Evaluation Report

Financial Sector Assessment Program

Independent Evaluation Office of the IMF

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Statement by the Managing Director, IMF Staff Response, and Summing Up of IMF Executive Board Discussion by Acting Chair

The following symbols have been used throughout this report:

– between years or months (e.g., 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g., 2003/04) or FY to indicate a fiscal (financial) year.

n.a. not applicable.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

Some of the documents cited and referenced in this report were not available to the public at the time of publication of this report. Under the current policy on public access to the IMF's archives, some of these documents will become available five years after their issuance. They may be referenced as EBS/YY/NN and SM/YY/NN, where EBS and SM indicate the series and YY indicates the year of issue. Certain other documents are to become available 10 or 20 years after their issuance, depending on the series.

Foreword

A sound and stable financial system is now widely recognized to be critical for achieving economic growth and reducing poverty. This lesson was highlighted by the Asian financial crisis of the late 1990s, when weaknesses in Thailand's financial system triggered speculative attacks on its currency and the ensuing financial crisis spread quickly to other economies in East Asia. The crisis underscored the potential for financial disturbances in one country to threaten regional, and even global, economic stability and growth.

Shortly after the Asian crisis, the IMF stepped up its surveillance over the financial sector and related policies of its member countries and, in 1999, partnered with the World Bank to establish the joint Financial Sector Assessment Program (FSAP). The FSAP was created as a joint IMF–World Bank initiative to strengthen monitoring of countries' financial systems and enable them to provide better policy advice to help countries address their financial sector weaknesses.

Given the importance of countries' fianancial soundness for the stability of the international financial system, the IMF's Independent Evaluation Office has evaluated the experience with the program since its inception, focusing on the role of the IMF. The evaluation shows that the program has deepened the IMF's understanding of the financial sector and significantly strengthened the quality of its dialogue with member countries on financial issues. But the FSAP initiative, given its expense, faces important challenges with respect to setting priorities for coverage of assessments and ensuring the results are fully incorporated into IMF surveillance over its member countries' policies.

Following standard practice, this volume includes, alongside the evaluation report itself, the response of IMF management and staff to the evaluation, as well as the Summing Up of the Executive Board discussion of this report.

Thomas A. Bernes
Director
Independent Evaluation Office

Financial Sector Assessment Program

The report was prepared by a team headed by David Goldsbrough and including Martin Kaufman, Mariano Cortes, Marko Skreb, Heinz Rudolph, Tim de Vaan, and Teresa Perez. It also benefited from contributions from David Peretz. Administrative assistance was provided by Annette Canizares, Arun Bhatnagar, and Maria Gutierrez, and editorial assistance by Esha Ray. The report was approved by Thomas A. Bernes, Director of the Independent Evaluation Office.

Abbreviations and Acronyms

AML/CFT	Anti-money laundering/combating the financing of terrorism
Baninter	Banco Intercontinental
BCP	Basel Committee's Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
CPSS	Committee on Payments and Settlement Systems
EMBI	Emerging Market Bond Index
ERM	Exchange Rate Mechanism
EU	European Union
FIRST	Financial Sector Reform and Strengthening Initiative
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSE	Financial Sector Vice-Presidency
FSIs	Financial soundness indicators
FSLC	Financial Sector Liaison Committee
FSR	Financial Stability Report
FSSA	Financial System Stability Assessment
G-7	Group of Seven
G-20	Group of Twenty
GDP	Gross domestic product
IAIS	International Association of Insurance Supervisors
ICM	International Capital Markets Department
IEG	Independent Evaluation Group
IEO	Independent Evaluation Office
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MFD	Monetary and Financial Systems Department
MONA	Monitoring of Fund Arrangements Database
PDR	Policy Development and Review Department
PIN	Public Information Notice
PRGF	Poverty Reduction and Growth Facility
ROSC	Report on the Observance of Standards and Codes
S&C	Standards and codes
S&P	Standard & Poor's
SIC	Systemically important country
SME	Small and medium-sized enterprise
TA	Technical assistance
TOR	Terms of reference

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Executive Summary

This evaluation assesses the effectiveness of the Financial Sector Assessment Program (FSAP) from the perspective of the IMF. A parallel evaluation by the World Bank's Independent Evaluation Group (IEG) assesses the World Bank's role. The FSAP was established in 1999 to provide advice to strengthen the financial systems of member countries by facilitating early detection of financial sector vulnerabilities and helping to identify financial sector development needs. Although a voluntary program, it has become the principal platform for financial sector diagnosis at the IMF. It is a joint IMF–World Bank exercise (except in industrial countries), but with different outputs for different purposes, including a confidential report to the authorities and separate summary reports to the Boards of the IMF (the Financial System Stability Assessment or FSSA) and the World Bank (Financial Sector Assessment or FSA), dealing with issues that are in their respective areas of responsibility.

Our overall assessment is that the FSAP represents a distinct improvement in the IMF's ability to conduct financial sector surveillance and in understanding the key linkages between financial sector vulnerabilities and macroeconomic stability. It has significantly deepened the IMF's understanding of the financial sector in specific countries, helped articulate policy recommendations, prompted better discussions with authorities, and helped support policy and institutional changes. The FSAP also permits an integrated approach to assessing financial sector vulnerabilities and development needs that could not be achieved by an ad hoc series of assessments. The evaluation also suggests that the joint IMF–World Bank nature of the exercise has been generally beneficial. Thus, putting in place this major new initiative within a relatively short period represents a substantial achievement.

Despite these achievements, the initiative is at a critical crossroads and there is a danger that some of the gains could be eroded without significant modifications. The evaluation indicates two related sets of problems. First, financial stability assessments have not yet been fully "mainstreamed" as a regular part of IMF surveillance. Second, looking beyond the stage of initial FSAPs, there are serious doubts that current incentives for participation and associated priority-setting procedures will be sufficient to ensure coverage of countries where a strengthening of financial sector surveillance is most needed. The evaluation also points to the need for changes in the way the IMF organizes its own activities in order to make the best use of scarce technical expertise as well as to a range of measures that would further improve the quality and effectiveness of FSAPs.

The evaluation has used a variety of evidence including cross-country analysis of all FSAPs; surveys and interviews of stakeholders; in-depth reviews of 25 FSAPs (including discussions with most authorities) as well as of all post-pilot Updates and post-2003 assessments; and interviews with a range of market participants. For comparison purposes, desk reviews were also undertaken of financial sector surveillance in a small group of systemically important countries that had not undertaken an FSAP.

The evaluation examines evidence on the various links in the chain of influences that go from FSAP inputs through immediate outputs to intermediate and final outcomes. The main evaluation findings address the following critical areas: (1) the nature of priority setting under the FSAP; (2) the efficiency of FSAP processes and quality of the main diagnostic tools; (3) the overall quality of FSAP content, including the communication of findings and recommendations; (4) whether the joint IMF–World Bank nature of the FSAP has been effective; (5) how well the IMF has used FSAP results in its surveillance, technical assistance, and program activities; and (6) evidence on the overall impact of the FSAP on the domestic policy dialogue, changes in policies and institutions, and market participants. The evaluation concludes with seven recommendations.

Priority Setting Under the FSAP

Choices on priorities under the FSAP—which countries to assess and what issues to examine within each country—are critical to the program's overall effectiveness. Several aspects of the FSAP make priority setting especially challenging—including the voluntary nature of the exercise and the joint IMF–World Bank approach with consequent multiple objectives.

Although country selection has largely followed the guidelines set by the two Boards, a significant proportion (some 20–25 percent) of countries that are "systemically important" and/or have vulnerable financial systems—two key criteria endorsed by the IMF and World Bank Boards—have not been assessed, because the countries concerned have not volunteered to participate in the initiative. Moreover, a significant proportion of FSAPs that have been undertaken for countries that fit these criteria are becoming dated. Again, this largely reflects a reluctance of some countries to volunteer for FSAP Updates, so that the actual participation is not in line with the broader objectives of the initiative.

This reluctance by some countries to participate has eased what would otherwise have been potentially sharp trade-offs between different priority criteria. Going forward, if incentives to participate can be strengthened, the priority criteria may need to be modified to clarify how these trade-offs should be managed.

In response to the resource intensive nature of the initiative, the 2003 review of the FSAP called for more selectivity by reducing the depth of analysis of certain issues and the number of standards to be assessed in detail for each country, while remaining comprehensive in coverage. The evaluation suggests that these streamlining efforts have not adversely affected the quality of the overall vulnerability assessment in most cases. But there is inadequate discussion of the expected scope of the FSAP, including with the authorities, at the terms of reference stage. Moreover, there are limits to how far selectivity can be taken without losing the broad overview of intersectoral linkages that is one of the key advantages of the FSAP approach.

Different IMF and World Bank budget procedures (including treatment of anti-money laundering/combating the financing of terrorism (AML/CFT) complicate estimates of overall FSAP costs, but IEO estimates suggest that the total direct average costs (i.e., excluding overhead) of a post-2003 FSAP initial assessment were about $668,000 ($438,000 for the IMF alone). Average costs fell by about 6 percent (10 percent for the IMF) since 2003, reflecting the effects of streamlining and the fact that some of the most complex financial systems were assessed prior to 2003. Since 2003, there has been surprisingly little difference between the average costs of FSAPs for advanced, emerging market, and low-income countries.

Quality of FSAP Processes and Diagnostic Tools

Country authorities generally rated the technical quality of the FSAP teams highly, particularly the expertise of specialists. However, insufficient time for the FSAP team to prepare and familiarize themselves with country-specific circumstances was a widespread complaint. In addition, the burden of the FSAP on the authorities, inevitably very high, could be eased by better planning, including greater prior consultation with authorities at an early stage, more lead time on information requests, and greater personnel continuity.

