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BACKGROUND PAPER

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IMF Engagement on Financial Sector Issues in Small Developing States

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ABBREVIATIONS

ADB	Asian Development Bank
AFR	African Department (IMF)
AFRITAC	Africa Technical Assistance Center
AML/CFT	Anti-Money Laundering/Countering the Financing of Terrorism
CARTAC	Caribbean Technical Assistance Center
CBDC	Central Bank Digital Currencies
CBR	Correspondent Banking Relationship
CD	Capacity Development
ECCU	Eastern Caribbean Currency Union
EUR	European Department (IMF)
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicator
FSSR	Financial Sector Stability Review
G20	Group of Twenty
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GROWTh	IMF acronym corresponding to five key thematic areas
LEG	Legal Department (IMF)
LIC	Low-Income country
MCD	Middle East and Central Asia Department (IMF)
MCM	Monetary and Capital Markets Department (IMF)
NPL	Non-Performing Loan
OFC	Offshore Financial Center
PFTAC	Pacific Technical Assistance Center
RCDC	Regional Capacity Development Center
REO	Regional Economic Outlook
SACU	Southern African Customs Union
SDS	Small Developing State
SOE	State-Owned Enterprise
SIP	Selected Issues Paper
TA	Technical Assistance
TSR	Triennial Surveillance Review
WHD	Western Hemisphere Department (IMF)

EXECUTIVE SUMMARY

This study assesses the Fund's role in supporting the development of financial sectors in the IMF's 34 small developing states (SDS) during the period 2010–2020. The assessment is against a background of adaptations made to the Fund's broad policy guidance on financial sector issues in the immediate post-Global Financial Crisis period to recognise the unique challenges in small states and which included "thin financial markets" as one of the five priority concerns for Fund work in SDS. Accordingly, resulting staff guidance prioritized policy advice around deeper and more competitive, yet sound financial sectors, better service delivery, and strengthened oversight.

Overall, the paper provides a positive assessment of the IMF's sustained and multi-modal (research, surveillance, capacity development and program) efforts to promote financial stability in SDS. At the country level, analytical work by staff to understand the unique macro-financial challenges in SDS has been impressive and efforts at engagement and dialogue related to, for example, correspondent banking relationships, has contributed to building trust and cultivating partnership. Attention to institutional and systemic solvency, supervisory frameworks, including for AML, and supervisory practices has had significant traction with authorities.

Application of this multi-modal approach in other aspects of Fund engagement has, however, been less evident with resulting less impact. This shortcoming is most evident with Fund engagement with SDS to support financial resilience—the ecosystem for financial intermediation. This outcome seems to reflect in part operational ambiguities in Bank/Fund responsibilities related to the provision of capacity support on financial resilience issues.

While attention to the channels of macro-financial shocks in SDS have improved, key gaps remain. Greater attention is needed to address "inward" regulatory and operational spillovers that can be as impactful for SDS as weather or global/regional macro-economic shocks, given their inherent openness to the global environment through trade financing, remittance flows and the prevalence of foreign intermediaries. An equally important risk arises from the current compartmentalization between staff advice on fiscal consolidation (reducing fiscal dominance) and advice regarding financial intermediation (the ecosystem to facilitate crowding in). Addressing these gaps may involve analytical work, but spillovers could simply imply more structured contact with home supervisors of international banks operating in SDS.

In supporting the resilience of the financial systems in SDS, there are strong, mutually reinforcing opportunities for the IMF to further innovate in its support to SDS, through regional or "common issue" approaches already applied by the Fund in its engagement with non-SDS. This approach would align with the Fund's broader research agenda on regional solutions to resilience building; offer opportunity to augment IMF engagement with SDS members in a cost-effective way, by supplementing both surveillance and capacity support; and align and build on efforts already underway in some SDS, notably in the use of new technology (regional sandboxes and national central bank digital currencies).

In providing capacity support to SDS, there remain important challenges to more effective collaboration with partners. This has already resulted in uneven delivery of capacity support for reforms associated with the narrow financial ecosystem. Strengthened collaboration can help address these gaps and prevent similar gaps emerging as the Fund deepens its engagement with SDS on the financial sector impacts of climate change and new technology, both issues of critical importance to these members.

I. INTRODUCTION

1. The IMF has paid increasing attention to financial sector issues since the Global Financial Crisis (GFC). The IEO 2019 evaluation of IMF Financial Surveillance found that while much Fund attention had focused on financial sector issues in systemically important countries, financial sector issues have become more important to the work of the Fund and its ongoing engagement with the entire membership (IEO, 2019). This background paper assesses the Fund's role in supporting the development of financial sectors in the IMF's 34 small developing states (SDS) during the period 2010–2020. It reviews Fund work to support policymakers' efforts to foster financial stability, to promote competition, and achieve efficient scale in financial sector activities. It also assesses Fund engagement to advise and assist SDS strengthen legal frameworks for financial services and improve compliance with international standards and in addressing emerging financial sector challenges including disruption of correspondent banking relationships (CBRs). The paper draws on interviews with IMF staff, and a broad range of external literature and Fund documents, including Article IV staff reports, Selected Issues Papers (SIPs), Financial Sector Assessment Program (FSAP) and Financial Sector Stability Review (FSSR) reports, and reports on program engagement; and on capacity development (CD) initiatives undertaken including through Regional Capacity Development Centers (RCDCs).

2. While SDS are heterogeneous and face country-specific challenges in developing their financial systems, many also manifest similar characteristics. Financial systems in SDS have been described as being typically shallow, lacking competition and operating in an environment of narrow economic bases with limited lending opportunities.[1] Shallow financial systems in SDS tend to impede the proper transmission of monetary policy. These financial systems also often operate in volatile macro-financial environments, susceptible to climate related shocks,[2] and partly incentivized by the typical preferential treatment of sovereign public debt in regulatory frameworks for capital and liquidity, with disproportionate lending to the public sector.[3] Given their inherent openness and intersection with the global environment through trade financing, remittance flows, and the prevalence of foreign intermediaries, financial systems in SDS are likely predisposed to "inward" regulatory and operational spillovers.[4] Moreover, as several SDS operate offshore financial centers (OFCs), they can face particular reputational challenges in complying with international standards, including in anti-money laundering and combating the financing of terrorism (AML/CFT) and tax transparency issues.

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[1] See, for example, IMF (2017).

[2] The 2020 World Risk Index assessing exposure to disaster risk, ranks 9 SDS (4 Pacific; 3 Caribbean; 1 Africa; and 1 Middle East) amongst the top 15 countries most at risk in the world.

[3] This exposure to the state inevitably links financial sector soundness closely to fiscal sustainability. Financial system vulnerability poses risks, in turn, for budgets (through potential bailout costs).

[4] The proportion of foreign bank branches or subsidiaries in the SDS range between 25 percent in Belize to 100 percent in Barbados and some Pacific islands.

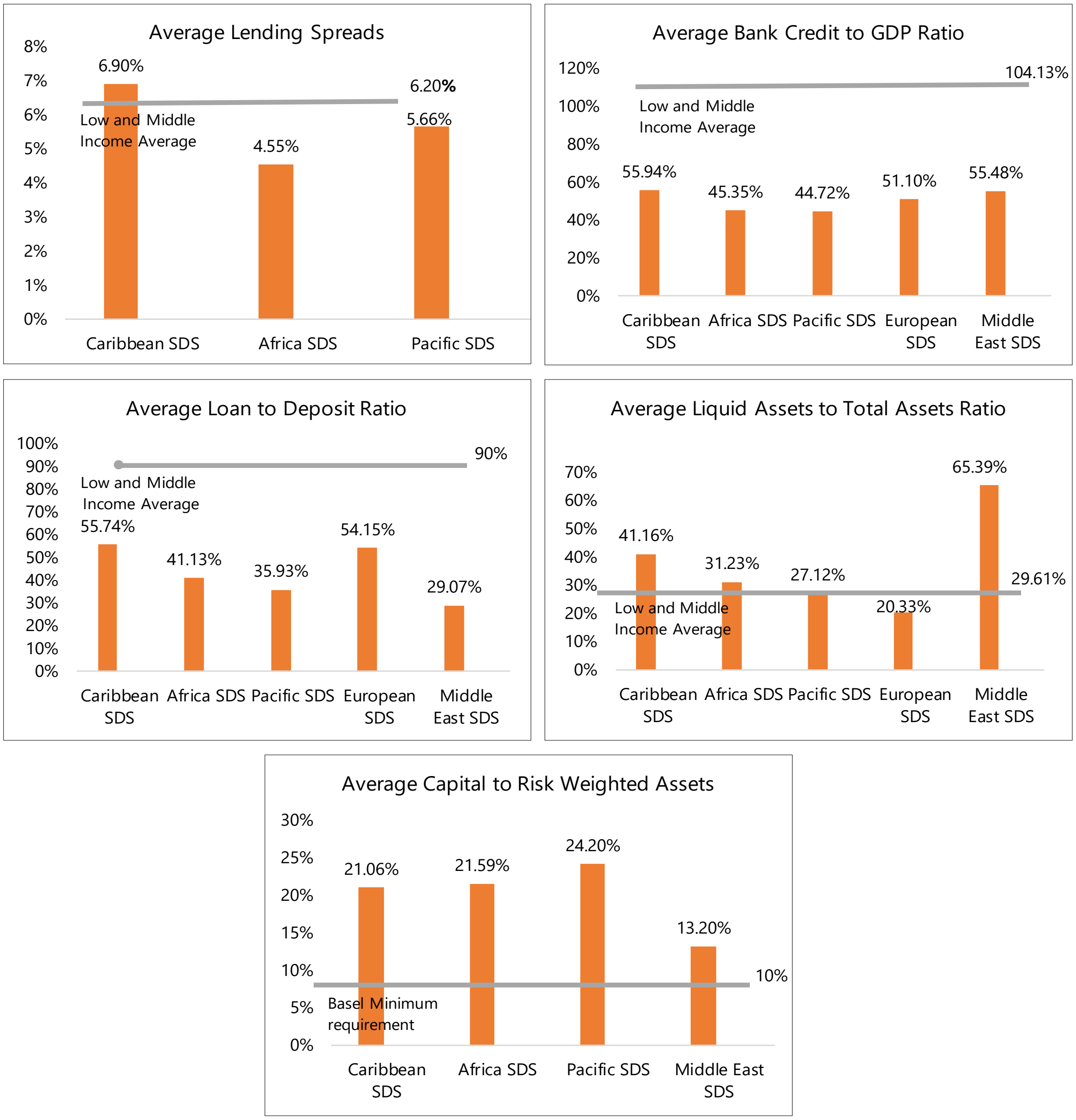
3. This paper considers the following key evaluation questions on financial sector issues: (i) was the Fund's bilateral surveillance and policy advice to SDS consistent with both IMF-wide and SDS-specific staff guidance notes; (ii) were policy advice and surveillance sufficiently tailored to the challenges facing SDS and to country-specific circumstances; (iii) what challenges hampered the effectiveness of IMF surveillance and how did the Fund respond; (iv) how much value added did specific research, analytical and specific surveillance tools, including SIPs, FSAPs, and Financial Sector Stability Assessments provide in the SDS context; (v) was program design sufficiently well-structured and tailored to the specific financial sector challenges faced by SDS; (vi) was Fund CD adequately integrated in surveillance; and (vii) how well did Fund engagement adapt to emerging challenges, for example, the withdrawal of CBRs, and to new opportunities, including fintech? To address these questions, the paper considers the Fund's role in engaging with SDS members in the context of Fund research, policy guidance, surveillance, program engagement and CD.

4. The paper is organized as follows: the remainder of this section provides summary stylized facts regarding the characteristics of SDS' financial systems. Section II provides an overview of the evolution of Fund-wide engagement on financial sector issues, highlighting how Fund-wide engagement escalated from the late-1990s. Section III outlines Fund policy guidance on financial sector issues, both on a Fund-wide basis as well as guidance specifically applicable to SDS. Section IV assesses staff engagement on financial sector issues with SDS in six areas: (i) Fund research specifically tailored to challenges in SDS; (ii) the quality and impact of SIPs; (iii) regional surveillance; (iv) bilateral surveillance; (v) program engagement, including the design of program conditionality in IMF programs; and (vi) CD on financial sector issues in SDS. Section V identifies several challenges and opportunities that have emerged during the evaluation period and assesses how Fund engagement has adapted to these. Section VI provides findings and conclusions.

Financial Systems in SDS—Stylized Facts and Common Challenges

5. While with some regional variation, SDS financial systems are characterized by relatively low intermediation with large operating buffers. Stylized indicators in Figure 1 indicate that relative to low- and middle-income countries, SDS in the Caribbean have higher lending spreads, Pacific SDS have larger liquidity and capital buffers, and all have substantially lower credit/gross domestic product (GDP) and loan/deposit ratios with the exception of Montenegro. As against low/middle income comparators, where bank credit/GDP ratios averaged 104 percent over the review period, ratios in SDS averaged 52 percent over the period, with 30 percent of reporting countries in 2019 having ratios below 30 percent (with the lowest being 15.7 (Comoros). Similarly, in the case of banking spreads that average 6.2 percent for low/middle income comparators, 72 percent of reporting SDS had higher lending spreads (with the highest averaging 15 percent (Timor-Leste and Micronesia) in 2019.

Figure 1. Stylized Profile of Financial Systems in SDS



Sources: WDI; IEO calculations.

6. These data reflect the reality that small size constrains the development of hedging instruments and markets including capital, equity, and bond markets. Moreover, risk diversification is challenging and difficult to achieve in economies with few potential borrowers, high openness, and little geographical or economic diversification. The challenges to ensuring adequate financial intermediation, including for cross-border flows, have been further amplified by changes to the regulatory environment, including to tighten requirements to guard against money laundering and terrorist financing that have threatened to sharply curtail CBRs.

7. For SDS, these adapted characteristics in their financial systems are as pernicious as they are unique. Relatively low intermediation reduces the capacity of households and corporates to manage the shocks to which they are often exposed, amplifying the need for public intervention, often with adverse debt implications. A resulting challenge has been navigating this need for fostering financial depth while preserving institutional and systemic solvency.

8. The consequences of these unique characteristics have been subject of an extensive external literature and a growing body of analytical work. King and Levine (1993) show a causal relationship between financial depth and economic growth and various studies including Levine (2004), Demirgüç-Kunt and Levine (2008), and Dabla-Norris and Srivisal (2013) evidence the role of access to financial services as not only an important channel in fostering inclusive growth but also its role as a shock absorber in mitigating the negative effects of real external shocks on macroeconomic volatility, which is particularly important for SDS. Moreover, Sahay and others (2015) and Beck and De La Torre (2007) show that financial development accounts for about a third of the variation in poverty reduction rates across countries.

9. The literature has also been rich in its attention to financial inclusion, particularly since the 2011 Maya Declaration, an international initiative for responsible and sustainable financial inclusion that aimed at reducing poverty and ensuring financial stability, and in financial inclusion being identified as an enabler to 7 of 17 Sustainable Development Goals.[5, 6] Companion to this focus, digitization as an enabler to inclusion was highlighted by the G20 in 20 endorsing principles for digital financial inclusion and elaborated in the 2018 Bali Fintech Agenda.[7] Extensive work has been undertaken by the Consortium for Financial Systems and Poverty (CFSP)[8] on the interactions between financial depth, access, growth, stability, and efficiency, both at the theoretical level and through micro econometric studies in individual countries. Carstens (2019), Patwardhan and others (2018), and IFC (2017), also provide overviews of the barriers to financial inclusion and how fintech may help to overcome these barriers.

10. The COVID-19 pandemic has amplified macro-financial fault lines in SDS. The “sudden stop” for tourism dependent countries, combined with sharp declines in remittance flows for most, and the steep drop in commodity prices for commodity exporting SDS impacted fiscal positions and broader economic activity, as disruption to supply chains for imported food and medical supplies reduced capacities to deliver quality health care. Financial sectors were hard hit by domestic interlinkages and credit concentration.[9] While initial policy responses varied,

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[5] https://www.afi-global.org/global-voice/maya-declaration/.

