?*

- *Do Executive Directors agree that the objective should be to undertake about 30 FSAP assessments each year, subject to decisions on resource availability that will be made in the context of each institution's budget discussions and procedures? This would enable all member countries of the Bank and the Fund to be covered on a six-year cycle.*

- *Do Directors further agree that higher priority should be given to assessing systemically important countries, including industrial countries, while continuing to provide, within an expanded program, full scope for countries in various circumstances and states of financial market development to participate?*

- *Do Executive Directors agree with managements' policy not to provide authorization for the publication of FSAP reports in their entirety? Do Directors endorse the management's intended policy to provide authorization for the publication of the detailed assessments of observance of standards and codes that are included in these reports?*

- *Would Directors agree that it would be appropriate to have a further review of the FSAP taking into account the next financial year's experience, that is, in about 18 months?*

Issues for the Fund

- *Do Executive Directors agree that FSSAs originating from the FSAP are the preferred tool for strengthening the monitoring of financial systems under Fund surveillance?*

- *With the exceptions explained in paragraph 88, should publication of FSSAs be permitted on a voluntary basis at the conclusion of the FSAP process, consistent with the publication policies for staff reports for Article IV consultations and with the same deletions policy?*

Issues for the Bank

- *Do Executive Directors agree that insights and recommendations from the FSAP assessments must be considered in the development of the Bank's country programs so that the potential benefits of the comprehensive diagnosis can be realized?*

- *With the exceptions explained in paragraph 88, should publication of FSAs be permitted on a voluntary basis at the conclusion of the FSAP process?*