In many countries the FSAP has contributed significantly to assessing financial sector vulnerabilities—by helping to change the culture toward one that emphasizes system-wide risk assessments and to upgrade methodologies. Within this overall positive experience, however, there are significant differences across countries, and several shortcomings need to be addressed:

(1) Reporting of results from stress testing in many FSAPs takes a "black box" approach, with too little discussion of the limitations implied by data and methodological constraints and choices on which shocks to analyze. This often results in overly simplistic messages about the strength of the financial sector. Greater "health warnings" about the interpretation of results are needed.

(2) There is a considerable gap between the "good practice" approaches to modeling shocks and those used in many other cases. Some assessments have avoided analyzing the consequences of politically sensitive shocks (e.g., public debt defaults).

(3) Financial soundness indicators (FSIs) have generally not yet been used in a meaningful manner in most assessments, reflecting problems with data and interpretation of appropriate benchmarks for signaling vulnerability.

(4) The quality of the data on the financial system is often not emphasized sufficiently. In some countries, more caution is needed before using available statistical data at face value, either for stress testing or other analysis.

(5) Integration of the various standards and codes assessments into an overall FSAP assessment has added value, but the degree of integration varied from case to case. Moreover, there appears to be excessive focus on the "number" of principles for which a country was fully or largely compliant, which could give a mis-

leading signal on the potential downside consequences of remaining gaps.

(6) While the assessments of standards generally distinguish between de jure standards and de facto implementation, the crucial significance of institutional weaknesses for actual implementation is often not emphasized sufficiently.

FSAP Content

Overall quality

The overall quality of the FSAP assessments is high, although problems were encountered in a minority of cases. A high-quality overall assessment is one that combines effectively the results from the various evaluation tools to present the main risks and vulnerabilities to the financial sector with an indication of criticality and consequence. Such a "comprehensive" approach combines a variety of assessment instruments, coverage of the overall financial sector, and an analysis of the interaction between key macroeconomic risks and the financial sector in a manner that the sum is greater than the individual analytical components.

In a minority of cases, the overall assessment does not give a clear indication of the macroeconomic/systemic importance of vulnerabilities and potential consequences if key problems are not addressed. These comprised cases where there was inadequate analysis of the criticality or urgency of vulnerabilities, the potential spillover effects to other segments of the financial system or corporate sector, and the macroeconomic impact and potential policy implications.

One area that received too little attention in many FSAPs was the analysis and integration of financial cross-border issues. FSAP stability assessments have generally been limited to the segments and risks of the financial system that have domestic implications, even when some external/macro risks were considered for the stress-testing analysis. FSAPs in countries with extensive cross-border financial sector participation have generally made little inroads into the broader global and regional dimensions of those cases, with limited contribution to identifying and highlighting potential spillover channels and effects.

The effectiveness with which FSAPs addressed both stability and development issues in an integrated manner varied substantially and appears to have depended in part on the nature of the development issue. While overall judgments by IEO assessors on the balance between stability and development issues were generally quite favorable, FSAPs were more successful in handling some types of development issues than others. When the issue was one of reforming existing segments of the financial system to promote growth, there tended to be a close association between the development and stability aspects and FSAPs often handled these issues well. However, when it was a question of promoting the development of largely nonexistent financial sectors, or encouraging the provision of financial services to underserved or excluded groups, there was generally little integration between the two aspects. Indeed, whether the FSAP is the best vehicle to address such types of development challenges remains an issue.

Articulation of findings and recommendations

The main findings of the FSAP were generally presented in a reasonably candid manner in both the FSAP aide-mémoire and the more widely circulated FSSA, although couched in cautious language. But there were significant shortcomings in the prioritization of recommendations in many cases. The reviews of the latest vintages of initial FSAP assessments and of FSAP Updates suggests that these shortcomings have continued.

While there was no major loss in candor across earlier stages of the FSAP process, candor was sometimes lost at the critically important stage of integration with Article IV surveillance reports. There was a "loss in translation" in a number of cases between the messages of the FSSA and those incorporated in the staff reports for Article IV surveillance. When this happened the Board discussion tended to focus on the issues discussed in the Article IV report, crowding out problems that were flagged only in the FSSA, even though the latter report was also available to the Board. Factors that influenced how well key FSSA messages were integrated into the Article IV report comprised the degree of country ownership and the degree of integration between work of the FSAP team and area department teams.

The Joint IMF–World Bank Nature of the FSAP

The principal rationales for making the FSAP a joint IMF–World Bank initiative were that, in light of the overlapping mandates of the two institutions on financial sector issues and the scarce technical expertise on such matters, considerable potential synergies could be attained by addressing stability and development aspects in a comprehensive manner and that combining the respective expertise of the two institutions would produce a more integrated analysis and set of recommendations.

The evaluation suggests that, while there were some coordination problems, organizing joint teams that include both IMF and World Bank staff members has contributed significantly to the depth of analytical expertise and credibility of the findings in many, but not all, cases. Also, there is no evidence that the joint approach has led to a "watering down" of messages in order to achieve consensus between the institutions.

Discussion of the relative weight to be given to stability and development issues was generally inadequate in earlier cases but there have been some improvements over time. However, the tools for analysis of financial sector development issues remain less well developed, a point noted in the parallel IEG evaluation.

How Well Has the IMF Used the FSAP Output?

The overriding message emerging from the evaluation is that the FSAP exercise has deepened the IMF's understanding of the financial sector and strengthened the quality of the surveillance dialogue on financial sector issues, but the IMF is not yet using the results as effectively as it might.

The incorporation of FSAP results into Article IV *surveillance* has broadened the scope of monitoring of financial sector issues. Coverage of financial sector issues and vulnerabilities in Article IV consultations generally improved from the treatment before the FSAP, but financial stability issues have not yet been fully mainstreamed into Article IV assessments.

In many cases, discussion at the Executive Board of financial sector issues has been weak. In a few extreme cases, the Article IV surveillance reports and subsequent Board discussion failed to pick up on key messages in the FSSA (e.g., Dominican Republic). Contributing factors include the use of cautious language in most FSSAs; the traditional focus and expertise (of both area departments and the Board) on macroeconomic policies; the prevalence of area department views when there were disagreements with the FSAP team; the failure of the internal review process to ensure an effective integration of FSAP issues in such cases; and the secondary role that the FSAP team leader played vis-à-vis area department and Policy Development and Review Department (PDR) staff at Board surveillance discussions.

In terms of follow up, the financial sector content of surveillance in years following the FSAP has tended to diminish, but generally remained better than before the FSAP. The availability of adequate technical expertise within surveillance teams has been the major constraint on the effectiveness of follow-up activities when complex issues are involved. In many such cases, tracking the implementation of FSAP recommendations has taken a "checklist" approach of enumerating measures rather than appraising whether underlying vulnerabilities have been addressed. Focused assessments, with expert assistance from the Monetary and Financial Systems Department (MFD) (or the International Capital Markets Department (ICM)), have done a more thorough analysis of implementation of recommendations in particular areas.

Only FSAP Updates appear to have had the capacity to undertake an in-depth tracking of implementation in specific areas; in the case of comprehensive reassessments, they also were able to take a broader view of how vulnerabilities had been addressed and of remaining challenges.

The FSAP and associated Reports on the Observance of Standards and Codes (ROSCs) have become increasingly important drivers of IMF *technical assistance* (TA) in the financial sector, with a substantial proportion of TA going to emerging market countries. Within individual countries, post-FSAP TA provided by the IMF was in most cases broadly in line with the main areas of FSAP recommendations.

However, many FSAPs have significant shortcomings as a platform for organizing follow-up TA, reflecting insufficient prioritization of recommendations and sense of sequencing as well as limited judgments on implementation capacity. Moreover, while the countries themselves should obviously take ownership of any follow-up plans of action, it would be helpful to have a clearer institutional framework for linking FSAP recommendations to plans for TA delivery that coordinate the activities of all important donors. A number of actions have been taken recently to provide a better interface between the FSAP and TA follow-up work, but it is too early to judge the results.

The extent of conditionality on financial sector issues in *IMF-supported programs* has increased markedly since the late 1990s, but evidence suggests that this reflects underlying developments in the financial sector rather than the existence of an FSAP per se. A comparison of program conditions with the main FSAP recommendations suggests a mixed picture with regard to alignment.

Evidence of FSAP Impact

Attributing specific final outcomes within complex systems to particular activities such as the FSAP is extremely difficult. In this context, the evaluation sought to identify the proximate contribution of the FSAP (in terms of influence of the policy debate or use by country authorities) and assess what has actually happened in terms of changes in key policies and institutions.

Impact on the policy debate

The greatest impact has been on within-government dialogue and in supporting the authorities' position in discussions with the legislature. In contrast, the use of the FSAP in general public debate has been very limited. In many cases, the main value-added of the FSAP process was through the interaction of the FSAP team with high-level policymakers, not through the final report.

The impact on the policy debate was not confined to developing countries; among advanced economies, the FSAP has been instrumental in raising a number of "taboo" subjects or in influencing an ongoing political debate within the administration or legislature. The largest impact was in those countries where the government already had a high commitment to financial sector reforms.

Impact on policies and institutions

The evaluation has identified a wide range of cases in which significant changes did take place subsequent to the FSAP and in which there is some evidence that the FSAP was at least a contributory factor, although direct attribution is not possible.

The most commonly identified value added of the FSAP was as an independent, expert "second opinion" on the financial system and reform plans. In a number of cases, this contribution increased the credibility of reform initiatives (including in the legislature).