[6] See https://www.smefinanceforum.org/data-sites/msme-finance-gap.

[7] G20 High-Level Principles for Digital Financial Inclusion.

[8] http://www.cfsp.org.

[9] As compared to the Basel Guidance on large exposures relative to capital of 25 percent, the 9 SDS reporting on this indicator had average exposure of 96 percent in 2020. https://data.imf.org/?sk=51B096FA-2CD2-40C2-8D09-0699CC1764DA.

common across most SDS was the provision of liquidity support to institutions, loan moratoria/renegotiation to borrowers by banks, and timebound relaxation of macro and micro-prudential requirements. To preserve foreign exchange reserves, some countries suspended the distribution of dividend payments, particularly relevant given high foreign presence in their financial systems.

II. FUND-WIDE APPROACH TO FINANCIAL SURVEILLANCE

11. IMF bilateral financial surveillance began in earnest in the aftermath of the Mexican crisis of 1993–1994.[10] Successive Biennial Surveillance Reviews (1995 and 1997) reiterated the need to pay greater attention to financial sector issues, and along with the issuance of staff guidance notes, led to a series of innovations that included the joint IMF-World Bank FSAP in 1999 and organizational changes within the IMF that eventually birthed the Monetary and Capital Markets Department (MCM) in 2006.

12. Initiatives to strengthen financial surveillance continued through the eve of the GFC.[11] These initiatives moved in two parallel directions: (i) to strengthen the analysis and understanding of two-way links between finance and macroeconomics; and (ii) to expand the focused attention of financial surveillance to all countries with systemically important financial sectors, not just emerging market economies (EMs). To facilitate the integration of financial issues into Article IV consultations, in April 2009, management issued a "Financial Sector Surveillance Guidance Note," as a complement to the broader Surveillance Guidance Note. To strengthen the surveillance of all countries with systemic financial systems, the FSAP was reformed in two stages. First, in September 2009, the administration of the FSAP was made more flexible, with a clearer delineation of responsibilities between the IMF and the World Bank, allowing the Fund to conduct financial stability modules separately from financial development modules by the Bank.[12] Second, in September 2010, the Executive Board made financial stability assessments (FSAs) under the FSAP "a regular and mandatory part of the Fund's surveillance for members with systemically important financial sectors (SIFS)" (IMF, 2010a).[13]

13. The 2011 Triennial Surveillance Review (TSR) (IMF, 2011a) brought increased attention to financial surveillance in shallow markets (as exist in many low income countries and SDS) and the interplay between financial sector development and stability. The staff background studies found that financial sector coverage in low-income countries (LICs) paid insufficient attention to the impact of underdeveloped financial markets on the effectiveness of macroeconomic policies, the economy's ability to absorb shocks, and to support strong, durable growth (IMF, 2011b). This

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[10] The Whittome Report (IMF, 1995) attributed part of the IMF's failure to detect the emerging crisis to the insufficient attention surveillance had paid to financial market developments.

[11] See IEO (2011), IMF (2009a, updated 2010).

[12] https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/14/Financial-Sector-Assessment-Program.

[13] The number of SIFS increased from 25 to 29 and 47, respectively in 2013 and 2021 (IMF, 2021b).

built upon an earlier 2009 staff paper (IMF, 2009b) that had highlighted that inconsistent coverage of macro-financial issues in developing countries, besides data constraints, reflected a tension between stability concerns (which are in the purview of Fund surveillance) and developmental issues (in the purview of the World Bank mandate) as well as that "uncoordinated, these 'boundaries' limit focus on an important source of macroeconomic and financial vulnerability." To address this potential divide, a Fund-Bank LIC Financial Group under the auspices of the Financial Sector Liaison Committee (FSLC)[14] was established with the explicit objectives to: (a) key off the upcoming Article IV missions to establish the macro-financial stability issues and the associated market development needed for financial internediation; (b) serve as a forum to align Bank "development" projects under FSAPs with financial stability needs of LICs; and (c) establish modalities for collaboration in the field or in off-site work jointly with the World Bank. A third strand of reform was the use of risk assessment matrices to capture channels of inward spillovers to LICs, beyond trade, commodity process and remittance flows.

14. Throughout, CD on financial sector issues (supported by strong growth in external funding and enhanced through a growing set of RCDCs) has become an increasingly prominent aspect of the IMF's work, serving as an important complement to surveillance and lending in meeting the Fund's mandate. In November 2017, MCM launched a new integrated and demand-driven CD diagnostic instrument—FSSR with the objective to assist low- and lower-middle-income countries to identify and address weaknesses in financial stability frameworks and to help promote financial development and inclusion. The FSSR serves as a demand-led technical assistance (TA) instrument, providing a diagnostic review of key components of the financial sector, as well as an assessment of financial statistics (i.e., Financial Soundness Indicators and balance sheet matrices), a TA Roadmap, and follow-up TA to strengthen and reinforce financial stability frameworks. Efforts to "mainstream macro-financial surveillance" have been sustained over the years. These have included area and relevant functional departments formulating specific plans to mainstream macro-financial surveillance, starting with 24 countries for 2015 on a pilot basis (the number was expanded to 66 in 2016).[15] After reviewing progress with these pilots at the March 2017 Board discussion of "Approaches to Macro-financial Surveillance in Article IV Reports" (IMF, 2017a), it was decided to progressively mainstream macrofinancial surveillance across the full membership.

15. Nonetheless, these efforts remain a work in progress (IEO, 2019). In the context of discusions on the 2021 Comprehensive Surveillance Review (IMF, 2021a), Directors noted the ongoing need to deepen macro-financial analysis and further integrate it into bilateral surveillance and stressed the need for closer integration of FSAP findings and recommendations with the Article IV Consultations. They also underscored the need to expand macro-financial

[14] The FSLC was established in September 1998 and is comprised of senior staff from both institutions. Its main objective is to enhance operational coordination between the Bank and the Fund on financial sector issues.

[15] The initial pilot included two SDS, Samoa and Sao Tome & Principe. See Approaches to Macrofinancial Surveillance in Article IV Reports, February 2017; and The Macrofinancial Linkages in Shallow Markets: Experience from the African Department's Pilot Countries Departmental Paper No. 18/12; July 24 2018.

talent at the Fund, particularly in country teams, while taking into account budget considerations.[16]

III. EVOLUTION OF POLICY GUIDANCE TO SDS ON FINANCIAL SECTOR ISSUES

16. In the immediate post-GFC period, broad policy guidance on financial sector issues prioritized attention to issues of financial stability, the cross-border transmission of risks and the two-way linkages between the financial sector and the real economy.[17] Country teams were encouraged to seek information on: (i) the size, structure, soundness/performance, and cross-border exposures of banks and non-bank financial institutions and financial markets, and characteristics of the investor base when relevant and (ii) institutional, regulatory, and policy frameworks both for crisis prevention and management. Assessments were encouraged to focus on the stability of the system as a whole, and to gauge the potential or actual spillovers that could significantly impact global stability. Macro-financial risks and the interlinkages between financial and sovereign balance sheets were recognized, as was the dynamic of how restoring financial stability could impact growth and policy responsiveness.

17. Starting in 2013, staff began to examine the unique challenges of financial systems in small states in a series of reports focusing on the particular macroeconomic issues facing these countries.[18] These papers noted that SDS were characterized by a general lack of market depth, low availability and high cost of credit; output volatility, limited financial infrastructure and oversight, low financial inclusion and access to finance, concentrated market structures; and, high public debt. Moreover, the experience in the aftermath of the GFC showed that domestic credit cycles had become more closely linked to international markets, particularly in small states with OFCs. This underscored the inadequacy of information sharing, practical difficulties in resolving insolvent foreign financial institutions, and other limitations in the home-host supervisory frameworks.

18. In 2014, a Staff Guidance Note on Engagement with Small States (IMF, 2014) was issued that built on prior Fund-wide guidance, the external literature, and and the 2013 staff papers. It introduced the GROWTh framework,[19] which included "thin financial sectors" as one of five priority concerns for IMF work on SDS. Accordingly, it prioritized policy advice around deeper and more competitive, yet sound financial sectors, better service delivery, and strengthened

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[16] See also 2021 FSAP Review,(IMF, 2021b), which found that the FSAP has evolved in response to changing global challenges, is highly and increasingly valued for its contributions to surveillance, and should continue to adapt to the evolving financial stability landscape.

[17] IMF (2009).

[18] See IMF (2013a; 2013b; 2013c).

[19] The GROWTh framework is based on five key thematic areas identified by staff as relevant to small states: Growth and job creation; Resilience to shocks; Overall competitiveness; Workable fiscal and debt sustainability options; and Thin financial sectors. For more background on policies and guidance related to IMF SDS, see Abrams (2022).

oversight. Notably it encouraged efforts to promote competition and exploit technological opportunities to achieve scale in banking and other financial sector activities. In strengthening the legal and prudential framework for financial services and implementing relevant international standards, the guidance urged that advice should be tailored to the challenges of small markets, their limited supervisory resources, and reputational risks. Where fiscal positions were especially important to financial development, in view of the sovereign's dominant role in local markets, it encouraged that policy advice on fiscal and debt management should take this into account. The guidance acknowledged the macro-financial implications of weather-related disasters and more generally pinpointed the vulnerabilities from interconnectedness intrinsic to small open economies.

19. Equally important for financial systems in SDS, though not explicit in the initial 2014 GROWTh framework were two issues flagged in subsequent guidance notes related more broadly to IMF surveillance (IMF, 2015a). The first was a requirement that in covering external risks (i.e., potential inward spillovers), surveillance should assess actual inward spillovers in all cases. The analysis of inward spillovers (both potential and actual) demanded thorough understanding of the channels for inward spillovers for a country (e.g., trade, links through the banking system and financial markets, foreign direct invesment (FDI), corporate borrowing, commodity prices, etc.). A second issue flagged related to staff engagement on structural issues, noting that staff are required to carry out analysis and provide policy advice on structural issues that are macro-critical and where the Fund has in-house expertise; however, where structural issues are macro-critical but the Fund lacks expertise, staff should draw on expertise from other organizations in carrying out their analysis, thereby placing importance on IMF collaboration with partners.

20. Particular guidance on the financial consequences from the disruption of CBRs was provided in an updated guidance note on the Fund's engagement with small developing states issued in 2017 (IMF, 2017b). This Staff Guidance Note encouraged staff to support member countries in addressing issues leading to and arising from the withdrawal of CBRs and to monitor risks to help tackle the adverse impacts from the withdrawal of CBRs and ensure financial stability and promote financial inclusion. It envisaged that through surveillance and FSAPs and providing CD staff could support affected countries to help enhance their monitoring of CBRs and strengthen their legal, regulatory and supervisory frameworks.

21. Beyond the formal process of policy guidance, analytical work in departments, facilitated by the "small states club," an internal informal group of Fund staff working on SDS issues, has also been an important vehicle informing staff advice in individual country cases. While not developed explicitly to guide SDS policy guidance, the collective body of departmental research work, working papers, analytical contributions to Board papers on SDS issues and SDS-related contributions to Regional Economic Outlooks (REOs) discussed in Section IV contributed importantly to shape broader policy guidance on SDS.

IV. ASSESSING FUND ENGAGEMENT ON FINANCIAL SECTOR ISSUES IN SDS

22. Building on insights and guidance provided in both the 2011 TSR and in the "GROWTh" framework, ensuing sections of this paper assess staff engagement through three inter-related lenses: (i) the efficacy in understanding the macro-financial context of the financial system (sources and channels of risk impacting the financial system); (ii) the adequacy of coverage of issues related to financial stability of the system (institutional and systemic solvency and supervisory frameworks); and (iii) attention to financial resilience (the ecosystem supporting intermediation). This approach is grounded in the finance and development literature that views these elements as mutually reinforcing and critical to financial depth.

23. During the evaluation period, small states (and their financial systems) have been challenged by persistent global and idiosyncratic shocks. The GFC impacted tourism, remittance and FDI flows to SDS. Offshore activity (a source of tourism and real estate activity for some countries) declined as global financial institutions initially sustained large losses, resulting in a decline in funds for treasury management in the offshore sector.[20] Concurrent with the GFC, SDS members in the Caribbean were managing the substantial cross border fallout of the corporate collapse of CLICO and its affiliate BAICO (2009), while the Pacific islands were soon to be impacted by Cyclone Ian (2014) and Pam (2015). Major weather events (Erica, 2015; Earl, 2016; Harvey, Irma, and Maria, 2017; Dorian, 2019; and Harold, 2020) continued to disrupt the Caribbean and Pacific. Additional stress has come through regulatory/tax policy channels and spillovers—including the well documented issues associated with the impact on CBR.[21]

24. This section assesses five substantive components of IMF engagement on financial sector issues in SDS: (i) internal Fund research; (ii) Selected Issues Papers (SIPs); (iii) bilateral surveillance, including the quality of FSAPs and Article IV reports; (iv) regional surveillance, including coverage and quality of surveillance in REOs and statutory regional consultations; (v) program engagement; and (vi) the provision of CD. Several evaluative tools and methods are used in each case. To assess the quality and coverage of SIPs, the paper reviews, scores and ranks all SIP chapters on financial sector issues during the evaluation period. In assessing bilateral surveillance, the paper identifies and assesses the quality in Article IV reports of coverage of financial sector issues across aspects of stability, macro-financial links and resilience. For program engagement, the paper evaluates the distribution of program conditionality, including prior actions, quantitative performance criteria,

[20] A more durable impact of the GFC on offshore activity was the political impetus to calls for increased regulation of OFCs and other jurisdictions labelled as "tax havens." Notably, the G20 communiqué issued at the close of the London Summit on 2 April 2009 sets out the organization's intention to take action, including potentially imposing sanctions, against non-cooperative jurisdictions such as tax havens as part of a package of measures aimed at strengthening global financial supervision and regulation (see G20 Communique: London Summit – Leaders' Statement; 2).

[21] Additional more localized spillovers have for example, come from Canada's modifications to its foreign property income regime that reduced the tax benefit of holding companies in some SDS's. Similarly, enhanced tax oversight by Australia of its citizens financial assets in SDS's in the Pacific with low/no tax regimes resulted in repatriation of some foreign currency deposits in some jurisdictions.

and structural benchmarks with Board action dates that fell in the evaluation period. For CD, the paper draws on published TA reports, the annual reports of the relevant RCDCs that serve SDS, as well as internal travel management data, to assess how well aligned CD was with issues identified in surveillance.[22]

A. Research

25. Over the evaluation period, IMF research to understand and address the unique challenges experienced by the financial systems of small states and the implications for broader economic resilience steadily intensified. Policy and research work on common challenges and opportunities in intermediation in SDS (and subsets of SDS) deepened, building on the external literature cited earlier; and a growing volume of research and analytical papers evolved to support and contribute to the "GROWTh" framework.

26. In initial years of the evaluation period, relevant Fund's research output coalesced around core macroeconomic and macro-financial challenges in shallow financial markets and in the context of the unique features of SDS.[23] While the work was a response to the gaps identified in the 2011 TSR, it informed subsequent staff guidance and departmental macro-financial pilots. Distinct threads in this research focused on shallow financial markets and macro-financial channels in developing countries in general, while other work incorporated the size and remoteness dimensions of SDS along with examining specific issues (debt, non-performing loans (NPLs), and high spreads) for specific groupings of SDS.

