ANNEX

5 Weaknesses in FSAPs in Advanced Economies

This annex describes the main factors that contributed to a mixed record in the quality and usefulness of FSAPs in advanced countries. It draws on the FSAPs of advanced countries during 2004–08 and staff's 10-year retrospective of the FSAP (IMF, 2009b).

Lack of candor and clarity. This seems to have been more of a problem in the FSAPs for advanced than for other countries, as some of the IMF's assessments for emerging markets were pointed and direct about risks and vulnerabilities. According to IMF (2009b), lack of candor and clarity "might be symptomatic of a desire of team members to avoid conflict with national officials." The typical tendency was to present a "balanced" view, beginning with a positive statement before acknowledging any risks.

Inadequate or lack of coverage on topics relevant to the crisis. Coverage of liquidity risks, crisis preparedness, bank resolution, and external funding risk seemed less consistent in the FSAPs for advanced countries than for emerging markets. To assess liquidity risks, for example, FSAPs sometimes reviewed only the central bank's liquidity management instruments. Some aspects of capital markets that should have received attention in advanced countries—asset securitization, commercial paper, and short-term funding markets—were not routinely covered.

Stress test weaknesses. According to IMF (2009b), "stress tests … did not provide significant insights regarding the crisis." Reasons include: specifying shocks that were not sufficiently severe (reflecting, in part, the sensitivity of country authorities and the difficulty in "thinking the unthinkable"); missing important sources of instability—liquidity risks, concentration of exposures in real estate, off-balance-sheet exposures; working with inadequate data, particularly regarding off-balance-sheet exposures and balance-sheet interconnectedness; as well as methodological challenges in modeling liquidity risk, contagion channels, second-round effects, nonlinearities, and correlation across portfolios.

Failure to integrate multilateral perspectives. The FSAPs for most countries did not discuss the global macroeconomy nor the developments taking place in countries with strong economic ties to the subject country. They typically focused on domestic issues and scenarios and did not look at cross-country risks or spillovers, crosscutting issues, or global economic risks. In fact, in those instances where global risks were considered, the scenario was the impact from a disorderly collapse of the dollar in line with the IMF's focus, which is not the way the crisis impacted financial sectors.

Reassuring messages that induce complacency. Among the key messages from advanced county FSAPs in the run-up to the crisis were: "the outlook for the financial system is positive;" "financial institutions have sufficient cushions to cover a range of shocks;" "the diversification of sources of foreign wholesale funding is a source of strength;" "stress tests … suggest that the financial system as a whole is well positioned to absorb a significant fall in housing prices;" "the financial sector is generally sound and should be resilient to large, but plausible shocks;" "no weaknesses that could cause systemic risks were identified."