Critically, there has been a change in the "culture" in many countries vis-à-vis approaches to financial sector risk assessments. While there have been a number of other major influences from relevant institutions (e.g., the Bank for International Settlements (BIS) and the Financial Stability Forum), the FSAP initiative does appear to have played an important contributory role in this change.

But there were also a number of "missed opportunities" where the FSAP did not, for various reasons, lead to timely changes to forestall problems. The most dramatic example was in the Dominican Republic where a banking crisis broke out less than a year after the FSAP.

There has been a high level of satisfaction among various standard-setting bodies with the feedback received from the IMF (and World Bank) on the standards through formal and informal channels. Greater efforts by the IMF to distill common cross-country messages from the various FSAP exercises would be welcomed.

Impact on markets

While many authorities identified the "signaling role" to markets as one of their motivations for participating in the FSAP exercise, the impact of FSSAs on the views of financial market participants appears modest. Credit-rating agencies appear to use FSSAs somewhat more than other market participants. Within this generally limited impact, the effects appear greatest in countries where overall transparency is the least; failure to participate or to publish a FSSA is regarded as perhaps the most significant signal.

Recommendations

The evaluation's seven recommendations are focused on three key themes: (1) reconsidering incentives for participation, clarifying priorities, and strengthening the links with surveillance; (2) steps to maintain and strengthen further the quality of the FSAP and organizational changes within the IMF; and (3) the working of the joint IMF–World Bank approach. Consistent with the IEO's mandate, the recommendations are couched in terms of actions to be taken by the IMF, although, given the joint nature of the initiative, a number could require decisions by both the IMF and World Bank Boards. The recommendations are elaborated further in Chapter 7.

Recommendation 1. The IMF Board and management should refine the criteria for setting priorities on IMF resource inputs into financial sector surveillance, including the FSAP. Based on these priorities, IMF staff should indicate, as part of its medium-term planning, what components are needed for strengthening financial sector surveillance in each country, drawing upon a range of possible modalities. These strategies would form the basis for more explicit accountability on results.

Recommendation 2. To strengthen incentives and drawing upon these country-specific plans, IMF management should clearly signal to the Board those countries that it sees as the highest priorities for FSAPs and Updates, irrespective of whether these countries have volunteered. These lists should be the basis for periodic discussions by the Board of country-specific priorities.

Recommendation 3. Strengthen the links between the FSAP and surveillance by mainstreaming FSAPs and follow-up work into the IMF's regular surveillance activities.

Recommendation 4. Implement steps to improve further the quality of the FSAP and strengthen its impact.

Recommendation 5. Introduce changes in the organization of IMF mission activities to utilize scarce financial sector technical expertise (especially in MFD and ICM) more effectively in the surveillance process.

Recommendation 6. Maintain the current joint approach, but clarify further the distinctive contributions the Fund and Bank can make, with the IMF taking the lead where significant domestic or global stability issues are present, and the Bank taking the lead where financial sector development issues are more paramount. Such clarity should include a clear delineation of primary responsibilities for setting priorities (and contributing resources).

Recommendation 7. The IMF, in conjunction with the World Bank and other technical assistance providers, should seek to establish a clearer framework for coordinating follow-up capacity-building technical assistance activities, based on the country's own action plans.

CHAPTER

I Introduction

This evaluation assesses the effectiveness of the Financial Sector Assessment Program (FSAP) from the perspective of the IMF. A parallel evaluation by the World Bank's Independent Evaluation Group (IEG) assesses the World Bank's role.[1]

The FSAP was established in response to the financial crises of the late 1990s, which led to a call for the IMF and World Bank to jointly find an effective way to provide policy advice to strengthen the financial systems of member countries, facilitating early detection of financial sector vulnerabilities and identification of financial sector development needs. It was introduced to fill an identified gap in the international financial architecture in support of crisis prevention, based on a judgment that existing surveillance approaches at the IMF under Article IV consultations were not sufficient for effective financial sector surveillance. In this context, although a voluntary program, it has become a principal platform for financial sector diagnosis at the IMF. As of the end of FY2005, 111 country assessments (including Updates) were completed or were under way (see Annex 11, Table A11.1).

The design of the initiative has evolved over time, first as lessons from an initial pilot stage were absorbed and then as various reviews were completed. The most important of the latter was the 2003 review, which led to a number of modifications. However, the core features have remained unchanged:

- Voluntary participation;
- A joint IMF–World Bank exercise (except in industrial countries); and
- Differential outputs for different purposes.[2]

[1]The terms of reference for the evaluation are available on the IEO's website (www.imf.org/ieo). The IEG's Approach Paper is available at www.worldbank.org/ieg.

[2]Including (1) a confidential report to the authorities by the FSAP team (initially called the FSAP report and subsequently an aide-mémoire) followed by a volume of detailed assessment of standards and codes and typically one or more additional volumes on selected issues; and (2) separate summary reports to the Boards of the IMF (the Financial System Stability Assessment (FSSA)) and the World Bank (the Financial Sector Assessment (FSA)).

The FSAP was conceived as a diagnostic and policy advice tool. In this connection, it was designed to work at two levels: confidential advice to country authorities and peer review. The peer review element works through the regular Article IV process, with the FSSA report as part of the Article IV documentation distributed to the IMF Board. However, the precise legal position of the FSAP within this framework is a nuanced one. Strictly speaking, the FSAP is a form of technical assistance from the IMF and is not by itself an exercise of surveillance under Article IV. Rather, the FSAP "feeds into" surveillance through the FSSAs (i.e., provides material that deepens the understanding of the member's circumstances for the purpose of surveillance).[3]

Scope and Methodology of the Evaluation

Evaluation of the FSAP, like other aspects of surveillance, faces significant methodological challenges because the final objectives are hard to define and measure and because attribution of particular outcomes to IMF activities is difficult.[4] There

[3]For a discussion of the legal basis for surveillance under Article IV, see Appendix I of the "Biennial Review of the Implementation of the IMF's Surveillance and of the 1977 Surveillance Decision—Modalities of Surveillance" (SM/04/212, Supplement 1, July 2, 2004). Activities of the IMF that fall outside of Article IV may still inform an Article IV consultation. An FSSA under the FSAP is a technical service provided by the IMF to a member at its request under Article V, Section 2(*b*). However, the information obtained through the FSAP can be used for the purposes of informing discussions under an Article IV consultation. Many of the issues that are discussed in an FSSA do fall within the scope of surveillance under Article IV; in the absence of an FSSA, the issues that are normally discussed in such an assessment could be discussed by the IMF as part of surveillance. In identifying such issues, the Executive Board needs to be satisfied that they are relevant for this purpose. Under the IMF's present approach, the selection of topics to be covered by surveillance is based on their macroeconomic relevance.

[4]This is frequently referred to as the results chain or logical framework. See also Duignan and Bjorksten (2005) for a discussion of approaches to the design of a strategy for evaluating different aspects of surveillance where final objectives can be difficult to measure and attribution to specific IMF activities is even harder.

are generally recognized difficulties in defining "financial stability" and the concept was not defined precisely in the various policy papers on the FSAP.[5] Some define it in the negative—that is, by the absence of financial crises that have a significant impact on GDP. But there are potential trade-offs between measures to increase resilience to crises and economic and financial efficiency. For example, requiring all banks to hold 100 percent of their assets in low-risk securities would minimize the risk of crises but would not foster growth. In this context, the final objective of the FSAP initiative can be summarized as to help countries reduce their financial sector vulnerabilities and thereby enhance crisis prevention, while helping to foster financial sector efficiency and development. The ultimate objective of reducing financial sector vulnerability has been linked to several intermediate goals that include: the systematic assessment and monitoring of financial systems to identify vulnerabilities and risks; the development of strategies for strengthening the financial sector; and the identification of development and technical assistance needs.

Moreover, while it is generally not possible to establish attribution between the FSAP and final outcomes, many important questions can be addressed by examining available evidence on the various links in the chain of influences that go from FSAP inputs through immediate outputs to intermediate and final outcomes (see Annex 1). Specifically, the evaluation seeks to address the following sets of issues:

(1) *Inputs.* Has the allocation of resources under the FSAP followed priorities that are relevant for achieving its objectives and have FSAP processes worked effectively?

(2) *Outputs.* Have the assessments of financial vulnerabilities been of good quality (i.e., effective in terms of identifying the principal sources of risks) and have findings and recommendations been clearly articulated and prioritized?

(3) *Integration with surveillance.* Has the overall surveillance function of the IMF with regard to the financial sector improved as a result of the integration of the FSAP/FSSA into Article IV surveillance? Have the arrangements for follow-ups and reassessments resulted in effective support to ongoing financial sector surveillance?

(4) *Outcomes.* Has the FSAP process as well as supporting IMF instruments contributed to policy and institutional changes that significantly reduced financial sector vulnerabilities?[6] Have follow-up activities by the IMF provided effective encouragement to this process?

As noted in the original terms of reference, a number of issues are not addressed in this evaluation, in order to keep the scope of the project manageable or because evidence to perform an assessment is not yet available.

- We do not evaluate the technical merits of particular codes and standards, but will examine how the IMF experience in assessing these standards has informed its feedback to the standard-setting bodies. Nor do we attempt to assess whether the entire international architecture of standards and codes is better than other possible approaches, since such questions go well beyond the role of the IMF.[7]
- Specifics of the assessments of the anti-money laundering/combating the financing of terrorism (AML/CFT) standard and of offshore financial centers—except to the extent that these activities affect the broader FSAP.
- Other crisis prevention activities of the IMF (e.g., the efficacy of multilateral surveillance activities and early warning system models).
- Most aspects of IMF surveillance of the financial sector beyond the FSAP, except to investigate how such activities have been integrated with or complemented the FSAP.