27. The focus shifted in the middle of the evaluation period to address conjunctural challenges facing SDS, particularly assessment of climate shocks and the impact and management of regulatory spillovers in the form of the withdrawal of CBRs.[24, 25] The focus on climate aligned with regional developments with the 2015 decision of Pacific Islands Ministers of Finance to establish the the Pacific Catastrophe Risk Insurance Company (PCRIC). Research also contributed to the Climate Change Policy Assessments conducted for the membership, with Seychelles being amongst the first of such assessments.[26] Research on CBR provided the

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[22] These centers include Caribbean Technical Assistance Center (CARTAC), Pacific Technical Assistance Center (PFTAC), AFRITAC West; AFRITAC South; South Asia Technical Assistance Center, and Middle East Technical Assistance Center.

[23] As examples of this focus, see IMF (2012; 2013a; 2013b; 2013c); Leigh and Mansoor (2016); Jahan and Wang (2013); Beaton and others (2017); Jamaludin and others (2015).

[24] See Marto and others (2017); IMF (2016a); Acevedo (2016); Cabezon and others (2015).

[25] See Alwazir and others (2017); Kaieteur News (2016); Zhang (2016); Sheridan and others (2012); Dabla-Norris and others (2012).

[26] Lombardi and Rustomjee (2022).

foundations for Fund engagement with SDS and standard setters on mitigation of the impact on SDS of CBR withdrawal.[27]

28. Research in the final years of the evaluation period has been more solution driven, embodying work on financial inclusion, the prospects for financial technology, and regional approaches to common issues in SDS. The Funds' Financial Access Survey launched in 2009,[28] helped to foster a body of work on financial inclusion issues in SDS. Its value has been particularly relevant when combined with the research and evolution of policy positions on the potential role of technology in overcoming relatively low financial access in SDS.[29, 30] Potentially of importance to SDS is emerging research on regional approaches to SDS issues—as envisaged in the GROWTh guidance framework—including but not restricted to technology solutions.[31]

29. Research work has also benefitted from evolving modalities of engagement. For example, in the context of surveillance, semi-annual REOs provide analysis of financial issues as appropriate. Research work has also been prepared for annual regional seminars like the "Caribbean Forum" (since 2012) and topical fora like the 'Pacific Initiative to Address the Pressures on CBRs and Remittance Channels" and associated roundtables in other regions (convened in 2018).[32] Besides topical concerns, these engagements have also been used to advance key and forward looking financial sector issues. As an example, the 2017 and 2019 Caribbean Forum events held in St. Kitts and Barbados respectively, discussed issues of access to finance, and opportunities for regional solutions.

30. The overall quality and breadth of research on issues of relevance to financial sector issues in SDS conducted over the review period has been impressive. IMF research has been a key contributor to broader understanding of issues such as how challenges related to financial inclusion and withdrawal of CBR has affected SDS and can be addressed. Moreover, the attention to CBR issues and the intense outreach activity that took place around these issues—involving knowledge sharing on research findings, broad SDS consultation, rapid policy development, and, advocacy with standard setting bodies—appears to have served the Fund well in building trust and in cultivating a sense of partnership on this policy issue.

[27] IMF (2017c).

[28] Espinoza-Vega and others (2020).

[29] Dabla-Norris (2015); Davidovic and others, 2019; Barajas and others (2020); Li and Wong (2018). Capacity Building Seminar on Financial Inclusion in Asia-Pacific The Way Forward.

[30] Ndung'u Morales and Ndirangu (2016); Sahay and others (2020); IMF (2020; 2021c).

[31] Al-Hassan and others (2020).

[32] Alwazir and others (2019).

31. At the same time, there are issues where the Fund moved very slowly at first—but recently has devoted rising attention—including on fintech and digital currency issues.[33] In addition, while IMF research on financial sector issues in SDS work has informed internal Fund policy development, efforts at engagement, and traction or dialogue have largely been idiosyncratic. Besides the annual Caribbean Forum there does not appear to be any sustained fora that engage researchers and policymakers in SDS on financial sector issues. Modalities for SDS specific engagement on technology and climate issues have also been idiosyncratic despite the relevance of the research and their centrality to SDS policy challenges.[34]

B. Selected Issues Papers

32. Building on Fund research, staff have prepared numerous SIPs on financial sector issues in specific SDS. SIPs serve as analytical background for key policy issues discussed during Article IV consultations and play an important role in the provision of bilateral policy advice. Indeed, interviews of SDS authorities for this evaluation consistently signalled strong interest in receiving granular analytical work from the Fund that was tailored to and took account of country-specific challenges.

33. This section examines the technical quality of SIPs prepared for SDS on financial sector issues. During the evaluation period 2010–2020, a total of 111 SIP chapters were prepared for SDS. Of these, 36 chapters covered issues relevant to the financial sector, of which 16 were associated with consultations in Africa, 14 in the Caribbean, and 6 in the Pacific, Europe and the Middle East.

34. To assess the extent to which SIPs took account of country-specific challenges in SDS, supported and enhanced the quality of Fund advice to SDS, and used appropriate and well-tailored analytical frameworks, each SDS SIP chapter on financial sector issues was scored, with account taken of the particular role as well as the key target audience for these chapters. In general, SIPs accompanying Article IV consultations are expected to address issues of high policy relevance, preferably associated with the ongoing consultation.[35] Their basic audience is in the country where the consultation is taking place and consequently SIPs need to address policy

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[33] See, for example, IMF (2021).

[34] Among the recommendations of the 2013 IEO evaluation on *The Role of the IMF as Trusted Advisor* (IEO, 2013) was the suggestion to "Incorporate early and openly the views of all countries—particularly those that stand to be most affected by changes in the Fund's policy stance—during the preparation of major policy papers on which analytical debate is still ongoing."

[35] In this regard, its worth noting that while the majority of SIPs were directly aligned with issues raised in the companion staff report, close to 30 percent were "free-standing." Aligned content included financial stability topics (45 percent) related to institutional solvency, AML/CFT frameworks, regulatory spillovers (including AML/CFT and CBR); macro-financial shock transmission (40 percent); and ecosystem issues (including topics on financial inclusion and the use of cryptocurrencies) (15 percent). Remaining "free standing" papers while contextually relevant were largely papers proposing methods supporting financial oversight and risk identification and/or analyzing broader macro-financial questions.

issues in a way that can be understood and can be leveraged by the economic community in the country.[36] Aggregated results are presented in Table 1.

Table 1. Evaluation of SDS SIPs on Financial Sector Issues
(In percent)

Evaluation criteria	E	VG	S	MU	U
The question					
Question is clearly posed and its relevance to the country was well articulated	8	5	1	17	5
Analysis					
Uses an appropriate macro-financial/conceptual framework	9	5	0	19	3
Uses appropriate data and empirical methods proficiently	9	5	0	16	6
Includes critical discussion and/or robustness analysis of results	7	6	1	17	5
Output					
Writing is clear and well organized	8	5	1	15	7
Conclusions are firmly grounded in the analysis	8	4	2	15	7
Articulates clearly the policy relevance of findings for the country in question	9	3	2	17	5
Aggregate average distribution of criteria (in percent of total)	8.3 (23.3)	4.7 (13.0)	1.0 (2.7)	16.6 (46.0)	5 .4 (15)

Note: Five ratings were used to assess the chapters on each evaluation criterion: "excellent" (E), with a score of 7; "very good" (VG) with a score of 5 or 6; "satisfactory" (S) with a score of 4; moderately unsatisfactory (MU) with a score of 2–3; and unsatisfactory (U) with a score of 1 or (0).

35. Fourteen chapters, or 39 percent of all financial sector chapters reviewed, were considered "satisfactory" or above. These had scores higher than 3, namely those either "satisfactory" (S), "very good" (VG), or "excellent" (E). Within this group 8 papers (22 percent of the chapters were judged to be "very good" or "excellent". The middle group of 17 chapters (47 percent of the sample included chapters with scores that ranged between 2 and 3, namely those considered "moderately unsatisfactory" (MU), with a bottom group of 5 chapters (14 percent) being considered "unsatisfactory" (U) with sores of 0–1.

36. "Excellent" and "very good" chapters were found in all regions (AFR-4); Pacific-1; MCD-1; WHD-2*)*. Among these chapters, common attributes included either an elaboration of a particular policy question raised in staff reports or a dissection of financial risks raised in the report. Articulation of the macro-criticality of the issue was invariably stated upfront and the channel(s) of likely transmission were clear—and in most cases there was explicit cross-reference to the staff report. Moreover, many relied on simple analytical tools or simple models that were replicable by

[36] Scores of 0 or 1 were allocated depending on whether or not (i) the question was clearly posed and its relevance to the country was well articulated ; (ii) the analysis used an appropriate macro-financial conceptual framework; (iii) analysis used appropriate data and empirical methods proficiently; (iv) analysis included critical discussion and/or robustness analysis of results; (v) the writing was clear and well organized; (vi) conclusions were firmly grounded in the analysis; and (vii) the chapter articulated clearly the policy relevance of findings.

authorities using national/peer or publicly available data. In some cases, the SIP chapter was akin to knowledge transfer in that it demonstrated how existing data could be leveraged by authorities to yield useful insights into *specific* issues impacting financial stability (e.g., AML/CFT frameworks, asset concentration, inward spillovers, evolution of NPLs); in elaborating on impediments to intermediation (e.g., issues of financial inclusion); or in understanding channels of macro-financial linkages in the particular country. Other chapters in the group had an even narrower focus of elaborating the staff's advice on an issue (e.g., crypto currencies). Strong papers almost uniformly concluded with a clear statement of "policy implications."

37. Generally, weaker chapters were less precise in their motivation, which as discussed later in this chapter affected the relevance of policy conclusions. Some weaker chapters were also more ambiguous on audience and their content appeared more technique-driven than a response to particular issues raised in the staff report.[37] On technique, often the method applied was somewhat of a "forced fit," sometimes with questionable data proxies that conceptually changed the intuition of the presumed transmission. The issue of data in SDS is not trivial, but it would appear that alternative approaches (including reduced form/or fewer parameter assumptions and variables) or applying a more thorough process in gathering data, including taking more time to develop country data, would have been more appropriate, practical and useful for country authorities. The underlying problem appears to be connected to motivation of the SIP chapter. As noted earlier, SIPs that were tightly aligned to the policy issue in the staff reports invariably had a specific focus and intent that helped in managing the method of elucidating the issue under consideration.

38. In their content, SIPs were quite detailed and customized on issues of financial stability and with good examples of discussion of macro-financial linkages. Financial stability coverage was especially bank focused, which may be attributable to staff's comfort in method, policy positions, and the general availability of "core" Financial Soundness Indicator (FSI) data that focus largely on solvency indicators.[38] The strength of macro-financial analyses have been best displayed where there was continuity in successive SIPs on the issue highlighting the evolution in the country and the need for policy adaptation.

39. Coverage of issues around impediments to intermediation and financial inclusion however, sometimes lacked much depth.[39] For example, SIPs contained little useful analysis to support generic exhortations like "reduce bank spreads" to facilitate bank lending or to "address structural excess liquidity through reducing lender risk aversion." Staff analysis sometimes lacked sufficient country-specificity given the less robust data on "encouraged" FSI (that are more tilted

[37] In one instance for example, the SIP chapter indicates the motivation/audience as being "to help [IMF] staff."

[38] The FSI is a list of core and encouraged indicators used. As of 2019, the IMF's FSI database reported only 21 of 34 reporting SDS, with all reporting core indicators and only one with complete encouraged FSIs—see https://data.imf.org/?sk=51B096FA-2CD2-40C2-8D09-0699CC1764DA.

[39] The SIP on crypto currency (Marshall Islands) is a notable exception, with impressive rigor especially given the evolving stage of Fund policy positions at the time.

to the operating environment; e.g., large exposure, geographical distribution of loans, lending spreads and foreign currency lending). Several papers defaulted to rely on somewhat mechanical aggregate benchmarking against other countries done by others, without providing their own analysis.

40. A common observation across SDS SIP chapters on financial sector issues relates to their shifting focus. With few exceptions, the subject matter of SIPs differed with each consultation, and was not particularly related to earlier SIPs, even if the thrust of the staff report was broadly unchanged, especially for annual consultation cycles. In instances where there has been continuity, the "suite" of SIP chapters served more effectively as building blocks and appeared to have been effective.[40] Traction has also been more evident where the staff report, SIP chapter, and CD priorities of the relevant RCDC have coincided. Examples of traction have been most evident with SIP chapters focused on AML/CFT, where country incentives to take action to address challenges have been strong. Opportunities for thematic continuity in SIPs to reinforce messages in staff reports appear to have been missed on issues of technology supporting financial inclusion, with the content and findings in a SIP chapter in one consultation having discouraged the authorities from pursuing their plan while the subsequent SIP did not offer alternative solutions to the underlying need.

41. It is worth emphasizing that among the Fund's research outputs, SIPs have the most significant potential to enhance direct policy advice to a country as part of bilateral surveillance. These papers also carry important reputational responsibilities for the institution and are potentially important vehicles for knowledge transfer and capacity building. From this perspective, the uneven quality of SIPs seems a serious missed opportunity. It would be helpful for the Fund to better clarify the exact objective and function of SIPs and how they differ from other IMF analytical outputs such as working papers and TA activities. If the objective is to assist country authorities in addressing major policy areas, the institution should make this clear and draw its implications.

42. SIP topics could also be better selected and more thematic. Moreover, while preserving independence in advice, consideration could be given to a more consultative process with SDS authorities on future SIPs. Such consultations could increase relevance and improve traction for resource-constrained SDS. A forward-looking agenda could also provide space and time to address data needed to support analysis and to increase country knowledge. In the context of a given resource envelope this could be achieved by a more continued focus on a theme over time.

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[40] In Belize case the authorities used much or similar content in the SIP series in their annual Financial Stability Report following successive SIPs on macro-financial linkages and policy challenges over the period 2014–2017 (Appendix 1).

C. Bilateral Surveillance

43. Currently, 23 out of 34 SDS are on an annual (i.e., standard) Article IV consultation cycle. The remainder (including six Pacific microstates and three countries with an IMF-supported program) are on a biennial cycle. Bilateral surveillance is supplemented with regional analyses and multilateral surveillance initiatives, such as the annual discussions with the Eastern Caribbean Currency Union (ECCU). While financial services contribute significantly to growth and employment in many SDS, just 10 FSAPs have been conducted for SDS since the FSAP was launched in 1999, including one for the ECCU. During the evaluation period, there were only eight FSAPs for six countries. In addition, an FSSR was conducted for two SDS. The content analysis that follows attempts to distil focal themes, their appropriateness, impact and potential opportunities/gaps, where they exist.

Content and Focus of Article IV Staff Reports

44. A review of all SDS Article IV reports over the evaluation period found that discussion of financial sector issues represented, on average, 17 percent of issues discussed in SDS staff reports (Figure 2).[41] Coverage of financial sector issues in staff reports for the Caribbean SDS and European Department (EUR) SDS exceeded the period average, while the lowest coverage was in staff reports for MCD region.[42] Financial sector issue coverage in SDS Article IV reports spiked by 17 percent across all departments during 2016–2018 vis-à-vis the preceding period, in part reflecting the added treatment in these reports of the potential impact of the loss of CBRs in IMF (2017).

45. Despite the largely common impact of the GFC on SDS, and the subsequent CBR shock, Article IV reports during the evaluation period also clearly highlighted that financial systems in each region had their own unique challenges. For example, in MCD, Djibouti entered the period affected by a long war and a drought, which impacted the credit quality of a nascent financial system. In 2019, staff noted that notwithstanding progress in cleaning up banks' balance sheets, the financial sector remained fragile, and financial inclusion was low. In EUR, the recurring issue in Montenegro was the effect of a legacy of boom-bust macro-economic cycles and, subsequently, the regulatory agenda to comply with EU directives. Challenges in AFR were more diverse. Besides the common challenge of financial access (particularly in Comoros and Cabo Verde), issues ranged through off/onshore oversight in Cabo Verde, Seychelles, and Mauritius, to the impact of tourism volatility (Maldives) and SACU revenues (Eswatini) on asset quality. Similarly, financial systems in the Asia and Pacific Department's SDS had differentiated

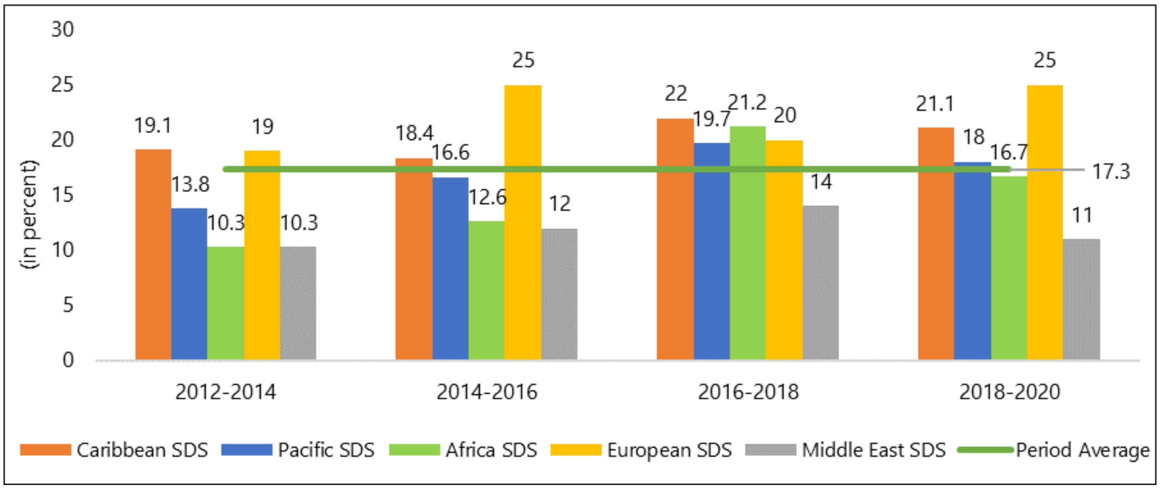
[41] The specific measure is the number of paragraphs devoted to financial sector issues as a percentage of the total number of paragraphs in the staff report, This measure should be treated as indicative only since it does not assess the depth of analysis and or take account of country-specific factors such as the macro-criticality of financial sector issues

[42] Of note however is that the number of SIPs on financial sector issues supporting staff reports in Africa was relatively high, only equaled by the Caribbean, despite their relatively fewer paragraphs (see discussion of SIPs).

challenges, though given the importance of remittance flows, vulnerabilities related to AML/CFT issues were a recuring focus. For the more mature systems (e.g., Fiji, Samoa, Tonga, Bhutan), while financial inclusion and non-bank oversight remained an issue, collateral constraints experienced in some micro-states were less binding. Moreover, differences in monetary arrangements (national currencies and central banks) allowed for more flexibility in the development of financial systems vis-à-vis other states that used external currencies and/or were intermediated by foreign bank branches. In WHD, among Caribbean SDS, besides access to domestic finance, sovereign/financial sector exposure, interconnectedness, non-banking and onshore/offshore issues featured prominently as financial sector challenges.

Figure 2. Financial Sector Paragraphs in Staff Reports

(In percent of total)



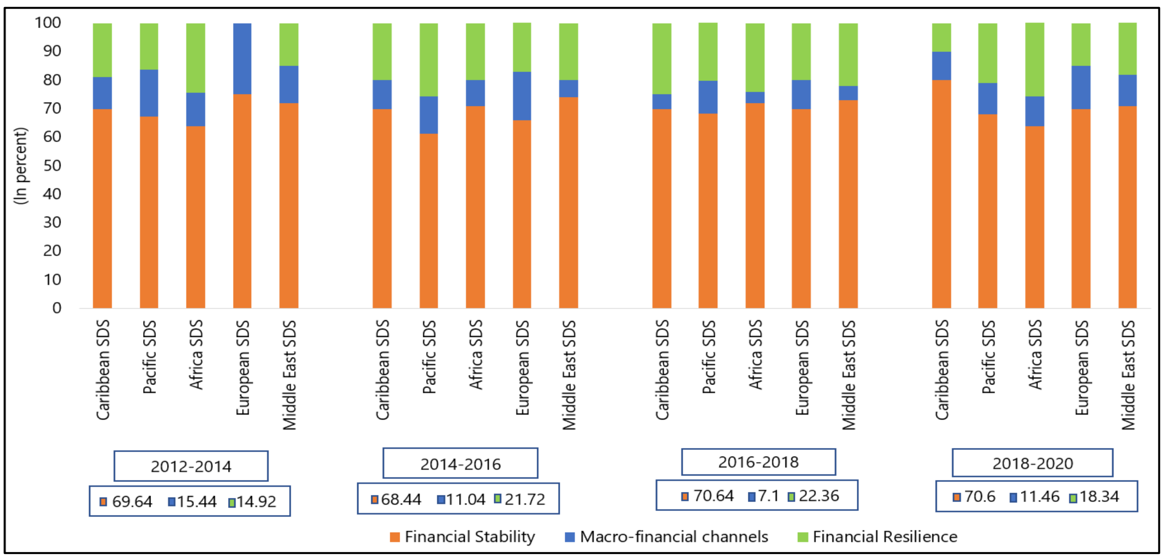
Sources: AIV Staff Reports, 2010–2020; author's calculations.

46. Financial sector coverage in Article IV reports was boosted by the timing of FSAPs. Thus, in the year following the completion of respective FSAPs the number of paragraphs in a SDS member country's Article IV staff report increased by 21 percent on average over the evaluation period. The expanded coverage was both to report on progress and/or to reiterate findings and, in each case, this was done either through paragraphs and/or dedicated boxes or annexes. In most cases staff noted substantial progress in implementing FSAP recommendations within a year of the conclusion of the FSAP.[43]

[43] For example, in Montenegro, staff reported on preparation/implementation of Central bank Act alignment with European System of Central Banks/European Central Bank treaty, banking law, and deposit insurance, and regulatory reforms supporting intervention in institutions, provisions for NPLs and payments system reform. In the Bahamas, staff noted the creation of a credit bureau, strengthening of the deposit insurance system and progress in implementing Basel II and III frameworks. In Trinidad and Tobago, the progress was in drafting of new Insurance and Credit Union bills, while in Mauritius progress was reported in off-site supervision for banks, new insurance solvency stress tests, and alignment of capital adequacy and liquidity regulation with the Basel III framework.

47. With Fund policy guidance emphasizing the need to address concerns for financial stability, macro-financial issues and fostering financial intermediation as described in Section II, Article IV reports were also reviewed to assess the extent to which Fund staff devoted attention to each of these policy themes. Financial stability issues dominated coverage throughout the period averaging 70 percent of financial content (Figure 3). The issues flagged typically related to managing threats to institutional solvency (asset quality, legacy and new NPLs, and the adequacy of provisioning and capital) and strengthening of legal and supervisory frameworks. While for some countries, including Comoros, Cabo Verde, Djibouti, and Belize, this stability focus was sustained throughout the period (all with average composition above 70 percent), for other staff reports there was variation. For members of the ECCU (as distinct from other Caribbean SDS) and for Montenegro, stability issues accounted for 58 percent in the first half of the review period and declined to 49 percent in the second half, likely due to their respective progress in addressing underlying issues. Issues of the complexity (conglomerates) and risks associated with domestic interconnectedness of the financial system in Eswatini and Trinidad and Tobago persisted throughout the evaluation period while, in contrast, for Kiribati and Micronesia, the focus of discussion was on the basic ecosystem for intermediation throughout the period.

Figure 3. Issue Focus of Paragraphs on Financial Sector



Sources: SDS Article IV Reports, 2012–2020; author's calculations.

48. Unique paragraphs on core macro-financial issues accounted for 11 percent of financial sector content in SDS Article IV reports and discussion of these issues showed little variation across time. The issues spanned considerations regarding fiscal/financial links (e.g., indigenous bank exposure to the sovereign) and issues related to debt for land swaps and asset price implications of citizenship programs in the ECCU; size, remoteness, and their cost implications in the Pacific; asset concentration and single borrower exposures in Djibouti and Guyana; climate exposure in the Maldives; and risks arising from fiscal uncertainties associated with Compact arrangements in the Pacific.

49. The remaining 19 percent of SDS Article IV paragraphs discussed issues in the ecosystem supporting intermediation. In regional composition, staff reports for SDS prepared by the AFR received greatest attention with a period average of close to 24 percent of paragraphs, with those from EUR receiving the least coverage at an average of 14.5 percent. Recurring themes in staff advice across all SDS centered around the issues of credit access and technology, including: (a) the need to establish or strengthen credit bureaus (94 percent of staff reports); (b) registries for collateral (76 percent); (c) clarifying property rights and land tenure—including issues of customary land in the Pacific and lease issues in Eswatini (51 percent); (d) SME specific guarantee/subsidy schemes (20 percent); and creation of credit/insurance products and financial literacy programs (12 percent). Proposals were generally country specific, e.g., the tailored advice in Djibouti on the need for a Sharia'a Board to adjudicate on products; the state contingent advice in compact states on the need for credit and insurance products—vis-à-vis the advice provided to Mauritius where, with deeper markets, discussions were around proposals for a secondary market for small investors in government paper.

50. Engagement on financial technology, as a component of resilience issues, has been more variable. Staff report content has been complemented by facilitation of knowledge sharing including, but not restricted to, Fund analytical work.. While there have been no neat buckets, it seems that, besides mobile money, technology discussions in the Pacific islands have had more of a focus on the facilitation of cross-border payments and remittances, while developments in the Caribbean have been more tilted towards staff positions on central bank digital currencies (CBDCs).[44] In the Pacific, for example, while the potential of improved telecom connectivity is flagged in all staff reports, operational advances have been largely facilitated through the partnership between the Reserve Bank of New Zealand, South Pacific central bank governors, the IMF and other partner agencies on the Pacific Remittance Project (PRP), to address challenges facing remittance services in the Pacific region.[45, 46] The modality of knowledge sharing,

[44] Discussions on the use crypto-assets (Marshalls Islands 2018) SIP and Samoa (2019) are an exception to this categorization. Moreover, the authorities in Palau have urged staff to be proactive in assisting small states with regulations for cryptocurrency and blockchain technology. In response to a request from IMF Executive Directors representing small states, the Asia and Pacific Department, in collaboration with WHD and MCM, organized a closed-door roundtable on crypto assets for Pacific and Caribbean delegations during the IMF-World Bank Spring Meetings in April 2018.

[45] A key focus has been to develop a regional "Know Your Customer" (KYC) facility.[1] The first phase of this work was successfully completed and approval for the second phase was agreed at the South Pacific Governors Forum held on November 17–18, 2020.

[46] Also of note is that Seychelles has launched an initiative to formulate a National Financial Technologies (Fintech) Strategy working with the Financial Services Authority, World Bank and Central Bank of Seychelles towards a coordinated approach to promoting the introduction of Fintech in the country, including the enabling regulatory framework. Moreover, staff notes that Mauritius, with aspirations of becoming a regional hub for fintech activities and they along with at least Barbados and Trinidad and Tobago have already established a regulatory sandbox licensing regime for fintech startups.

including an instance of an SDS sharing experience,[47] has also been used in the Caribbean but in addition staff have also had to opine on the modalities of at least two CBDC projects (ECCB, Bahamas) with the Bahamas now being the first small state with a digital currency.[48]

Financial Sector Assessment Program

51. During the evaluation period, a total of eight FSAPs were completed for six SDS with all but two (the second FSAPs for Trinidad and Tobago and Bahamas) being done in the first half of the review period.[49] Five of these were updates of earlier FSAPs. Thus, 25 out of 34 SDS have never had an FSAP or FSSR although the six ECCU members benefitted from the 2004 ECCU FSAP. FSSR reviews supported by a dedicated Financial Stability Fund have been conducted in two SDS to date (Fiji 2019; Djibouti 2020).[50]

52. Besides the standardized three pillars for assessment, in general FSAPs provided scope for differentiated focus on specific issues/sectors of the financial system most relevant to the recipient country (Table 2). The FSAP for Montenegro in 2016 was unique among SDS in the number of technical notes, examining issues in financial deepening that accompanied the core assessment.[51] The most recent FSAP for Trinidad and Tobago was also unique among SDS in including an explicit assessment of financial sector readiness relative to climate risks.

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[47] Fintech and Mobile Payments Developments in Mauritius, presentation by Vikram Punchoo, Second Deputy Governor of the Bank of Mauritius at Unlocking the Potential of Financial Innovation for Sub-Saharan Africa Organized by the Bank of Botswana, International Monetary Fund (IMF) and Bank of Canada (BoC), July 9–10, 2018.

[48] While welcoming the authorities' pursuit for more financial innovation, Directors recommended that the ECCB's digital currency pilot project should proceed with caution. In particular, they advised that the authorities fully implement safeguard measures to contain various risks, including those related to financial intermediation, financial integrity, and cybersecurity.

[49] FSAPs are largely a voluntary exercise, with the exception of systemically important countries, where the FSAPs are considered a surveillance tool. The annual cost of all FSAPs is approximately 2–3 percent of the total Fund-wide direct spending. The costs of preparing an FSAP is much lower for smaller and less complex jurisdictions than for systemically important jurisdictions.

[50] Current partners supporting the Financial Sector Stability Fund include China, Germany, Italy, Luxembourg, Saudi Arabia, Sweden, Switzerland, the United Kingdom, and the European Investment Bank.

[51] To assess development aspects, FSAPs examine institutions, markets, infrastructure, and their inclusiveness; the quality of the legal framework and of payments and settlements systems; obstacles to competitiveness and efficiency; progress in financial inclusion; and access to retail payment digital technology. They also examine the financial sector's contribution to economic growth and development. Issues related to the deepening of domestic capital markets are particularly important in developing and LICs.

Table 2. SDS FSAPs (2010–2020): Key Topics

FSAP	Date	Focus topics (unique chapters or technical notes)
Trinidad and Tobago (Update)	2011	Supervisory frameworks, Safety nets, Macro-prudential arrangements (*Insurance and pensions, credit unions*)
The Bahamas	2013	Supervisory frameworks, safety nets, macro-prudential arrangements (*Offshore risks and oversight*)
Barbados (Update)	2014	Supervisory frameworks, Safety nets, Credit unions (*Off-shore sector-benfits and regulatory threats)*
Samoa	2015	Supervisory frameworks, safety nets (*public financial institutions)*
Mauritius (Update)	2016	Supervisory frameworks, safety nets (*large and complex financial institutions)*
Montenegro (Update)	2016	Supervisory frameworks, safety nets, macroprudential arrangements (*creditor rights, SMEs finance, access to finance, credit reporting, financial infrastructure; payments systems)*
The Bahamas	2019	Supervisory framework, safety nets (OFCs)
Trinidad and Tobago (Update)	2020	Supervisory frameworks (*financial developments, digital finance, climate risk*)

Sources: FSAPs for The Bahamas (2013, 2019); Barbados (2014), Mauritius (2016), Montenegro (2016), Samoa (2015) and Trinidad and Tobago (2011, 2020).
Note: (Update) indicates that a previous FSAP was conducted prior to the evaluation period.

53. In practice, FSAPs for SDS have largely focused on financial stability issues.[52] This topic coverage contrasts with a broader range of coverage in FSAPs in some other EMs and LICs, where technical notes were prepared on financial intermediation issues e.g., financial inclusion (Brazil and Morocco); small and medium enterprise (SME) finance and technology enabled channels to scale financial access (Mexico); access to finance (Malawi). This contrast (including the precedent of Montenegro) suggests that more flexibility could usefully be applied to provide greater attention to common impediments to financial deepening in SDS that are flagged by staff in surveillance.