The evaluation used a variety of evidence to address these questions with two goals in mind: (1) to check the robustness of emerging message by triangulating between different types of evidence; and (2) since the design of the FSAP has changed over time, to check whether key messages remain valid for the most recent FSAP vintages:

- *Cross-country analysis of the full sample of FSAP countries* (e.g., to examine how FSAP priorities were set in practice). The cutoff date for the sample was the end of FY2005.

[5]Houben, Kakes, and Schinasi (2004) discuss various definitions of financial stability.

[6]Although a precise delineation between the stability and development aspects of the initiative is generally not feasible, the impact on aspects that are primarily in the realm of financial sector development are addressed in the parallel IEG evaluation.

[7]For an alternative point of view on this broader issue, see Schneider (2003).

- *In-depth investigations of a subsample of 25 FSAP cases* (Annex 11, Table A11.2). The investigations cover desk reviews, interviews with country authorities, including a number of country visits, as well as interviews with IMF and World Bank staff. The sample was chosen to reflect different FSAP "vintages" (i.e., the pilot stage and before and after the 2003 FSAP review), as well as different levels of complexity of the financial system and geographic diversity. In conducting the country reviews, particular attention has been paid to organizing qualitative information in a systematic manner. A detailed template covering a wide range of questions concerning all stages of the FSAP process was completed for each country. For a number of questions, IEO assessors used a (four-point) rating scale to summarize judgments on how effectively particular FSAP exercises had implemented a particular component. Such ratings inevitably involve an element of subjective judgment but we have sought to minimize this by preparing guidelines on what we would expect to see to justify different ratings. An example of the detailed template is provided in Annex 3.
- *Desk reviews for all post-pilot FSAP Updates and all post-2003 full FSAPs*. All of the Updates completed as of end-June 2005 were subject to a desk review using a streamlined template based on that used for the 25-country sample, with the focus on the adequacy of the review of vulnerabilities and the stocktaking of policy and institutional changes since the initial FSAP assessment as well as on linkages to Article IV surveillance. Similarly, all post-2003 full FSAPs were reviewed using a similar template to check the conclusions reached from the in-depth 25-country sample.
- *Surveys of country authorities, FSAP teams, and IMF and World Bank staff*.[8] The surveys were conducted anonymously, with the aid of professional survey consultants and the overall response rate (averaging 53 percent) was high for this kind of (full sample) survey. Many of the questions were designed to test the broader applicability of the results emerging from the in-depth review of 25 country cases. Details of the surveys and a summary of the results are presented in Annex 2.
- *Structured interviews with a range of market participants, including rating agencies, investment banks, and asset fund managers.*
- *Brief desk reviews of the contents of financial sector surveillance in a group of systemically important countries that have not undertaken an FSAP.*

The remainder of the report is organized as follows. Chapter 2 discusses the effectiveness of priority setting across and within countries. Chapter 3 discusses the quality of FSAP processes and diagnostic tools, and Chapter 4 the FSAP content. Chapter 5 assesses how well the IMF has used the FSAP output in its surveillance, technical assistance, and program activities. Chapter 6 discusses evidence on the impact of the FSAP on countries' policies and on markets. Chapter 7 concludes with some overall lessons and seven recommendations.

[8]The evaluation also draws on the results of surveys of member countries, market participants, and IMF and Bank staff on the effectiveness of the broader standards and codes initiative undertaken as part of an internal review. See "The Standards and Codes Initiative—Is It Effective? And How Can It Be Improved?" (SM/05/252, July 1, 2005).

CHAPTER

2 Effectiveness of Priority Setting Under the FSAP

Choices on priorities under the FSAP—which countries to assess and what issues to examine within each country—are critical to the program's overall effectiveness. Three aspects of the FSAP make priority setting especially challenging. First, the voluntary nature of the exercise means that some countries that would otherwise be ranked as high priority may choose not to participate. This raises the important question of what incentives should be used to encourage participation. Second, the FSAP exercise is resource-intensive. As a result, resource constraints have required some scaling back of the number of assessments—from an initial goal of completing 24 cases a year to a rate of 17–19 a year following the 2003 review. The latter rate would imply that a comprehensive assessment of the entire membership would take a little over a decade. The 2003 review also called for more selectivity by reducing the depth of analysis of certain issues and the number of standards to be assessed in detail for each country, while remaining comprehensive in coverage.[1] Third, the FSAP's multiple objectives as well as its joint IMF–World Bank nature, with inevitable differences in institutional priorities, implies balancing a complex set of priorities.

In this context, the evaluation asked the following questions: (1) Are the priority-setting criteria set by the two Executive Boards the relevant ones, in the sense of being clearly linked to the overall objectives of the FSAP initiative; and (2) how effectively have they been implemented in practice? Our overall assessment is as follows (see Annex 4 for further details):

The criteria established by the two Boards to select priority countries are the relevant ones but should be more sharply focused. There is a clear emphasis on maximizing the program's contribution to the strengthening of national and international financial stability by giving priority to systemically important countries (SICs) and those potentially vulnerable to various pressures on the financial system.[2] The Boards also indicated that such countries should be reassessed more frequently. However, the absence of a specific list of "systemically important countries,"[3] and the use of additional priority criteria (e.g., on the need for geographical balance) have blurred this emphasis. In practice, some of the potential trade-offs between these criteria that would otherwise need to be faced have not been pressing because some countries have been reluctant to participate.

Although country selection has largely followed the guidelines set by the two Boards, a significant minority of countries that would appear to be "systemically important" and/or have vulnerable financial systems have not been assessed—because the authorities have not volunteered. We used a number of possible measures of systemic importance and potential vulnerability of financial systems.[4] The results are quite similar whichever measures are used:

[1]The 2003 review called for a typical FSAP to limit the number of standards assessed in detail to three, excluding AML/CFT, compared with a previous average of about five standards per FSAP.

[2]The criteria endorsed by the Board following the 12 pilot cases included a country's (1) systemic importance; (2) external sector weakness and financial vulnerability; (3) features of its exchange rate and monetary policy regime that make its financial system more vulnerable—such as inconsistencies with other macroeconomic policies; (4) likelihood of upcoming major reform programs; and (5) geographical balance among countries. One point to note about these criteria is that they provide little guidance on how (or what type of) financial sector development issues would enter into the priority-setting process. The criteria were refined following the 2003 and 2005 reviews, to take into account the need to accommodate countries' requests for Updates, but the emphasis remained the same. The reviews also clarified that countries undergoing financial crises were not expected to participate in the FSAP—other tools were considered more appropriate to help them deal with their problems.

[3]The review conducted after the initial round of pilot cases defined the notion of SICs as (1) countries whose capital markets intermediate the bulk of global financial transactions; and (2) emerging market economies whose financial systems have the potential to cause, or be subject to, undue volatility in cross-border flows and financial system contagion.

[4]For systemic importance, possible groups could include the G-20; G-7 plus those emerging market countries covered by the EMBI+ index; G-7 plus emerging market countries monitored regularly by the IMF's International Capital Markets Department (ICM); or countries monitored by the BIS in its surveillance work. For potential financial sector vulnerability, we looked at two possi-

Table 2.1. S&P Global Financial System Ratings and FSAP Participation
(Number of countries participating through FY2005)

	Number of Countries Rated	FSAP		No FSAP	
		Systemic[2]	Nonsystemic	Systemic[2]	Nonsystemic
Financial systems[1]					
10–20 percent	1	1	0	0	0
15–30 percent	7	3	1	1	2
25–40 percent	8	3	3	1	1
35–70 percent	17	3	9	5	0
Total	33	10	13	7	3

Sources: S&P Global Financial System Stress, October 2001; and IEO staff.
[1]Ratings are presented in terms of the proportion of credit to the private sector and to nonfinancial state enterprises that could be under stress under the full course of a recession, in percent of total bank credit to these borrowers (i.e., larger percentage implies a weaker rating).
[2]A country is considered to be of systemic importance if it appears at least twice among the four groupings listed in footnote 4 of the text.

- Some 20–25 percent of countries that are of some systemic importance had still not undertaken initial FSAPs after six years of operation of the initiative (FY2000–05). The list includes the United States, China, most of the emerging market countries of Southeast Asia, and the Républica Bolivariana de Venezuela.[5] The gaps are primarily because the authorities of the countries concerned have been reluctant to participate in the exercise. IMF staff emphasized during interviews that the FSAP work plan has been managed sufficiently flexibly to accommodate requests for participation from systemic countries at fairly short notice, if necessary by postponing other cases. Our examination of priority setting in several such cases (e.g., France, the United Kingdom, and, more recently, an FSAP Update now scheduled for Mexico) supports this view.
- About one-third of countries with some significant indicator of potential financial sector vulnerability have not yet undertaken an FSAP. For example, of the 17 emerging market economies tracked by S&P that received a low financial system rating in 2001, 5 had not undertaken an FSAP by June 2005; all of these countries also met several criteria of systemic importance (Table 2.1). Results using internal (MFD) judgments on potential vulnerabilities gave similar conclusions.