54. FSSRs completed for Fiji and Djibouti have by design similarly had a primary focus on issues of financial stability. In both cases, besides coverage of the core topics. the scope of the diagnostic were well adapted to the unique challenges of both countries to include for example, the role of pension Funds and bank branches in Fiji; and AML/CFT frameworks, central bank governance and supervisory capacity in Djibouti). While there is little attention to broader issues of financial deepening, there have been reference to opportunites that could be addressed through support from the World bank and other agencies**.**

[52] The choice of ancillary sectoral/issue(s) in an FSAP or its designation as "development" involves a number of parameters, including Fund expertise, collaboration with, and the priorities/resources of, the World Bank, and member input.

Assessment

Overall Coverage

55. As described above, financial sector issues received substantial coverage in bilateral surveillance during the evaluation period, particularly in Article IV consultations. Particularly noteworthy, there has been ample visibility and attention to two emerging issues of major importance to SDS, AML/CFT and CBR issues. Regarding AML/CFT, during the evaluation period, 98 percent of staff reports have devoted at least one unique paragraph to either call for strengthening of frameworks or to report on progress being made. Similar attention has been paid, especially in the second-half of the review period, to CBR issues, where in addition to 73 percent of staff reports referencing the issue, the Fund undertook a range of analytical work resulting in a note to staff (IMF, 2017c) to help country teams discuss these issues in consultations and to guide data gathering to assess the impact on members. Advocacy initiatives including through the Fund's active membership in the Financial Action Task Force, Basel Committee on Banking Supervision groups and Financial Stability Board were also undertaken.[53]

56. However, there were some noteworthy gaps in financial sector coverage. First, , the use of of FSAPs for SDS during the evaluation period was extremely limited—8 SDS of 122 FSAPs, and only two other SDS FSAPs since the establishment of the FSAP program—despite evidence of traction and responsiveness to findings, often within a year of FSAP conclusion. In this regard, the FSSR has not yet proven to be an adequate substitute, particularly since it also primarily focuses on financial stability rather than development issues, such as financial deepening

57. Second, while Article IV consultations reports were often supplemented by SIPs, some 30 percent of these papers did not directly reinforce messages in the related staff report. Moreover, while 39 percent of these SIPs were of "good" quality there is scope to strengthen their role in surveillance as noted earlier. Engagement through outreach and advocacy, on the other hand, appear to have been particularly effective in addressing common issues especially as it relates to CBR and technology issues.

58. Third, while issues associated with financial stability, macro-financial linkages and resilience were largely well treated, though with differing degrees of traction, there were important gaps. Some of these gaps are analytical but just as important others reflect issues related to to CD support, as discussed below.

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[53] See also "Relations in Banking: Making it Work for Everyone," Speech by the IMF Managing Director at the New York Fed, June 18, 2016 at https://www.imf.org/en/News/Articles/2016/07/15/13/45/SP071816-Relations-in-Banking-Making-It-Work-For-Everyone.

Financial Stability

59. Given the persistence of shocks and related impact on asset quality in SDS, stability issues were a persistent focal point of staff engagement, which seems to have gained some traction. Consistent with this focus, available cross-country series for selected FSIs for 22 SDS suggest sustained improvements in financial conditions, especially in the period 2016–2019. In all but three cases (Djibouti, Comoros, and Eswatini) NPLs to total loans declined, in some cases markedly (Montenegro, Grenada, Fiji, St. Lucia, Tonga).

60. Similar trends were observed for capital to risk weighted assets. With the exception of Dominica, Eswatini, and Vanuatu, the remaining 22 reporting SDS showed increases in this ratio, with all countries being well above regulatory requirements. In parallel, regulatory and supervisory frameworks were strengthened over the review period with all SDS reporting some country appropriate legislative reform (see discussion on TA and programs). Of note is the fact that new or strengthened AML/CFT legislation was common to 72 percent of SDS.

61. At the same time, while bank-centered stability issues were typically well covered, staff treatment of nonbank and state-owned intermediaries was tentative and uneven. This was especially the case in many microstates, where credit unions, micro-finance institutions, state-owned banks and pension funds in some Pacific Island Countries[54] had critical roles in intermediation, and often played a stabilizing role to shocks (in instances increasing credit while banks credit was contracting).[55]

62. While stability frameworks for credit unions received attention in the Caribbean (including both at the member and ECCU level) and on state-owned bank reform in Africa, advice on micro-finance, state-owned banks and pension fund intermediation in the Pacific was decidedly thinner and less prescriptive. This was particularly the case when contrasted with treatment of equivalent stability issues in the conventional banking sector and could reflect less developed policy positions for certain types of non-banks and also the fact that this source of vulnerability has not resulted in actual systemic problems.[56]

63. In contrast, stability issues arising from the intersection between domestic and offshore banking activities (affecting far fewer SDS) appropriately received considerable attention

[54] Examples include pension funds in Tuvalu and Tonga.

[55] In Dominica, credit union assets are 50 percent of GDP and account for half of bank deposits while in Fiji, the FNPF is the largest depositor for commercial banks.

[56] A notable exception to this is the TA provided to the ECCU on credit unions that provided a very granular reform strategy to strengthen the sector and its oversight.

(Seychelles 2016; Cabo Verde 2016), especially as this source of vulnerability has materialized and policy positions are better established.[57]

64. Work on climate-related risks for financial stability was limited during the evaluation period. It is noteworthy, given the propensity for recurrent weather related shocks, especially for island and coastal small states, that discussion regarding the integration of climate related risks in financial stability frameworks occurred only once.[58] That said, stress tests (including adverse and tail scenarios) on risks that could arise from the transmission of physical risks from climate-related shocks[59] were used extensively to inform advice on capital adequacy and provisioning for NPLs. These tests were also applied to insurance companies, notably in the Caribbean, to examine underwriting losses that could occur from weather events. However, advice on supervisory standards for how financial institutions should monitor and manage climate-related financial risks, including how such risks should be integrated into their governance, strategy and risk management has been limited, in part reflecting the evolution of the international standard-setting process.[60] In all of the six pilot climate risk assessments conducted as part of Article IV consultation since 2017, the financial system has not been much involved with the climate change policy assessments, and awareness amongst market partipants is reportedly relatively low.

65. However, it must be recognized that priority is now being given to substantially increasing a focus on climate-related risks. In concluding the recent FSAP review, Staff observed "given the increased relevance and recognition of climate-related financial risks, it is expected that the climate-related risk assessments will feature more prominently in FSAPs" and the FSAP staff paper (IMF, 2021c) outlines the intended approach to these issues going forward. The approach complements Board decisions taken in the context of the 2021 CSR that were supported by CSR background paper Integrating Climate Change into Article IV Consultations.

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[57] As example, the collapse of the Stanford Group in Antigua, led to a significant withdrawal of deposits from its locally incorporated subsidiary. The Bank of Antigua suffered a classic bank run following allegations that the offshore institution was involved in an international Ponzi scheme. The failure of the Bank of Antigua threatened the stability of the domestic banking and financial system, and by extension that of the ECCU because of its participation in the clearing and settlement system of the currency union. Similarly, the 2016 staff report on Mauritius noted vulnerabilities arising from "sizable linkages with "onshore" domestic sectors, including commercial banks and non-financial sectors and the role of the off-shore funding for domestic banks.

[58] The Trinidad and Tobago 2019 FSAP noted "The financial supervisors should strengthen the understanding, management, and disclosure of climate and environmental risks. A comprehensive environmental risk assessment would help raise awareness of the impact of climate change and environmental risks on the financial sector. This should be supported by improved data collection and monitoring of regional and sectoral exposures to climate and disaster risks. The authorities should also help deepen financial markets for green growth and resilience"

[59] The possibility that the economic costs and financial losses from the increasing severity and frequency of extreme climate-change related weather events might erode the value of financial assets, and/or increase liabilities.

[60] https://www.fsb.org/wp-content/uploads/P220720.pdf.

Macro-Financial Analysis

66. Macro-financial analysis was largely consistent with the two staff guidance notes. Core structural macro-financial risks and vulnerabilities in SDS, as required by the "GROWTh" framework, were generally well covered in Article IV reports. Broad themes included: trade dependence—and the macro-financial vulnerability to even small changes in relative prices or comparative advantage; sectoral concentration of balance sheets of financial systems—with fewer opportunities for diversification; domestic interconnectedness—common exposure to same borrowers and cross ownership of financial firms; and vulnerability to climate-related shocks. Transmission channels were calibrated across country circumstance and the treatment of cross border dimensions in the ECCU, and the discussion for micro-states in the Pacific were all notable.

67. Notwithstanding coverage of these core channels, two less developed themes are worth mentioning. In both, staff recognized concerns but did not provide granular advice on how to address them.

Ex ante Assessment of Inward "Regulatory" Spillovers

68. In covering external risks (i.e., potential inward spillovers), staff were required to assess actual inward (actual and potential) spillovers including an understanding of the channels for inward spillovers for a country (e.g., trade, links through the banking system and financial markets, FDI, corporate borrowing, commodity prices). As noted, financial systems of SDS are structurally predisposed to potential inward regulatory" and in cases, operational, spillovers arising from their intersection with the global environment through trade financing, remittance flows, and the prevalence of foreign bank branches.

69. Explicit ex ante monitoring/surveillance on the potential channels for regulatory and operational spillovers from "home" countries was largely absent in staff reports (Box 1). This is especially odd given the relatively few home supervisors and international bank parents involved in the intermediation of SDS and the reality of a changed operating environment—with one manifestation of this being issues around CBR (which could be argued was a "surprise" event in surveillance) but also more recently the closure of some branches operations in SDS. Staff were, however, consistent in speaking to some of the outcomes of these spillovers and in their advice on strengthening AML/CFT frameworks, increasing information sharing protocols between home and host supervisors and in the oversight and disclosure of OFC transactions.[61]

[61] Business decisions taken in 2019 have included the sale of operations by Canadian banks (RBC, BNS and CIBC) in the Caribbean (ECCU and Belize) to regional investors. Meanwhile Westpac Bank of Australia, is reportedly reassessing its presence in the Pacific—Australia's Westpac to sell Pacific businesses for $312 million ... Westpac sells Pacific businesses | Westpac.

Box 1. Approaches to Assessing Regulatory Spillovers in SDS

While for tourism dependent small states, staff routinely assess the prospects for tourist arrivals, forward looking approaches to gauge/anticipate potential inward regulatory spillovers have been uneven. While there is no one model—as each country has its unique exposure—the common challenge is for a more systematic scan of regulatory developments in the home countries of financial institutions operating in small states. This would be in addition to ongoing work on AML/CFT issues where the architecture (especially regional FATF frameworks) is already mature.

Mauritius *provides* a good example of a forward leaning approach. From as early as 2012, stress testing scenarios on the Mauritius banking system included an international exposure and funding risk analysis that could arise from Global Business Companies (GBCs). In 2014, staff repeated stress tests and also flagged that "the likely revision of the double taxation avoidance agreement (DTAA) with India could reduce GBC earnings and the associated decline in GBC deposits in domestic banks could create deleveraging pressures particularly in any small and medium-sized banks with liquidity-risk management systems insufficient to quickly mobilize foreign currency assets." In 2017, staff noted that the "the GBC sector will come under pressure from international anti-tax avoidance initiatives...and that a significant decline of GBC activity stemming from unfavorable changes to the tax framework would pose risks to external and financial stability."

In contrast, in the Bahamas and Barbados, both of which have similarly important international financial services sectors, surveillance of risks from regulatory spillovers has been less granular. In part this may be related to the broad presumption of segregation between onshore and offshore activities in both countries, even though there is significant foreign presence in onshore activity.[1]

The Bahamas. In 2016, staff discussions flagged the need to keep pace with evolving international standards, and the authorities called for "more clarity on regulatory expectations and requirements from international banks and from source jurisdictions." In 2019, staff observed that the changing international environment meant that offshore business models would continue to evolve and that tax transparency requirements and the requirements for real economic activity and substantial economic presence would likely to factor into business models. Moreover, staff also dedicated a unique annex on Global regulatory initiatives in the 2019 staff report.

Barbados. [Besides its off-shore operations] all banks in Barbados are foreign-owned—three from Canadian subsidiaries, two from Trinidad and Tobago, and one from the U.S. In 2014, staff reported that "growth in the offshore sector has been stagnant since the onset of the GFC because of regulatory changes in other jurisdictions, mainly Canada." In this context in 2015, staff reported that "the authorities being engaged in regional supervisory colleges and having stepped up communication with Canadian supervisory authorities to anticipate inward spillovers." In 2016, staff also discussed the implications of the Canadian government having modified its exemption under its foreign accrual property income regime to limit the erosion of its tax base (which reduced the benefit of holding companies and the Trust sector in Barbados). Somewhat off-setting was the observation in 2016 that available data suggest that changes in the UK corporate taxation could lead to a modest recovery in number of newly-licensed entities.

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[1] The 2013 FSAP for the Bahamas concluded that the domestic commercial banking sector is well insulated from the offshore sector, and mainly conducts traditional banking activities. The mission found that connections between the domestic banks and offshore banks are minimal (confined to intra-group activities). The FSAP however also cautioned that the external sector's health will be influenced to a great degree by changes in the international regulatory environment.

Interaction of Financial Sector and Fiscal Issues

70. The interaction between fiscal and financial sector activities in SDS were mostly well covered in Article IV reports. The channels identified ranged from exposure through debt financing, fiscal guarantees for bank lending, state-owned financial institutions, and implications for public safety nets through potential bail-out costs. Staff also noted common trends in these

exposures, with "indigenous" intermediaries being typically more exposed than foreign bank branches. Moreover, in the instances of debt restructuring, staff analyzed solvency implications of debt operations for domestic financial institutions.[62]

71. However, a less developed theme related to the implications for financial systems during periods of fiscal consolidation.[63] With an already limited asset pool to invest in and an inherently uncertain operating environment, the reduced need for sovereign borrowing (a capital efficient asset) amplified the intermediation challenge, as often, a multi-year stream of liquid resources was released for intermediation. For example, in Grenada, following debt restructuring and adoption of a fiscal responsibility law (FRL) in 2016, the debt stock was programmed to decline by close to 8 percentage points of GDP in three years. In the 2019 staff report, staff noted that "excess liquidity continues to be placed abroad and in unremunerated excess reserves at the central bank" but without further discussion. While the Bahamas (FRL 2018) activated the escape clause under their FRL in response to the dislocation caused by Hurricane Dorian, it too envisaged a debt stock reduction of close to 13 percent of GDP in seven years, amplifying the need to intermediate prospective liquidity. While staff recognized intermediation challenges in their discussion of the financial sector issues, this appeared compartmentalized from fiscal policy advice. Closing this analytical gap appears urgent as while to date only seven of 34 SDS have introduced formal FRLs, the framework or variants are either proposed or under consideration in a number of SDS jurisdictions.[64]

Financial Resilience

72. Topics associated with the resilience of the financial sector and its capacity to intermediate have evolved over the evaluation period. Throughout much of the first half of the review period, staff reports, FSIs and program benchmarks, with few exceptions, were almost exclusively focused on threats to institutional solvency, as noted earlier. However, over time there was increaed attention to policy and micro-structural rigidities that undermined an expanded role of institutions in intermediation consistent with call in the staff guidance note for deeper and competitive financial systems. For example, staff appropriately flagged issues associated with the credit infrastructure and policy distortions. Subsequently, staff paid more attention to issues of

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[62] For example, in Barbados, commercial banks' claims were reprofiled, with no face value reductions (haircuts). Under the restructuring of treasury bills, 85 percent of the claims held by commercial banks were exchanged into 15-year bonds. See Anthony and others (2020).

[63] In the cases of Grenada and the Bahamas the consolidation path was supported by the adoption of fiscal responsibility legislation that included a medium-term debt anchor complemented by fiscal rules to guide the conduct of fiscal policy.

[64] See IMF Country Report No. 19/63, "Eastern Caribbean Currency Union: Selected Issues Paper," and IMF Working Paper No. WP/19/186, "A Possible Approach to Fiscal Rules in Small Islands—Incorporating Natural Disasters and Climate Change."

access and financial inclusion as an intentional agenda of diversifying the base of intermediation, including through the use of new digital technology.