A significant proportion of FSAPs for countries of systemic importance and/or with potential financial sector vulnerabilities are becoming dated, even though the Boards have called for these countries to be given priority in Updates.[6] *Consequently, the actual participation of countries receiving FSAP Updates is not in line with the broader objectives of the initiative.* The reluctance of many countries to request FSAP Updates, at least until all of the major economies have participated in the exercise, has been an important factor in this development. For example, of the 11 countries with post-pilot Updates as of June 2005, only 3 (Colombia, Peru, and Hungary) are in at least two of the four groupings of potential SICs discussed earlier. Of the 9 Updates currently planned, 4 (Mexico, Philippines, Poland, and Russia) would meet this criteria. As a result, the proportion of SICs and of countries with some indicator of potential financial sector vulnerability that have never had an FSAP or have one that is at least four years old has been growing (Figure 2.1).[7]

The evaluation found no major evidence that the changes introduced in 2003 to be more selective about the number of issues and financial sector standards assessed in detail have had a negative impact on the quality of the overall vulnerability assessment. However, there are clearly limits to how far selectivity can be taken without losing the broad overview of intersectoral linkages that is one of the

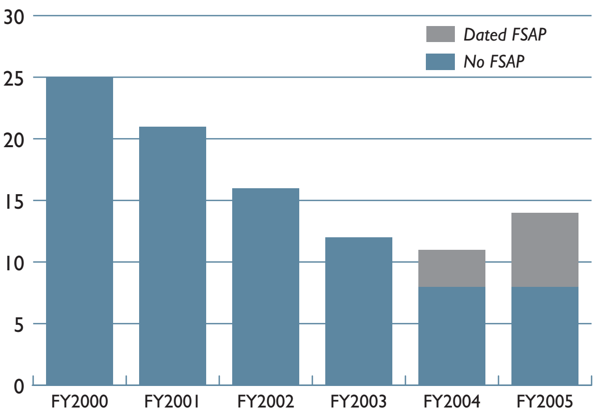
sible indicators: the S&P global financial system ratings and internal (MFD) judgments on potential financial sector vulnerabilities.

[5]This excludes two FSAPs that were suspended due to crisis (Argentina and Uruguay). Several countries of systemic importance have indicated their intention to participate in the FSAP in the near future (e.g., Turkey, Poland (for an Update); the FSAP for Spain began in mid-2005).

[6]The 2005 FSAP review called for the interval between assessments to be shorter for systematically important countries and for countries where there have been significant macroeconomic shocks to the financial system or major reforms.

[7]By comparison, 90 percent of IMF area department mission chiefs surveyed as part of the recent internal review of the standard and codes initiative thought that the shelf-life of standards assessments was four years or less. See Table 14 of "The Standards and Codes Initiative—Is It Effective? And How Can It Be Improved?" (SM/05/252, July 1, 2005).

Figure 2.1. Number of Systemically Important Countries (SICs) with No or a Dated FSAP[1,2]



[1]Definition of SICs is the same as that for Table 2.1 (i.e., meets at least two of the four criteria for systemic importance). Total number of SICs by this definition is 30.

[2]A dated FSAP is an initial assessment or an update that is at least four years old.

key advantages of the FSAP approach. The 2003 review introduced several changes to sharpen the scope of FSAP assessments, including (1) limiting the number of standards for which detailed assessments are undertaken; and (2) tailoring the depth of coverage of topics and analysis to country circumstances while continuing to be comprehensive in areas covered. There is no simple test to judge how well the tailoring of depth of coverage has worked, since it depends critically on individual country circumstances. Within the 25-country sample, there was inadequate coverage of cross-border issues in many cases (see below), but this is a problem that predates the 2003 efforts at streamlining. Beyond this, the only case in this sample where selectivity may have gone too far was the New Zealand FSAP, where senior officials indicated that it would have been useful for the FSAP to take a broader approach by examining payments system and insurance sector standards as well as those of the banking sector. To double check this conclusion, the evaluation team examined all initial FSAPs undertaken since the 2003 review.[8] The results of this assessment suggest that there are some opportunity costs to the streamlining, especially in countries with complex and diversified financial systems (e.g., there was less discussion of macroeconomic linkages with the securities sector than one might have expected in some advanced economy FSSAs), but it is not possible to say that the overall vulnerability assessment has been thereby weakened.

The 2003 streamlining of aspects of the FSAP has generated moderate cost savings for the IMF (and overall), mainly in FSAPs for advanced economies. However, there has been no decline in the average costs of FSAPs in low-income countries, where the IMF continued to contribute the largest share of resources through FY2004. The evaluation undertook a detailed examination of the direct costs of each individual FSAP initial assessment. Different IMF and World Bank budget procedures complicate comparisons, so that any conclusions can only be approximate; however, the exercise suggests the following (see Annex 4 for further details):[9]

- Average direct costs (IMF and World Bank staff, including experts, plus travel) for initial FSAPs have fallen by about 6 percent between pre- and post-2003 cases, with the savings mainly driven by lower costs in advanced economies. Reflecting the latter factor, average costs for the IMF alone have fallen by about 10 percent.
- Since 2003, there has been surprisingly little difference between the average costs of FSAPs for advanced, emerging market, and low-income countries. This reflects the bigger impact of the 2003 streamlining measures on advanced economy FSAPs and the fact that some of the most complex financial systems were assessed prior to 2003.
- Average direct costs of FSAPs undertaken for low-income countries have not declined and are as expensive as those for emerging economies. About 60 percent of these costs are still borne by the IMF.

There is inadequate discussion of the expected scope of the FSAP, including with the authorities, at the terms of reference (TOR) stage. Our reviews of the TOR for the 25-country sample found only a few cases where there was a serious initial discussion of priority setting and strategic trade-offs—although all of these cases were relatively recent, which suggests some improvement over time.[10] Many country au-

[8]The review was of the FSSA only, and covered the following countries: Albania, Austria, Ecuador, France, Kenya, Kuwait, the Netherlands, Norway, Pakistan, and Saudi Arabia.

[9]These figures exclude overhead for both institutions as well as the cost of AML/CFT assessments for the IMF. The average total direct cost of a post-2003 FSAP was $668,000, of which $438,000 was accounted for by the IMF. Applying the same IMF overhead factors used in the internal 2005 review "Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward" (SM/05/67, Supplement 2), the total estimated IMF cost per assessment was $721,000 for post-2003 cases.

[10]Recent good practice examples include Chile (initial FSAP) and Ghana (Update).

thorities said greater consultation at the TOR stage would have made the process more effective; some said they were surprised at a late stage by aspects of the FSAP's scope for their countries. Our interviews with IMF staff suggest that the scope of FSAP Updates is a source of debate between Bank and IMF staff, with Bank staff frequently pressing (successfully) for a larger scope—to address medium-term development issues not taken up in the original FSAPs—whereas the IMF would have preferred smaller Updates focused on a follow-up on core issues from the earlier FSAP.

The assessment of the AML/CFT standard has little integration with other FSAP activities. This view was broadly shared by country officials and FSAP team members. In practice, there was little synergy with other FSAP activities because of the special legal and accounting aspects involved, which required a different type of expertise.[11]

[11]This says nothing about the effectiveness or value added of the AML/CFT assessments, which was not part of the evaluation's terms of reference.

CHAPTER

3 Quality of FSAP Processes and Diagnostic Tools

We discuss here the efficiency of FSAP processes and views on the technical quality of the FSAP teams before going on to discuss various components of the FSAP output—the macroprudential analysis, the standards and codes assessments, and how effectively the various diagnostic elements are integrated into a comprehensive overall assessment with clear and well-prioritized recommendations.

Efficiency of FSAP Inputs and Processes

Our in-depth reviews of 25 cases as well as interviews and surveys of officials and IMF and World Bank staff suggest the following main messages with regard to organizational aspects of the FSAP:

(1) Country authorities generally rated the technical quality of the FSAP teams highly, particularly the expertise of specialists. Both our in-depth interviews with officials and the authorities' survey results (see Figure 3.1) suggest a high degree of satisfaction with FSAP teams' technical skills. A large proportion of officials we interviewed said that they viewed the opportunity to interact with the FSAP technical experts as a major value added from the exercise; indeed, many would have liked to have had more structured arrangements to follow up on specific issues with the experts concerned.

(2) However, insufficient time for the FSAP team to prepare and familiarize with country-specific circumstances was a widespread complaint—noted by many authorities and, to a lesser extent, by the teams themselves. In a number of cases, greater consultation with the authorities at an early stage of the process (i.e., the TOR stage) would have provided guidance on the most relevant expertise.[1] Interviews also suggest some shortcomings in the integration of the FSAP technical expertise with area department country-specific knowledge.

(3) The burden of the FSAP on the authorities is inevitably very high, but could be eased somewhat by better planning. While we have not been able to obtain any specific estimates of the costs the FSAP imposes on the authorities, the resource inputs required have strained the capacity of even well-trained and well-funded supervisory systems, especially when extensive translation of documents into English was required.[2] A large proportion of survey respondents were of the view that the time and data requirements of the exercise were excessive (Figure 3.2). The in-depth examination of the 25 country cases indicated that a large part of these costs were intrinsic to the exercise, and many officials recognized that the extremely intensive data gathering had eventually yielded benefits in terms of better data for macroprudential analysis or greater transparency about a country's financial system and regulatory approaches.[3] Nevertheless, the burden could be significantly eased by (a) better planning and consultation at an early stage to take account of country circumstances, leading to greater selectivity in information requests; (b) greater lead time on questionnaires and data requests; (c) greater personnel continuity from previous financial sector work

[1]For example, in several Eastern European countries looking toward membership of the European Union, cross-country experience on how a number of regulatory issues were dealt with in various EU members was of particular interest. However, some of the technical experts on the FSAP teams, while highly qualified, did not have the appropriate background to provide such information.

[2]For example, in the case of Japan senior officials noted that at some stage in the process about 10 percent of the staff of the Financial Services Agency were involved in the FSAP exercise—at a time when there was strong need to attend to the financial sector's difficulties.

[3]For example, in Korea, senior officials expressed the view that the FSAP had very high data requirements (e.g., on cross-sectoral data for stress-testing analysis of the corporate sector), but these subsequently proved very useful for their continued assessment of the financial sector and exposures to the corporate sector.

and in any follow-up work; and (d) possibly preparing some of the ROSCs in advance of the main FSAP mission.