73. While policy advice was generally sound, there was less traction in this area, in comparison with advice provided in relation to financial stability. For example, abstracting from the ECCU member countries where these issues were addressed regionally, for 13 of the 19 remaining countries where issues of the need for credit registries, property rights, collateral reform and the need for new products were raised, the same staff advice was repeated for an average of 5 annual and 2 biannual consultation cycles. While these issues are complex, the lower impact could also reflect potential shortcomings in the provision of TA (see discussion on capacity building).

74. Coverage of fintech issues began relatively slowly, and was quite limited in both Article IV surveillance and FSAP work prior to 2018. However, this work has subsequently picked up following the Bali Fintech agenda in 2018[65] coincided with the articulation of intentional financial inclusion strategies by several SDS. The Fund has been supportive (in research and in staff reports) of fintech solutions, including for example in regional initiatives around regulatory sandboxes and the role of technology in remittance flows especially in the Pacific.[66] By contrast, staff positions on the role of digital currencies in the Caribbean SDS have been more neutral in stressing the need to balance between the potential benefits against possible costs involving the AML/CFT and cyber-risks.[67] More recent policy papers have sought to clarify and better position the Fund on issues of technology and expertise is being built up.

D. Regional Surveillance

75. Regional surveillance in SDS took place through the Fund's engagement with the ECCU and through the semi-annual REO exercises.[68]

[65] The Bali Fintech Agenda 2018.

[66] Pacific Islands Regional Initiative.

[67] Fintech and Financial Services: Initial Considerations.

[68] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of these bilateral Article IV consultation discussion, staff hold separate annual discussions with the regional institutions responsible for common policies in four currency unions—the Euro Area, the Eastern Caribbean Currency Union, the Central African Economic and Monetary Union, and the West African Economic and Monetary Union. For each of the currency unions, staff teams visit the regional institutions responsible for common policies in the currency union, collects economic and financial information, and discusses with officials the currency union's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis of discussion by the Executive Board. Both staff's discussions with the regional institutions and the Board discussion of the annual staff report are considered an integral part of the Article IV consultation with each member.

Discussion with ECCU on Common Issues of Member Countries[69]

76. Annual consultations with the ECCU over the review period focused intensively on financial sector issues. On average, 35 percent of paragraphs in staff reports were on financial sector issues and in all but one consultation (2010) staff teams included at least one member of MCM staff. The consultations were supported by seven annexes, three SIPs, and a book (IMF, 2013). The reports focused on cross member issues (e.g., interconnectedness, sovereign exposures, exposure to common external shocks, stress testing for the pandemic, and crisis management frameworks), especially where "regional" advice (e.g., on asset quality review, bank resolution, cross border payments system reform, minimum savings rate, CBDC, banking union) was relevant to advance the functioning of the currency union.

77. Engagement with the ECCU has been supported by multi-year CD projects in which the Fund worked with multiple partners. The initial phase, provided in conjuction with the Canadian Development Bank and the World Bank, focused on addressing weaknesses in the ECCU indigenous banking system. The second phase, in partnership with the Caribbean Development Bank, focused on strengthening the capacity of the Eastern Caribbean Central Bank (ECCB), with the goal to foster financial stability. In particular, the project helped design and implement risk-based supervision, and expanded the tools for problem bank resolution, crisis management, and crisis prevention.

78. Given the high degree of financial interconnectedness and cross border intermediation amongst member countries of the ECCU, the sustained focus on common approaches in managing these risks has been appropriate but with uneven results. Broadly, while there has been alignment on objectives with the authorities and substantial progress on supervisory frameworks, important work remains in some areas.[70] After some delay, the Eastern Caribbean Asset Management Company (ECAMC), established in 2017, with the dual mandate of resolving failed banks and acquiring NPLs from approved financial institutions (AFIs), including banks, now expects to complete the acquisition of NPLs by end 2021 from an aggregate of 10 AFIs. In parallel, however, the ECCU has made good progress in modernizing their payments system. After initial reforms to a create a regional clearing house and an Electronic Funds Transfer system, in March 2019, the ECCB launched a digital currency pilot project to reduce excessive reliance on cash and cheques, promote inclusion, and further improve the efficiency of the regional retail payment system.[71]

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[69] The ECCU comprises Antigua and Barbuda (member since 1982), Dominica (member since 1978), Grenada (member since 1975), St. Kitts (member since 1984) St. Lucia (member since 1979), St. Vincent (member since 1979), and Anguilla and Monserrat (UK territories).

[70] The 2021 staff report (IMF, 2021c; 2021d) noted the "national authorities should complete long-standing financial sector reforms, including on the credit reporting and insolvency frameworks, centralized AML/CFT supervision for the banking system, and harmonized legislation for co-operative societies."

[71] In March 2021, the ECCB launched "DCash"—a digital currency that became the world's first retail CBDC to be publicly issued within a formal currency union.

Regional Economic Outlooks[72]

79. The semi-annual REO exercises prepared by area departments routinely analyze the macro-financial transmission of global and regional developments to small states in their region, even if the analytical lens varies across departments. Typically, small states in the Caribbean and Africa are analyzed through the lens of being either tourism dependent or commodity exporting; in the Middle East, SDS are variably categorized as an oil importer and/or a fragile state [Montenegro is examined through the lens of being a "Southeastern European non-EU member state"] and the Asia Pacific and WHD REO's group micro-states as "Pacific Islands" and "ECCU countries." While—with the exception of these micro-states—the classifications are not unique to SDS and include non-SDS, for the most part, they capture the openness and intersection of SDS with the global and regional environment and have allowed REOs to reflect on the major challenges of SDS over the evaluation period.

80. All REOs at the beginning of the evaluation period had assessments of the challenges and paths to recovery from the impact of the GFC. Issues flagged included financial market shallowness in the Middle East; debt and financial fragility in the ECCU microstates and the macroeconomic impact of slow tourism recovery in the broader Caribbean; uncertainty in remittance flows in the Pacific Islands; and NPLs and excess reserves in African SDS.[73] Similar attention was paid mid-period to SDS issues including natural disasters in African and Pacific SDS, and deepening financial systems.[74] The impact and strategies to address CBRs were also covered in the 2016–2018 period across all REOs while the most recent REOs have assessments of the effects of the pandemic on macro-financial outcomes in SDS.

81. In framing national policy challenges and options in a regional and global context, the REO exercise has played an important role for SDS, if only because there have been very few alternative vehicles for such perspectives. The relative high frequency of the exercise (annual with semiannual updates) also likely fills gaps in surveillance cycles for some countries. While the analytical lenses differ by departments, they offer useful aggregations of SDS relative to the financial transmission channels under consideration. Nowithstanding the convenience of these analytical lenses for departments, however, there could be value in more use of filters that are SDS specific. One example of this, as discussed in the following section on bilateral surveillance, is the possible analytical omission relating to viewing regulatory spillovers as an inherent macro-financial risk for SDS.

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[72] These reports discuss recent economic developments and prospects for countries in various regions. The also address economic policy developments that have affected economic performance in regions and discuss key challenges faced by policy makers. They address regional policy developments and challenges, and provide country specific data and analysis, including through analytical pieces on issues of interest to a particular region.

[73] For dedicated boxes and subsections of chapters see IMF (2010b), Box A2 "Impact of the Global Crisis on the Pacific Island Countries" and IMF (2010c), Chapter 2, "Monetary Policy Effectiveness in Sub-Saharan Africa."

[74] For unique boxes or chapters on SDS issues see, "NATURAL DISASTERS IN SUB-SAHARAN AFRICA; Financial Development and Sustainable Growth," April 2016 AFR.

E. Program Engagement[75]

82. Financial sector concerns, while important, were not the primary focus of conditionality in IMF-supported programs during the evaluation period. Of 10 upper credit tranche programs, 9 included at least one financial sector structural benchmark (Table 3). However, in only two programs (São Tomé & Principe and Antigua and Barbuda) did the share of financial sector-related structural benchmarks constitute a fifth or more of total structural benchmarks for that program. Where structural benchmarks were included, given the macro-financial context of programs, they tilted towards issues of financial stability reflecting concerns about the combination of unsustainable debt levels, the vulnerabilities in ECCU's regulatory framework, and spillover risks both across countries and between banks and non-banks (Table 4). In particular, around 80 percent of program structural benchmarks on the financial sector revolved around issues of bank solvency and arrangements for asset quality reviews, intervention, liquidation and the work out of NPLs through a regional AMC and in the strengthening supervisory frameworks, including for OFC operations. Also included were some issues that, while classified as "general government" (for example, the valuation of land associated with the debt/land swaps), had a direct bearing on bank solvency. Of the remaining benchmarks, 17 percent of the total focused on issues of resilience, including advancing work on credit bureaus and removing the minimum rate on saving deposits.

83. Approximately 60 percent of program structural benchmarks on financial sector issues were related to issues associated with reforms to the ecosystem (e.g., commercial court, payments system, housing finance, credit information and leasing), with the remainder focused on oversight and transparency in OFC activities and the strengthening of supervisory frameworks (all stability issues).

84. There is evidence that legislative submissions and their enactment and the articulation of frameworks were often met on a timely basis. The evaluation reviewed the IMF MONA database that inter alia tracks the implementation of program conditions. The review found that structural benchmarks associated with the preparation, submission and Board or parliamentary approval of financial sector related frameworks were often met on a timely basis in line with program review expectations.

[75] The review covers program engagements with Barbados and Seychelles (Extended Fund Facility); Cape Verde (Policy Support Instrument); Comoros and Djibouti (Extended Credit Facility); Sao Tome and Principe, Grenada (Extended Credit Facility); Solomon Islands (Standby Credit Facility); Suriname, Antigua and Barbuda, and St. Kitts (Stand-By Arrangement).

Table 3. Financial Sector Benchmarks in SDS Programs, 2010–2020

Country	Financial stability benchmarks	Number of financial stability benchmarks	Resilience benchmarks	Number of resilience Benchmarks	Financial issues as percent of total benchmarks
Barbados	Consultation with stakeholders on debt restructuring (MCM/LEG)	1	Framework for fintech sandbox	1	5.5
Cape Verde	Regulatory framework for on/offshore banks. (MCM) Framework for treasury bill auctions (MCM)	2	Central registry for mobile collateral	1	13.6
Comoros	None		none		none
Djibouti	Onsite inspection of 3 banks Revised banking law Timetable for banking law Dedicated AML/CFT unit and staffing of FIU (LEG)	4			8.7
Sao Tome & Principe	Onsite inspection of 2 banks Onsite inspection of largest bank (AFRITAC) Regulation to ensure capital/risk-weighted asset ratio of 12 percent. Supervision to require all banks to publish audited statements Revision to CB legislation to allow autonomy to address problem banks (MCM) Complete AQR (MCM) Develop strategy to deal with legacy NPLs (AFRITAC) Legislation on bank resolution Complete BCP assessment. (MCM) Draft amendments to AML/CFT law (MCM/LEG)	10			20
Solomon Islands	Guidelines on SOE borrowing Revision to NBF governance and oversight (MCM) Credit Union Act (PFTAC/LEG) SOE borrowing guidelines Financial Institutions Act (MCM)	5	Workshop by National Financial Inclusion Taskforce on access to finance	1	9.7
Suriname	BOS liquidity management operations (MCM) FX market reforms including on open positions (MCM) AML/CFT legislation (LEG)	3			5.0
Antigua and Barbuda	ECCB Onsite inspection of banks (MCM) Single regulatory unit for nonbanks (MCM/CARTAC) Baico/Clico resolution plan (MCM) Onsite inspection of indigenous banks (MCM) Recap of Bank of Antigua (MCM) Legislation for Financial Services Regulatory Commission. AML/CFT regulations (LEG)	7			25
Grenada	Valuation of land	1			2.7
Seychelles	Amendments to Fin Institution Act Transition to Basel 3 capital. (MCM) Crisis Management and bank resolution framework (MCM) Amendments to AML/CFT act (LEG)	4	House financing policy that limits public sector Introduce credit info system Approval of leasing bill Creation of commercial court MSME policy framework CBS policy on financial literacy	4	16.1
Total		34		7	

Sources: SDS program documents (2010–2020); author's calculations.
Notes: AFRITAC=African Regional Technical Assistance Center; AML/CFT=Anti-Money Laundering and Combatting the Financing of Terrorism; CARTAC=Caribbean Regional Technical Assistance Center; CBS=Central Bank of Seychelles; ECCB=Eastern Caribbean Central Bank; LEG=Legal Department; MCM=Monetary and Capital Markets Department; MSME=Micro, Small and Medium Enterprise.

Table 4. Distribution of Financial Stability Benchmarks

Type of Financial Stability Benchmark	Number of Benchmarks
Bank Restructuring/Resolution Plans	3
Liquidity Management	1
Foreign Exchange Market Reforms	1
Debt Restructuring and Resolution Plans	1
Non-Performing Loans	1
Regulatory and Supervisory Framework and Governance	6
Borrowing Guidelines	1
Inspections	5
Treasury Bill Auctions	1
Implementation of New or Revised Legislation	10
Creation and development of new institutions	2
Compliance with International Standards and Codes	1
Other	1
Total	34

Sources: SDS program documents, 2010–2020; author's calculations.

85. IMF capacity support to SDS of financial stability issues in the program context appears to have been highly targeted. Where financial reforms benchmarks were included in programs, follow-up TA and training was typically provided to help address capacity and funding challenges. For example, Sao Tome received 12 unique missions over the program period and Solomon Islands 4 missions in 3 years of the program. There was also a heightened degree of communication and intentional collaboration with partner IFIs and supporting agencies in the delivery of program benchmarks in the financial sector.[76]

F. Capacity Development

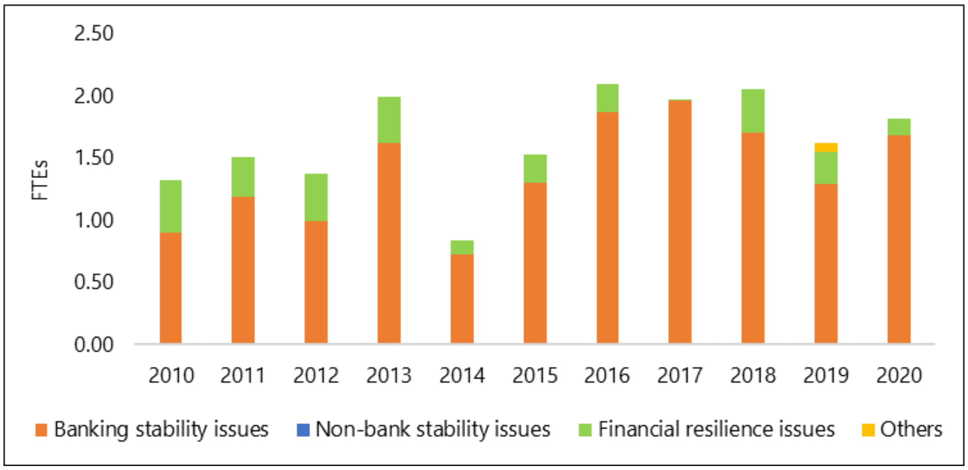
86. IMF CD on financial sector issues to SDS has largely been provided through the RCDCs rather than HQ-based missions. In fact, 78 percent of Pacific Technical Assistance Center (PFTAC) membership and 67 percent of Caribbean Technical Assistance Center (CARTAC) membership are SDS's.