(4) The choice of FSAP team leaders is critical. The team leader (and deputy) play a crucial role in identifying priorities for the assessment and integrating the results of the various diagnostic instruments into an overall assessment with clear, well-prioritized recommendations. This is an enormously challenging task for which considerable technical expertise and policy judgment is required. Our interviews with some IMF and World Bank senior staff indicate a concern that, as the FSAP becomes more "routine," less-experienced team leaders have begun to be chosen, with a potentially adverse impact on quality (e.g., a tendency to follow a "template" approach without a deep understanding of the situation in each country).

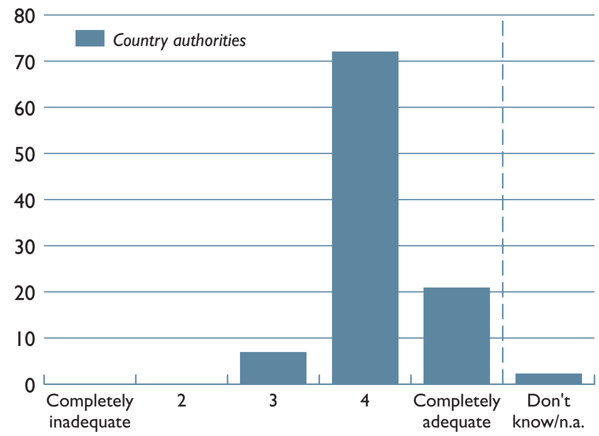
(5) From the IMF's perspective, the preparation of separate documents (the FSSA and the FSA, respectively) for the Board of the IMF and World Bank appears to have helped minimize delays and the burden of tailoring the FSAP results to different institutional needs. However, the FSSA is better anchored in IMF processes (Article IV) than the FSA is in those of the Bank (see IEG report) and FSSA reports are produced with a significantly shorter time lag than the FSAs.[4] A number of IMF staff emphasized that anchoring the FSSA in the Article IV surveillance process had imposed a clear timetable that had helped to avoid excessively drawn out discussions on details—both with the authorities and among the FSAP team.

Macroprudential Risk Analysis

A message from our interviews, reinforced by the survey results, is that in many, but not all, countries the FSAP has contributed significantly to assessing financial sector vulnerabilities—by helping to change the culture toward one that emphasizes system-wide risk assessments and, in many cases, upgrading methodologies. Within this overall positive experience, however, there are significant differences across countries, and several shortcomings need to be addressed.

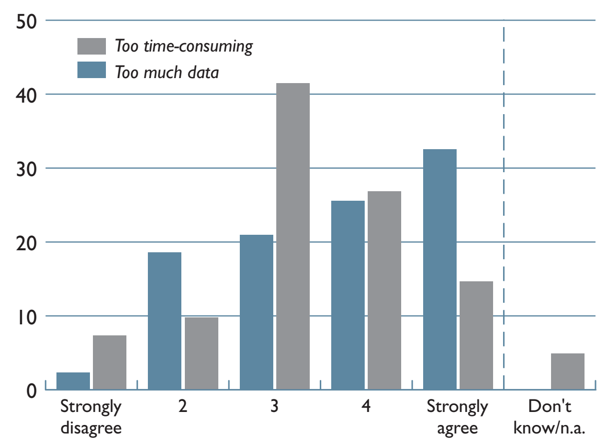
[4]The average time lag between the date of the first FSAP mission and circulation of the FSSA is just under 40 weeks; for FSAs, the average time lag is about 58 weeks; no FSAs for FSAP Updates had been completed as of end-August 2005.

Figure 3.1. Country Authorities' Assessment of FSAP Team's Technical Skills
(In percent)



Source: Q6 of the survey of country authorities.

Figure 3.2. Country Authorities' Views on the FSAP Process
(In percent)



Source: Q7.1 and Q7.3 of the survey of country authorities.

The two main diagnostic tools used in FSAPs for analyzing macroprudential risks of financial systems are, first, stress testing how different measures of financial strength (e.g., capital adequacy and profitability) would respond to a variety of shocks and, second, analyzing trends in various financial soundness indicators (FSIs). The principal conclusions are as follows (see Annex 5 for more details):

(1) The use of methodologies for stress testing at the level of the overall financial sector is still

Box 3.1. Good Practices on Stress Testing

Stress testing is a method for quantifying the impact of future extreme but plausible shocks on a financial system. The degree of sophistication of approaches used varies substantially across FSAPs, depending in large part on data availability, sophistication of the financial system, cooperation from the authorities, time available for the analysis, and the judgment of the FSAP team. We summarize here a number of "good practice" approaches to different aspects of such tests, drawn from the 25-country example (see Annex 5 for further details).[1]

Data quality. The quality of data, and its implications, for any results should be described candidly; many FSAPs are weak in this respect (Cameroon is a "good practice" exception). There are some cases where the available data are of poor quality and where vulnerabilities are fairly obvious. Not conducting stress testing should always be an alternative in such cases, as otherwise there is a high risk of spuriously concrete results that mask an unknown situation (e.g., the Costa Rica FSAP appropriately did not undertake any formal stress tests).

Scenarios and events. Most stress tests have included single factor sensitivity analysis. The most recent vintages (e.g., Jordan and New Zealand and many European countries) have also included the use of scenarios that involve simultaneous movement in various macro risk factors. This is a positive trend, as such scenarios could help analyze better the vulnerabilities of the financial system

Calibration of shocks. The challenge is to be able to have a common understanding for what can be considered exceptional but plausible shocks. Where feasible, the calibration techniques could use models to characterize the relationships among macro risk factors in the context of different scenarios and/or cases in which single variables are shocked (by using statistical or historical approaches). For example, some recent FSAPs (Germany and Chile) have derived a consistent set of shocks to macro variables from a macro model.

Methodologies. While it is often necessary to tailor an FSAP stress test to data availability and the sophistication of the financial system, it would be useful to form "country peer groups" based on some criteria related to the complexity and sophistication of a financial system. Standardizing a core set of data sets, methodologies and sensitivity analysis within the peer group could lead to the development of common benchmarks for cross-country comparisons, thus facilitating vulnerability analyses. For example, for the group of industrial countries, stress testing should aim to move toward a common good practices set of methodologies.

Interpretation of the results. More attention needs to be given to the interpretation of stress test results, not only in light of the methodological caveats but also in terms of the relative importance of different shocks (e.g., avoid overemphasizing market risks when credit risks are more relevant from a vulnerability perspective). This is an area where many FSAPs are weak, but Korea and Cameroon are "good practice" examples.

[1]Mention of a country's FSAP with regard to one aspect does not necessarily mean it was "good practice" in other respects.

in its infancy. The degree of sophistication of approaches used varies substantially across FSAPs, depending in large part on data availability, cooperation with the authorities, time available for the analysis, and the judgment of the FSAP team (see Box 3.1 for some "good practice" characteristics encountered in the country reviews). But even with relatively "sophisticated" approaches, the results obtained can depend critically on how various shocks are calibrated and feedback effects modeled. In practice, data and other limitations constrained the use of stress testing to fairly basic approaches. For example, in almost half of the 25 cases examined in depth, the principal methodology for analyzing credit risk of the banking sector was based on a simple static exercise that assumed (relatively arbitrary) increases in levels of banks' nonperforming loans together with assumptions on different provisioning levels. Even rudimentary tests can add value, especially when undertaken in conjunction with other analysis, but the limitations of such approaches need to be clearly flagged.

(2) The reporting of results in most FSAPs tends to downplay these limitations and often reports the bottom line results from stress testing as if from a "black box" exercise. This often results in overly simplistic messages about the strength of the financial sector. Greater "health warnings" about the interpretation of results are needed, especially when the quality of the data is weak.

(3) There is a considerable gap between the "good practice" approaches to modeling shocks and those used in many other cases. A number of recent FSAPs (including many for European countries, but also Chile) have generated a consistent series of shocks to specific macro variables derived from a macro model.

Table 3.1. Results of the IEO Assessments of FSAP Content[1]

Criteria	Mean Score (On scale of 1–4)	Percentage of Ratings Indicating Some Problems (I.e., ratings of 3 or 4)
Extent of incorporation of regional and global risks into analysis	1.84	28
Balance of development and stability issues	1.88	16
Integration of standards and codes in overall assessment	1.84	20
Coverage of overall financial sector[2]	2.00	20
Clarity and candor of findings	1.88	12
Importance and consequence well explained	1.94	20
Clarity of recommendations	1.82	8
Usability of recommendations (e.g., specificity)	1.96	16
Prioritization of recommendations	2.46	44
Degree of alignment of FSAP and FSSA[3]	1.42	0

[1]IEO assessors rated each of the FSAPs for 25 countries in depth with respect to the above criteria. Each aspect was rated on a four-point scale (with 1 being the highest). To minimize subjective judgments, the evaluations were guided by a detailed template of what would be expected to achieve specific ratings for each category (see Annex 3).

[2]This refers to structure, trends, and links to other sectors.

[3]Refers to extent to which key messages are candidly reflected in both publications.

In other cases, a series of shocks to particular variables have been aggregated but without being derived from a clearly defined, consistent macroeconomic model.[5] Stress tests are supposed to analyze "exceptional but plausible" scenarios of shocks, but in only about half of the cases we examined was there an attempt to provide a clear rationale for the size and composition of the shocks chosen.

(4) Some assessments have avoided analyzing the consequences of politically sensitive shocks (e.g., public debt defaults). While there is an understandable tendency not to rock the boat by focusing on such major potential adverse events, the result could be reassuring statements in the FSAP that the financial system is robust to a variety of milder shocks, leaving it to each observer to read between lines with regard to the larger shocks. This could lead to potentially misleading signals. One possible alternative could be to adopt an approach where certain types of shock are considered in certain situations—for example, when the consequences for bank balance sheets of specific downgrades in sovereign public debt are to be analyzed—but without creating uniform sets of shocks that preclude adaptation to particular country circumstances.[6]

(5) There is still insufficient attention in many FSAPs to global and regional linkages, including for countries with substantial international capital market links. The evaluation's rating on incorporation of global and regional risks shows that consideration of these risks for the 25 country cases has fallen short of good practice in a significant proportion of cases (e.g., about one-third of cases were assessed as having some problems in this respect; see Table 3.1). Moreover, the evaluation's average internal rating in this respect was even lower (2.2 on the four-point scale) for those countries judged to be of global or regional systemic importance. The evaluation found generally little analysis of cross-border linkages capable of spillover effects even in some countries with global systemic importance (e.g., Japan and Russia). Also, the Ireland and Singapore FSAPs focus their analysis on the vulnerabilities of local banks or the foreign banks that have domestic operations. They make reference to the linkages of do-

[5]In the case of Japan, problems associated with weak domestic "ownership" of the exercise also limited its usefulness. Agreement could not be reached on the nature of the tests to be undertaken and the authorities eventually asked that the data they had provided not be used. The FSAP team undertook at a late stage a number of tests using more limited data available from published balance sheets of banks.

[6]For example, one approach could be to include in the group of shocks "tested" the impact on interest risk premiums from a downgrade in public debt by a prespecified number of grades whenever the initial credit rating is below a particular threshold. This suggestion would be consistent with the Basel II capital standards methodology, which proposes a system of risk weightings (at least for foreign-currency-denominated debt) based on the sovereign's credit rating.

mestic banks with the international financial centers but do not analyze the risks of these centers in any detail, as it is assumed they do not belong to any country in particular.[7]

(6) FSIs have generally not yet been used in a meaningful manner in most assessments (reflecting problems with data and interpretation of appropriate benchmarks for signaling vulnerability as well as inadequate time series). Although most FSAP reports include tables on FSIs, in only half of the 25 cases examined in depth did the reports provide some interpretation in terms of the risk implications of the figures. Since sector-wide averages may mask concerns with specific groups, for analyzing potential vulnerabilities aggregate indicators frequently need to be complemented by indicators for key peer groups within the banking sector (i.e., state banks, foreign banks, local private banks). More generally, interviews with area department staff indicated that many felt they lacked the necessary training and experience to interpret FSIs and integrate the analysis into ongoing surveillance work, even when the data were available on a consistent basis.

(7) The quality of the data on the financial system is often not emphasized sufficiently. In some countries, more caution is needed before using available statistical data at face value, either for stress testing or other analysis.

Standards and Codes Assessments

The evaluation reviewed only assessments of standards and codes prepared as part of FSAP exercises.[8] Drawing on the 25 in-depth case reviews, interviews with country officials, and IMF and World Bank staff, as well as the survey results, the principal conclusions are as follows:

(1) There is no evidence that the streamlining of the number of standards assessed in detail has created problems for the ability of FSAPs to make overall judgments on financial sector vulnerabilities, but the rationale for which standards to assess is not discussed sufficiently. A "scoping exercise" is first conducted to identify the set of standards to be assessed in each FSAP, but in the cases we reviewed there was often limited discussion in the TOR or the subsequent FSAP reports of why choices are made (e.g., why insurance or securities standards were covered in some low-income countries where the sector was very small in relation to GDP or why payments system standards were or were not covered). However, the evaluation did not identify any cases where omission of a detailed standards assessment had contributed to significant shortcomings in the overall assessment of potential vulnerabilities. The review of all post-2003 FSAP cases confirmed these conclusions.

(2) While the assessments generally distinguish between de jure standards and de facto implementation, the significance of institutional weaknesses is often not emphasized sufficiently. In most of the 25-country sample, assessors did take account of differences between de jure laws and regulations and de facto implementation. Indeed, the assessment methodologies to some degree require making this distinction—that is, they require interpretation of compliance and evidence of enforcement or nonenforcement of various principles.[9] However, while many FSAP reports do discuss problems in forbearance in regulations or low enforcement capabilities, it is sometimes difficult to read between the lines to judge the severity of the potential macroeconomic significance of such shortcomings (e.g., Dominican Republic, Sri Lanka, Tunisia). One "good practice" example where enforcement issues are explicitly linked to the vulnerability analysis is the Ghana FSAP.

(3) Integration of the various standards assessments into an overall FSAP assessment does seem to have added value, but the degree of integration varied from case to case. The review of the 25 country cases suggests that incorporation of the standards assessments into

[7]One "good practice" exception where cross-border links were explicitly incorporated is the New Zealand FSAP; in light of the substantial role of Australian-owned banks in New Zealand, the mission discussed the performance of these banks with Australian regulatory authorities.

[8]See Annex 11, Table A11.3 for a full list of the various standards and codes. Those most often covered in FSAPs are the Basel Committee's Core Principles for Effective Banking Supervision (BCP), International Association of Insurance Supervisors (IAIS), International Organization of Securities Commissions (IOSCO), and Committee on Payments and Settlement Systems (CPSS), which were the main focus of the evaluation; the banking supervision standards were assessed in all FSAPs. For a discussion of other standards and codes, see "The Standards and Codes Initiative—Is it Effective? And How Can it Be Improved?" (SM/05/252, July 1, 2005). As noted earlier, assessment of the AML/CFT standard was not part of the terms of reference of this evaluation.

[9]See, for example, the Basel Core Principles methodology (available at www.bis.org).

a broader discussion of financial sector vulnerability and development issues did add value in many cases, especially for the banking sector standards.[10] In some cases, however, a "head count" approach to listing performance vis-à-vis various principles was not accompanied by a sufficiently integrated discussion of the potential impact of various identified shortcomings (e.g., in the Egypt, Philippines, and Romania FSAPs).

(4) A number of officials noted that an excessive focus on the "number" of principles for which a country was fully or largely compliant could give a misleading signal on the potential downside consequences of remaining gaps.[11] Interviews with staff and authorities indicate that there were often greater disagreements on the ratings than on the underlying qualitative assessment. In its recent review of the Standards and Codes Initiative, the IMF Executive Board endorsed a number of changes to the presentation of ROSC findings, including a principle-by-principle summary of the observance of each standard and an executive summary providing a clear assessment of the overall degree of observance of the standard, while avoiding a rating or "pass or fail" report.[12] While it is too early to judge the effect of such changes, this evaluation reinforces the view that the overall qualitative assessment and identification of key remaining gaps are the most critical elements and that the exercise should not be condensed solely to one of ratings, even if that is the aspect that market participants indicate that they value the most (see below).

(5) The governance structure for assessing standards is a little vague, but present arrangements for providing feedback work satisfactorily in practice. The issue is—"who assesses the assessors?" In principle, this is the responsibility of the IMF and World Bank Boards for those standards assessed under the FSAP. In practice, members of the Board are not in a position (e.g., they are not provided with the necessary information) to make such judgments. The various standard-setting bodies, and their secretariats, do have the appropriate background but do not have governance responsibility for assessing whether the assessment exercises are proceeding satisfactorily; indeed, they do not even see those FSSAs that countries do not agree to publish. Nevertheless, discussions with the various standard-setting groups suggest that, in practice, there are sufficient informal and formal channels (including the Financial Sector Forum and IMF–World Bank staff participation in various technical committees) for adequate feedback to be provided on how assessments are being conducted. Our interviews with the various secretariats suggest a high degree of satisfaction with the results (see below).

[10]This conclusion is supported by the survey of IMF surveillance mission chiefs conducted as part of the internal review of the Standards and Codes Initiative. A high proportion of mission chiefs—especially for emerging market and developing countries—were of the view that the standards assessments had added value to the usefulness of the FSAP for surveillance. See "The Standards and Codes Initiative," *op. cit.*, Background Paper (SM/05/252, Supplement 1), Table 15. See also the assessment of the overall FSAP content in the next section below.

[11]To give only one example, senior Egyptian officials noted that their efforts to strengthen further the supervisory framework initially encountered an internal reaction from many supervisory staff that the high proportion of "compliant" ratings under the BCP assessment meant that there was no need for substantial additional efforts.

[12]See "The Acting Chair's Summing Up: The Standards and Codes Initiative—Is It Effective? And How Can It be Improved?" (Buff/05/125, July 25, 2005).