87. Over the evaluation period, staff resources devoted to financial sector CD in SDS fluctuated between 0.8–2.1 full-time equivalent (FTE) staff per SDS, with a modest but discernible increase in the second half of the review period (Figure 4). Consistent with the focus of advice in

[76] Among many examples, the IMF TA team supporting the ECCB's (regional central bank and supervisor) efforts at resolving the cross border banking issues in the ECCU that in part triggered the programs with member countries Antigua and Grenada, liaised with the World Bank team on the ECCU's financial system stabilization strategy; with the IFC and CDB, advising on the establishment of an asset management company. Similar examples of collaboration are also evident in the programs benchmarks for Sao Tome and Principe (Asset Quality Review (AQR) and Seychelles (financial literacy/ombudsman).

surveillance, by far the largest proportion of CD was directed at issues related to financial stability; this balance prevailed throughout the evaluation period. Topics in banking stability included bank supervision (on and off-site data and process), transition issues in Basel 1–3, International Financial Reporting Standards implementation, consolidated supervision, legal frameworks including for bank resolution and crisis management, and the strengthening of AML/CFT frameworks. Non-bank issues covered similar issues for insurance, pensions (including stress testing) and credit unions, while resilience issues covered CD efforts around market infrastructure, including payments systems, credit bureaus and activities supporting fintech in recent years.

Figure 4. Financial Sector Regional Strategy Notes for SDS Countries, 2010–2020



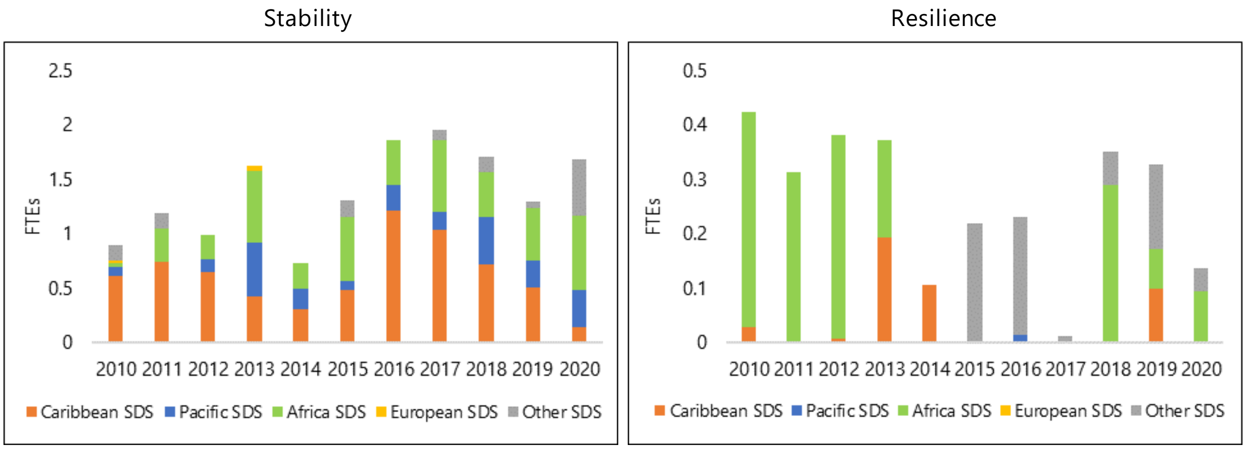
Sources: TRACES data; IEO calculations.

88. By region, Caribbean SDS received relatively more CD on financial stability largely consistent with the focus on surveillance on the legacy of the debt/financial sector crisis in the Caribbean (Figure 5). In contrast, African SDS (especially in the first half of the period) benefited from CD on issues aimed at strengthening the ecosystem supporting intermediation, reflecting the the challenges of financial access and inclusion in African SDS.

89. CD support on issues of financial resilience was quite selective but attention to financial resilience was also limited in surveillance. CD support for the development of credit bureaus and collateral registries was limited outside Africa and there was no CD support addressing collateral challenges in the Pacific islands and in Eswatini. This said, there was engagement on policy rigidities (e.g., interest rate floors and ceilings) that impeded the pricing of risk and intermediation, provided more in the context of HQ based TA on monetary and central bank operations, especially in the context of programs (e.g., Barbados and ECCB). In contrast, and

especially in the more recent years, SDS have received support through RCDCs on issues to deal with fintech, mobile money and cyber risks.[77]

Figure 5. Capacity Development: Allocations to Stability and Resilience, 2010–2020



Sources: TRACES data; IEO calculations.

Assessment

90. Especially on issues of financial stability, CD activities have been highly tailored to country circumstances. While capacity support to address the financial crisis in the ECCU is well documented,[78] multi-year engagements addressing the financial interconnectedness (complexity) of the financial system in Eswatini, and market stage appropriate engagements with Mauritius, Belize and Guyana and Solomon Islands were equally impressive.

91. The FSSR has proved to be a useful CD diagnostic tool where it has been deployed. The two FSSRs (Fiji 2019; Djibouti 2020) were quickly followed up by TA provided with support from the Financial Sector Stability Fund.[79] The FSSR is a less resource-intensive exercise than the FSAP, and therefore can be seen as a useful tool to expand the availability of financial sector diagnostics in SDS. The issue remains however that the FSSR (an IMF-only product) is configured largely towards financial stability and is therefore less suited to raise issues in the ecosystem to

[77] At the inaugural meeting of Directors of Training meeting in Singapore (2019) it was noted that "interest was highest for courses on digital economy, financial inclusion, management of cyber risks, analysis and regulation of financial sector innovation and Islamic finance." In addition, PFTAC in 2017 launched a regional effort around regulatory and supervisory frameworks for cyber risk.

[78] See IMF Monetary and Capital Markets Department Technical Assistance Annual Report; October 03, 2016.

[79] For Djibouti, the time lapse between scoping, the actual review and TA provision was under one year. For Fiji TA delivery occurred within two months of the completion of the review. Moreover, the attention to financial statistics is of material significance for SDS (discussed in Section IV).

support financial deepening. Notably, World Bank teams at times complemented the FSSR work by using the FSAP developmental modules.

92. RCDCs were generally responsive to SDS members' CD needs, due to their location close by, good understanding of country conditions, and practice of forward planning based on inputs from country authorities. Cross regionally observations include:

- Given the role of foreign banks in the Pacific (PFTAC) and Africa (AFRITAC West/South), there was particular attention to issues of home/host supervisory arrangements. This stream of work was less obvious in CARTAC where the focus was more on oversight of regional groups as opposed to foreign bank exposures.

- Reflecting the intermediation structure in many SDS in the Caribbean, frameworks for non-bank stability (credit unions, insurance, pensions) were a focus for CARTAC. On the other hand, there was relatively less attention by PFTAC to non-bank financial institutions in the Pacific islands though there was legislative support for frameworks for credit unions and in 2019 an agenda of work on Insurance frameworks was launched.

93. One continuing issue more generally, is the scope to reduce potential ambiguities in the respective roles of the IMF, World Bank and other development partners, in the delivery of TA around issues impacting financial resilience. In practice, authorities utilize a range of bilateral and multilateral partners on resilience/ecosystem issues. The creation of the Fund-Bank LIC Financial Group under the auspices of the FSLC in 2011 was intended to help in the assignment of responsibilities, including between the IMF and World Bank, on the assessment and capacity delivery of reforms loosely but not prescriptively organized around the "Preconditions" that underpin all financial supervisory standards. Elements of these "preconditions" included:

- Sound macroeconomic policies (mainly fiscal and monetary policies) as the foundation of a stable financial system (assessed by the Fund);

- Well established frameworks for financial stability policy formulation (assessed by the Fund;

- Public infrastructure—including business laws, judiciary, accounting, experienced professionals, secure and efficient payments systems, efficient and effective credit bureaus that make available credit information on borrowers (ambiguous);[80]

[80] For example, capacity support on the Pacific Credit Bureau, and on legal issues pertaining to insolvency and credit rights to the Solomon Islands was provided by the World Bank. At the same time, Middle East Technical Assistance Center is unique amongst RCDCs in having a developed program offering of assistance to its membership on credit bureaus. Other examples of provider ambiguity is in the provision of TA to Seychelles on Insurance Supervision by the Asian Development Bank (ADB) and World Bank, while the Fund (MCM) (IMF, 2016b) provided TA to the Solomon Islands on their National Provident Fund.

- Effective crisis management frameworks and resolution regimes (assessed by the Fund);
- Appropriate level of systemic credit protection (or public safety nets) (assessed by the Fund); and
- Effective market discipline—adequate flows of information and incentives (ambiguous).

94. The ambiguity is reinforced by the uneven practice governing World Bank participation in Article IV consultations, during which capacity needs are often identified and discussed with authorities. In practice, in all but one SDS in the Asia-Pacific region (when the mission was led by the resident representative), it has been routine for staff from the World Bank and AsDB to at least participate in wrap up meetings of the consultation. However, this has not been the practice for other SDS. In fact, in only one other SDS (Eswatini) is there evidence of this occurring and there does not appear to be an implementing framework, notwithstanding the presumption of partner collaboration in the both the 2014 and 2017 staff guidance notes.

95. Many of these issues could be resolved through revisiting the FSLC mechanism—which currently works well in staffing and prioritising the FSAP across the institutions—to ensure a more routine dicussion and allocation of reources to capacity needs in SDS.

V. OPPORTUNITIES TO STRENGTHEN FUND ENGAGEMENT

96. As discussed in the earlier sections of this paper, the various adaptations of financial systems to their operating environment in SDS create unique and sometimes mutually self-reinforcing challenges. The inherent exposure to inward macro-economic and regulatory spillovers and (for many) to climate-related shocks combined with the limited opportunities to hedge such risks (due to small scale) results in institutional risk aversion reflected in large capital and liquidity buffers. The resulting low levels of intermediation reduce corporate and household resilience to shocks, amplifying the need for public intervention, often with debt implications. Fund engagement with SDS has necessitated balancing issues of institutional and systemic solvency (financial stability) that arise from the operating environment with efforts to promote depth and its associated benefits (resilience), mindful of the macro-financial context of SDS. In navigating this challenge, staff have been particularly attentive to issues of financial stability and with good results and traction. Indeed, while it is too early to assess the impact of the unwinding of pandemic related accommodations, so far at least financial systems appear to have withstood the COVID-19 shock without widespread insolvencies.

97. In pursuing efforts to further strengthen engagement in SDS on financial sector issues, five opportunities warrant particular attention that offer scope for the Fund to substantially deepen and better tailor the quality of engagement with SDS and traction of Fund advice. In each instance, these are either nascent or ongoing Fund-wide work and staff have built a track-record of non-SDS experience which can be applied to the context of SDS. Moreover, demand by

SDS authorities for enhanced Fund engagement in these areas has built up, reflecting awareness of their need for expert guidance and advice on complex and fast-moving issues..

98. These issues which are addressed in the following paragraph comprise: (a) supporting SDS in addressing international standards and inward regulatory spillovers, beyond issues in OFCs; (b) strengthening support for fintech and other efforts among SDS to overcome size limitations and reduce operating costs to facilitate financial inclusion; (c) contributing to strengthening modalities for SDS collaboration with the Fund and with other development partners on structural issues particularly related to financial resilience; (d) more actively pursuing opportunities to address analytical gaps; and (e) greater attention to financial sector consequences of climate change.

99. Inward regulatory spillovers have been a common challenge for financial systems in SDS and elsewhere**.** While occuring in different forms, the issue in SDS extends beyond countries with significant offshore operations, to countries intermediated largely by foreign branches and subsidiaries to SDS relying heavily on CBRs. While a common thread through these spillovers are associated with AML/CFT concerns,[81] actions by global banks' to withdraw from CBRs are multiple and interrelated and were shaped by the changed regulatory, supervisory, and enforcement environment post-GFC and the resulting increases in overall compliance costs. The form in which these issues evolved, and their impact on SDS—which are deeply exposed—has been unpredictable. Strengthening the quality, granularity and impact of Fund engagement in this area will require taking a more structured and anticipatory approach. Some simple steps could catalyze this new approach. For example, simply engaging with the few home supervisors of international banks that intermediate SDS could be a start toward augmenting assessments of external risk facing SDS through this channel. More generally, consistent with the "GROWTh" framework guidance that advice on relevant international standards be tailored to the challenges of small markets, work could be considered explicitly for SDS similar to that done for emerging market economies on "proportionality" in supervisory arrangements and expectations. Initial steps could include reviewing lessons from the Fund's experience in emerging market economies that may apply to SDS and developing new guidance tailored for staff working on external risk assessment in SDS.[82]

[81] Several SDS have over the course of the review period been listed either as "high-risk jurisdictions subject to a call for action" (blacklist) or "jurisdictions under increased monitoring" (grey list) under the Financial Action Task Force's International Cooperation Review Group process though only two (Barbados and Mauritius) are on either list in 2021.

[82] For discussion on the principles associated with the application of international standards to less developed markets, see Dordevic and others (2021); Ferreira and others (2021); and https://openknowledge.worldbank.org/bitstream/handle/10986/34040/Using-the-FSB-Key-Attributes-to-Design-Bank-Resolution-Frameworks-for-Non-FSB-Members-Proportionality-and-Implementation-hallenges.pdf?sequence=4&isAllowed=y.

100. There are also substantial untapped opportunities to strengthen the Fund's engagement with SDS in the area of financial inclusion. Such efforts could focus on identifying, encouraging and supporting national and regional efforts to foster application of fintech to promote inclusion and to overcome constraints to financial sector development due to sizeby lowering cost and increasing access for unbanked population. As noted earlier, the Fund has already played significant role in contextualizing national policy choices in this area in a regional and global context through the REO exercise. Moreover, RCDCs have helped to support the formation and the work of regional supervisory groups especially in the Caribbean and the Pacific islands. Emerging strands of research in the Fund noted earlier are also highlighting the opportunity for more intentional engagement on innovative approaches (technology and regional) that help SDS overcome limitations of size and achieve scale in the provision of financial services. This approach is consistent with staff guidance on Fund engagement with SDS.[83]

101. With relatively little direct IMF involvement, SDS have been at the frontier of exploring the use of new digital technology in overcoming size constraints and in promoting inclusion. For example, besides the developments in CBDC issuance in Bahamas and ECCU noted earlier, regulators in all but one SDS (Comoros) in Africa and two (Guyana and Belize) in the Caribbean have in recent years formally established regulatory sandboxes to allow testing of innovative financial services solutions in a controlled environment. SDS in the Pacific islands have articulated the Pacific Regional Regulatory Sandbox Guidelines,[84] an approach not dissimilar to that taken by the ECCB for its micro-state membership.[85] Each sandbox reflects jurisdictional priorities, with for example, the Bahamas and the ECCB deciding to issue digital currencies, but a stated objective in all cases has been to enhance financial inclusion. While the use of technology impacts operating costs (a significant contributor to high lending spreads in SDS) it also has the potential of addressing some size constraints in SDS.[86]

102. These organic initiatives by SDS on technology applications could be supported more actively by the Fund through a more intentional agenda. This could involve a "common issue" approach, which has been used elsewhere to leverage Fund engagement on common issues

[83] IMF (2017b) states: "Efforts to promote competition should foster rather than detract from stability, exploiting technological and other opportunities to achieve efficient scale in banking and other financial sector activities. An example is the East Caribbean Regional Governments Securities Market (RGSM), which consolidates the regional trading of debt instruments for member states of the Eastern Caribbean Currency Union (ECCU), thereby creating a single regional financial space."

[84] https://www.afi-global.org/publications/pacific-regional-regulatory-sandbox-guidelines/

[85] ECCB to Issue World's First Blockchain-based Digital Currency (ECCB, 2019).

[86] "By acting as a regional bloc rather than individual markets, countries participating in the sandbox should provide interested startups and FinTech companies with access to a larger and more diverse market, as well as greater potential within a well-defined, regulatory structure" AFI, 2020.

facing a group of members.[87] For example, a common issue approach could explore how inherent asset concentration and asset quality issues in individual small states could be addressed by pooling costs and diversifying risks across regional capital markets over regional platforms. In addition, a diagnostic to ascertain cost/benefit and operational implications could be developed through a "common issue/thematic" regional exercise for a group of SDS—for example, common issues facing SDS with significant off-shore activity; or the grouping of micro-states in the Caribbean and Pacific. In the context of SDS, other potential initiatives that could support ongoing efforts by these members include regional assessments on credit information systems or collateral rigidities in the Pacific; regional capital markets for SDS in the Caribbean; and the role of CBDCs and financial inclusion in SDS more generally.

103. There are strong mutually reinforcing reasons for greater Fund innovation in supporting SDS in these areas. For SDS, enhanced Fund engagement can provide important guidance and support for practical solutions to the challenges of small size. For the Fund, benefits from supporting a wider range of regional and pan-SDS initiatives include more efficiently leveraging use of Fund resources to contribute to SDS' efforts to strengthen national and regional ownership and accountability and to benefit from new technologies.

104. There are also untapped opportunities to provide CD support to supranational organizations, especially where there are existing supranational fora with mandates to facilitate integration of financial markets, for example the Caribbean Community (15-member state intergovernmental organization) in the Caribbean, Pacific Islands Forum Secretariat (PIFS), and the Melanesian Spearhead Group (MSG). This could be a useful augmentation of existing bilateral support under RCDCs and the already important role that these RCDCs play in facilitating regional supervisory groups and regional peer to peer learning and the work of the Fund's regional offices.

105. Stronger collaboration by the Fund with partner institutions on structural issues could help to address persisting deficiencies in the ecosystem for broader financial intermediation and resilience. On financial stability issues, a mature framework (e.g., CD to the ECCU) comprising RCDC and HQ capacity support exists to address issues of financial stability identified in surveillance and has evolved further with the introduction of the FSSR. However, arrangements to support ecosystem reform—where the need is equally important for SDS—are much less structured and with ambiguity around the roles of different partner institutions in providing capacity support. While it is the prerogative of authorities to choose CD partners, at a minimum a

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[87] This would not be dissimilar to the "common issue" approach taken to NPLs in the euro area in 2015. NPLs were highlighted as a major issue in 2015 in a dedicated box in the Article IV consultation staff report (IMF, 2015b), which drew from a forthcoming paper cited in the associated SIP and subsequently published as a Staff Discussion Note in September 2015 (Aiyar and others, 2015). Note as well the precedents of the Selected Issues accompanying the 2013 Nordic Regional Report (https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Nordic-Regional-Report-Selected-Issues-40920) and the 2016 policy paper on "Financial Integration in Latin America (https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Financial-Integration-in-Latin-America-PP5026).

more rigorous and operational framework for information sharing on capacity needs for SDS would be highly valuable. As a start, consideration could be given to more formal or more regular and structured arrangements between IMF and World Bank staff and Fund engagement with the World Bank's Small States Forum, as well as the Asian Development Bank (ADB), respectively. Going further, it would be valuable to develop understandings about the relative role of different partners on financial resilience issues. Progress on this issue would facilitate coordination and make CD work more effective. More generally, it would allow the Fund to better align with SDS efforts at financial inclusion.

106. Greater attention is needed to analytical gaps in analyzing and advising on financial sector and fiscal issues. As described above, fiscal and financial issues are closely connected in SDS, but IMF work has been too compartmentalized. In an operating environment of relatively few assets and limited hedging opportunities, intermediary exposure to the sovereign is a capital efficient and safe asset and reduced availability of this asset class releases liquidity. Where rigidities in the ecosystem constrain intermediation, as noted earlier some SDS have experienced additional excess liquidity that have had significant monetary policy and foreign exchange market implications. Staff certainly have recognized these connections in country work but there is room for further cross-cutting research on how fiscal and financial issues interact and implications for policy approaches.

107. Another growing opportunity relates to advancing considerations of the financial stability implications of climate change to which SDS are particularly exposed but not very well equipped to handle. As of 2020 only three SDS (Seychelles, Mauritius and Trinidad and Tobago) were members of the 42-member Network of Central Banks and Supervisors for Greening the Financial System (NGFS), which has undertaken the task of integrating climate related risks into supervision and financial stability monitoring. One area of contribution by the IMF could be to promote the understanding of the macro-financial transmission of climate risk though augmentation of stress test scenarios in FSAPs.[88] However the limited number of FSAPs for SDS may require additional efforts that could involve the "common issues/thematic" approach proposed earlier or such stress testing being added to RCDC delivery.

VI. KEY FINDINGS AND CONCLUSIONS

108. Issues of financial stability dominated IMF staff advice to SDS in surveillance, capacity delivery and in the design of program benchmarks in IMF-supported programs during the evaluation period. Indeed, 70 percent of paragraphs on financial sector issues in staff reports, 90 percent of capacity delivery and 83 percent of program benchmarks were devoted to topics related to financial stability. This attention to solvency (institutional and systemic) supervisory frameworks, including for AML, and supervisory practices, has certainly had traction. Besides noted improvement in financial stability indicators over the review period, all SDS report country

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[88] Grippa, Schmittmann, and Suntheim (2019).

appropriate legislative reforms, while new or strengthened AML/CFT legislation was common to 72 percent of SDS.

109. The IMF has made concerted efforts over the review period to strengthen its analytical framework for understanding the unique macro-financial and policy challenges of SDS. Following the issuance of Staff Guidance in 2014 to prioritize policy advice around "deeper and more competitive, yet sound financial sectors" an initial focus on core macro-financial issues implied by shallow financial markets was supported by surveillance pilots in a number of SDS. Over time, attention transitioned to research around conjunctural challenges (climate change and correspondent banking relations—through Climate Change Policy Assessments and extensive engagement on responses to withdrawal of CBRs. In the final years of the evaluation period, additional themes have involved issues of financial inclusion, financial technology (following the Bali Agenda), and regional approaches to SDS challenges. The unifying thread across the various strands of analytical work has been the appreciation of the interdependencies between financial stability and financial depth and inclusion as being critical to broader macro-financial resilience in SDS.

110. The translation of this improved understanding on financial resilience issues into policy advice with traction has been decidedly uneven, and in consequence, there has been much less traction on reforms around issues impeding financial intermediation (financial resilience) in SDS. While there is little evidence of authorities disagreeing with the staff's diagnostic on these issues, the outcome has been that the same staff advice was repeated over many consultation cycles.

111. While the factors that have constrained financial intermediation in SDS are often complex, low traction could partly reflect a lack of effective arrangement for collaboration with partners in areas of overlapping mandates and expertise. Article IV reports have certainly brought attention to these issues: credit bureaus (94 percent of reports); registries for collateral (76 percent); (c) clarifying property rights and land tenure (51 percent); (d) SME specific guarantee/subsidy schemes (20 percent); and (e) creation of credit/insurance products and financial literacy programs (12 percent). However, while there is a presumption of partner collaboration on structural issues, mechanisms—outside of program arrangements—for coordination and delivery of policy advice and capacity support to SDS on structural issues affecting financial intermediation—with the World Bank appear ineffective. Moreover, there is no policy or uniform departmental practice governing the participation of partner institutions (e.g., World Bank, ADB) in Article IV consultations where capacity needs are identified. As an initial step in addressing this gap, it would be worth exploring more formal or structed relationships between [the respective SDS groups] of the IMF, World bank and the ADB, with an initial focus on coordinating policy advice and capacity delivery.

112. The focus on issues of domestic financial stability was also at the expense of attention to some other key sources of macro-financial risk. While ex post the Fund's response to the withdrawal of CBRs was comprehensive (bilateral and multilateral) and valued, the development was somewhat of a surveillance "surprise". Greater attention is needed to anticipate and address

inward regulatory and operational spill-overs that can be as impactful for SDS as weather or global/regional macro-economic shocks, given their inherent openness to the global environment through trade financing, remittance flows and the prevalence of foreign intermediaries. Given the uncertainty as to how these channels evolve, more proactive surveillance of developments in source jurisdictions would help deepen assessment of external risk facing the SDS host. An equally important risk arises from the current compartmentalization between staff advice on fiscal consolidation (that potentially releases domestic savings and increases demand for safe assets) and advice regarding financial intermediation (the ecosystem to facilitate productive deployment of released financial resources. Uncoordinated, fiscal consolidation can imply excess liquidity that could create unintended monetary and foreign exchange management challenges in SDS. There is a need to better integrate these two strands of policy advice.

113. Modalities of Fund engagement on financial sector issues have evolved over the review period with some positive results, but more effective use could be made of regional and other approaches to leverage Fund resources. Topical outreach (e.g., on CBR, remittances, fintech) through regional conferences and the deployment of survey tools (CBR) have been particularly impactful, not only as knowledge sharing but also in creating a sense of "commonality" of interest. Moreover, where these engagements converted into advocacy with standard setters (CBR), the Fund was seen as a useful trusted broker. Opportunities to replicate this approach on issues of technology and climate change however appear to have been missed.

114. In contrast, use of more "traditional" modalities like the FSAPs as well as the new FSSR tool has been quite limited in SDS. Not only have SDS been underserved by FSAPs, but of the eight completed, only one offered a full suite of accompanying technical notes oriented to topics in financial resilience as is more common practice in emerging market FSAPs. Notwithstanding the potential value of more "common issue/regional exercises discussed below, at a minimum FSAPs to SDS should be staffed to explore relevant issues in resilience and there should be greater use of the FSSR tool for SDS.

115. With respect to SIPs, while several have been of high quality, many have fallen short of providing useful country-specific insights. Moreover, successive SIPs in a country seldom follow a developing theme—even though there is evidence that this approach has traction with authorities. Given the potential value of SIPs in enhancing policy advice and in knowledge transfer, a review of the objective of SIPs and the process of topic selection and quality control is warranted. The objective of a SIP is to assist country authorities in addressing major policy areas: the institution should make this clear and draw its implications. On topic selection, consideration could be given to a more consultative process with SDS authorities on future SIPs. Such consultations could reduce the apparent lack of coherence in choice and improve traction for resource constrained SDS. A further advantage of a more medium-term agenda would be to provide space and time to address data needed to support analysis.

116. In supporting the resilience of the financial systems in small states, there are strong and mutually reinforcing reasons for Fund innovation to provide support through regional or common issue approaches already used in non-SDS member countries. This is clearly the case for diagnostic approaches to "common issues" amongst a group of countries—to better understand and advise on reforms needed to address intermediation rigidities. In capacity building, opportunities exist for RCDCs to provide implementation support to transnational bodies in SDS, as well as their traditional bilateral capacity delivery that have been tasked with integrating regional financial markets to overcome size constraints. Both these innovations would align with efforts already underway in some SDS notably in the use of technology (regional sandboxes and national CBDCs) but are also aligned with emerging research in the Fund on regional solutions. For SDS, such enhanced approaches for Fund engagement would bring much closer the opportunity to realize solutions to the challenges of small size. For the Fund, there are also likely to be important benefits from supporting a wider range of regional and pan-SDS initiatives, including contributing to SDS' efforts to strengthen national and regional ownership and accountability, with potential cost savings in conducting "common issue/regionally-focused exercises, and potential to strengthen cohesion in provision of ensuing CD.

117. Partner collaboration, especially in the area of capacity development, is critical to addressing financial sector challenges in SDS. While over the review period, the "service gap" was mostly manifested in reforms associated with the narrow financial ecosystem, new issues—of critical importance to SDS—of climate and the use of technology will likely present new challenges to an already ambiguous framework. While the FSLC was originally established to facilitate partnership, its current role appears most effective in programing and staffing FSAPs. Given the ongoing potential for ambiguity relative to the needs of SDS, besides the collaboration between the respective SDS groups in the institutions (to elevate the need for intentional approaches to SDS) noted above, a revived FSLC could be a useful fora to facilitate clarity and resourcing of capacity delivery to SDS.

APPENDIX I. SIP EVALUATION FRAMEWORK

Seven evaluation criteria, in three categories, were used to assess the quality of SIPs prepared for SDS. The first category refers to how clearly the issue addressed in the chapter is posed, and how well its relevance—particularly its financial sector policy relevance to the country in question—is explained. The chapter needs to convince the reader of the importance of the issue, particularly for the authorities and researchers in the country. Criteria in the second category examine how the question is addressed. Does the macro-financial framework and data being used match the question? Here the framework is defined to include the technique being used as well as the implied transmission behind it. A discussion of limitations and robustness is important to make the results credible and usable by the economic community in the country in question, and also to encourage further work on the topic. The third category of evaluation criteria examines how the conclusions are delivered. Are they clearly presented? Do they follow logically from the earlier analysis and are their implications for policy well-articulated? In each case, where the requirements posed by each question was satisfied, a score of "1" was assigned. Where the requirements posed by each question was not satisfied these criteria were not fulfilled, a score of "0" was allocated.

Five ratings were used to assess the chapters on each evaluation criterion: "Excellent" (E), with a score of 7; "Very Good" (VG) with a score of 5 or 6; "Satisfactory" (S) with a score of 4; Moderately Unsatisfactory (MU) with a score of 2–3; and Unsatisfactory (U) with a score of 1 or (0). In scoring SIP chapters, account was taken of the particular role as well as the key target audience for these chapters. SIPs accompanying Article IV consultations are expected to address issues of high policy relevance, preferably associated with the ongoing consultation. Their basic audience is in the country where the consultation is taking place and consequently SIPs need to address policy issues in a way that can be understood and can be leveraged by the economic community in the country.

SDS Country	Year	Selected Issues Papers—Topic Coverage
Trinidad and Tobago	2011	*Collapse of CL Financial and Government intervention*
Suriname	2013	*Monetary and Financial system of Suriname*
	2014	*What does Ms. Muffet tell us about the macro-financial situation in Suriname*
	2019	*Dollarization in Suriname; Curse or Cure?*
Seychelles	2017	*A Risk Management framework for Disasters and Climate change--Monetary Policy and Financial sector issues.*
	2019	*Estimating a Financial Conditions Index for Seychelles--using a FCI for macro-prudential policy purposes*
Republic of Marshall Islands	2018	*Correspondent Banking Relationship pressures*
		The SOV-RMI: Decentralized digital currency
Mauritius	2017	*Implications of International Tax transparency and Anti-tax avoidance initiatives for Mauritius.*
	2019	*Estimating A FCI for Mauritius--Using the FCI for macro-prudential policy purposes*
		Private Savings in Mauritius.
Swaziland/Eswatini	2013	*Financial Stability in Small Middle-Income countries.*
	2015	*Macro-financial risks in Swazi banking sector associated with SACU revenue fall*
Montenegro	2017	*Analysis of Macro-financial linkages and other financial sector issues*
Samoa	2010	*Impediments to bank intermediation and monetary policy transmission*
The Bahamas	2017	*Structure and Trends in Bahamas Off -Shore Financial Sector.*
Guyana	2013	*The Financial sector in Guyana*
Djibouti	2015	*Financial Inclusion in Djibouti*
	2019	*Reform to strengthen Governance--AML/CFT frameworks*
Cabo Verde	2013	*Financial Stability in Small Middle-income countries.*
	2016	*Determinants of Private credit growth in Cabo Verde*
		Benchmarking Cabo Verde's Financial sector.
	2018	*Loss of CBR in Cabo Verde: and application of the minimal scope framework*
Sao Tome	2018	*Analyzing the evolution of credit and NPLs based on credit registry data*
Belize	2014	*Where do we stand on efforts to strengthen the Belize financial sector*
	2015	*Review of recent efforts to strengthen Belize financial sector and CBR*
	2016	*Toward a better understanding of macro-financial linkages*
	2017	*Recent developments in Belize financial system*
	2018	*CBR recovery and the way forward*
Dominica	2016	*Credit Unions in Dominica: Financial importance and policy challenges*
	2018	*Identifying systemic vulnerabilities: network analysis in the Dominican financial sector*
Barbados	2010	*Barbados: Financial system in the aftermath of the Global Crisis*
	2018	*Towards a sustainable International business and financial services sector*
Union of Comoros	2018	*Financial Sector risks and monetary policy effectiveness*
	2020	*Banking sector solvency stress tests*
		Strengthening Governance and reducing vulnerability to corruption.

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