CHAPTER 4

FSAP Content

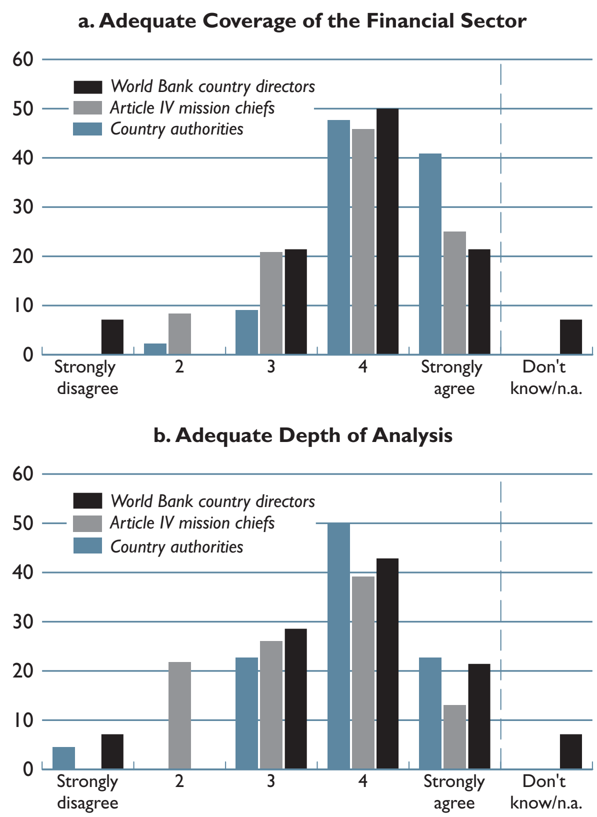
In judging the overall quality of the FSAP content, we relied upon two major sources of evidence. First, IEO assessors rated the content of the FSAPs for the 25 country cases on a four-point scale according to various criteria: coverage and balance of assessments; clarity and candor of findings; as well as clarity, usability, and prioritization of recommendations (see Table 3.1). These ratings on individual components were also used as inputs into an overall qualitative judgment on how well the FSAP assessment was integrated across the various sectors and with the overall macroeconomic picture. A high-quality overall assessment is one that combines effectively the results from the various evaluation tools to present the main risks and vulnerabilities to the financial sector—that is, those of macroeconomic or systemic significance—with an indication of criticality and consequence. Second, the surveys of various groups of stakeholders included questions on various aspects of the quality of FSAPs. We discuss first the overall quality of the FSAP assessment and then the articulation of findings and recommendations. Finally, some issues related to the "joint" IMF–World Bank nature of the FSAP are addressed.

Overall Quality

The overall quality of the FSAP assessments is high, although problems were encountered in a minority of cases. The evaluation of the 25 countries reviewed shows, for example, good ratings for the overall financial sector coverage, the clarity and candor of findings, and the explanation of importance and consequence but with low ratings for a proportion of cases (typically about 10–20 percent) (see Table 3.1). The survey of the authorities supports these conclusions, indicating a strong satisfaction with the adequacy of coverage and depth of analysis. Survey results for Article IV mission chiefs tend to agree with those views, but a larger share indicated some dissatisfaction with the results; in particular, about one-fifth of mission chiefs indicated dissatisfaction with the depth of analysis in FSAPs (see Figures 4.1a and 4.1b).

The integrated approach to financial sector assessment does offer considerable advantages, which have been utilized in many but not all cases. Such a "comprehensive" approach combines a vari-

Figure 4.1. Coverage and Depth of Analysis of Financial Sector
(In percent)



Sources: Q5.1 and Q5.2 of the survey of country authorities; Q7.1 and Q7.2 of the survey of Article IV mission chiefs; and Q7.1 and Q7.2 of the survey of World Bank country directors.

Box 4.1. The Comprehensive Approach of the FSAP: Country Examples

A key potential value added of the FSAP is that it takes a comprehensive approach, which is expected to result in an overall assessment that permits a greater understanding of the financial sector than would be possible through the separate assessment of specific components.

The FSAP is supposed to be comprehensive in several respects: the type of assessment instruments it applies (stress testing, FSI, ROSCs, etc.); the coverage of the financial system (banking, insurance, securities markets, payments systems, etc.); the analysis of interplays between macroeconomic and financial sector trends and policies; and in the identification of interactions with other economic sectors. This integrated approach is expected to strengthen the ability to recognize and analyze sectoral and macroeconomic linkages. Understanding these linkages in turn permits a fuller comprehension of risk and vulnerabilities, and the identification of potential policy options, complementarities and sequencing/prioritization needs.

While none of the 25 country cases examined in depth was "best practice" in all respects, there are many examples where the integrated approach has yielded results. Without trying to be exhaustive, the following examples can be mentioned:

- Cases in which macro/stability issues have a clear linkage with the financial sector. The case of Japan shows an FSAP where findings are embedded into a four-pillar macroeconomic framework (broader and faster financial reforms, accelerated corporate restructuring, more aggressive monetary policy, and medium-term fiscal consolidation). Linkages and synergies of reforms are presented as part of the overall assessment, for example, on the need to address jointly corporate and banking reforms, and in highlighting the adverse effects of protracted low nominal interest rate on incentives to restructure bank portfolios.
- Cases in which the interlinkages among different markets are clearly analyzed. For example, the Chile FSAP identifies that pension funds' investment limits are creating scope for pension funds to provide a stable source of funding to the banking system. Similarly, the FSAP for Kazakhstan identified the connection between weak banking supervision and a structure of ownership linked to de facto conglomerates owned by some government officials that took control of recently privatized public enterprises.
- Cases in which the comprehensive analysis provides the elements for the design of a coherent program of structural reforms. For example, in the case of Mexico, the FSAP provides a comprehensive sequencing of necessary reforms in the capital market, including corporate government, institutional developments and banks' crisis resolution mechanisms.
- Cases in which incipient deepening of financial segments with inadequate regulatory and supervisory frameworks can have potential stability implications. The cases of Costa Rica and India highlight the challenges involved in countries where the financial system is evolving from one with a pervasive and commanding presence of the public sector to one where private sector participation takes a more prominent role. The challenges are partly associated with the need to sequence appropriately changes in organization and incentives in the financial sector with the necessary transformation of the regulatory framework.

ety of assessment instruments, coverage of the overall financial sector, and an analysis of the interaction between key macroeconomic risks and the financial sector in a manner that the sum is greater than the individual analytical components. A qualitative assessment of the 25 case studies suggests that in about 60 percent of the cases, this overall integration has been handled well (see Box 4.1 for examples). In about 20 percent of cases, the quality of the integrated assessment is broadly adequate but some gaps could have been filled by a better integration of the various components (e.g., in the case of Egypt's FSAP, important qualitative findings in the BCP assessment as well as data limitations impairing the analysis should have figured more prominently in the assessment). Finally, in about 20 percent of the cases, there are significant gaps in the overall assessment. For example, the Philippines FSAP does not make sufficiently clear the extent of weaknesses found in the banking sector nor their potential macroeconomic or systemic consequences, and there is no meaningful stress testing of the implications of key macroeconomic risks that were being actively discussed in surveillance reports.

Analysis and integration of financial cross-border issues generally received limited attention. FSAP stability assessments have generally been limited to the segments and risks of the financial system that have domestic implications, even when some external/macro risks were considered for the stress testing analysis (e.g., the focus on the domestic consequences alone was especially notable in the Singapore FSAP). As noted above, FSAPs in countries with extensive financial sector cross-border activities have generally made limited inroad into the broader global and regional dimensions of those cases with limited contribution to identifying and highlighting potential spillover channels and effects.[1]

In a minority of cases, the overall assessment does not give a clear indication of the macroeconomic or systemic importance of vulnerabilities and potential consequences if key problems are not addressed. The review of the 25 cases indicates that in about one-fifth of FSAPs there were significant shortfalls in the explanation of systemic importance and consequence of findings (see Table 3.1). These mainly comprised cases where there was insufficient analysis of the criticality or urgency of vulnerabilities, the potential linkages and spillover effects to other segments of the financial system or corporate sector, and the macroeconomic impact and potential policy implications. Although it is not possible to assess statistical significance with our sample size, later vintages of FSAPs appear to have improved on the reporting of macroeconomic or systemic importance and consequence of findings.

The effectiveness with which FSAPs addressed both stability and development issues in an integrated manner varied substantially and appears to have depended in part on the nature of the development issue. While overall judgments by IEO assessors on the balance between stability and development issues in the 25-country sample were generally quite favorable (see Table 3.1), FSAPs were more successful in handling some types of development issues than others. When the issue was one of reforming existing financial systems to promote growth, there tended to be a close association between the development and stability aspects and FSAPs often handled these issues well. For example, recommendations on shifting from a public-sector-dominated banking system and a relatively closed capital market—in, say, India or Costa Rica—were primarily motivated by the goal of faster growth and development, but FSAPs rightly noted that managing the transition in a manner consistent with financial stability would require a carefully sequenced approach, including a strengthened supervisory framework. However, when it was a question of promoting the development of largely nonexistent financial sectors, or encouraging the provision of financial services to underserved or excluded groups, the integration between the two aspects was generally handled less well. Indeed, whether the FSAP is the best vehicle to address such types of development challenges remains an issue (examples where the integration of such issues was not handled well include South Africa, discussed further below, and Kazakhstan).[2]

Articulation of Findings and Recommendations

The main findings of the FSAP were generally presented in a reasonably candid manner (in both the FSAP aide-mémoire and the more widely circulated FSSA), although often couched in cautious language. The detailed reviews of the 25 country cases and the broader survey results both indicate a relatively high rating on this category (see Table 3.1). However, in the view of the IEO assessors, the language used was often very cautious and a franker presentation of key messages would have been useful. Officials of the various standard-setting organizations made a similar point, stressing that they found the overall messages of FSSAs highly informative but often couched in overly technical and oblique language (which some commentators referred to as "Fundese").

In most cases, the main recommendations were clear and well linked to the findings (see Table 3.1 and Figures 4.2a and 4.2b).

There were significant shortcomings in the prioritization of recommendations in many cases. The ratings of IEO assessors for the 25 in-depth cases show problems with prioritization in over 40 percent of cases (see Table 3.1). Similarly, only half of Article IV mission chiefs think that FSAP recommendations for their countries were well prioritized (Figure 4.3); as will be discussed in the next section, this factor appears to have had a significant influence on the effectiveness of subsequent follow-up on financial sector issues in IMF surveillance. Difficulties with prioritization were more of an issue in countries where the FSAP assessment suggested the need for an extensive financial sector reform agenda (e.g., Ghana, Kazakhstan, Philippines), but it is precisely in those cases that effective prioritization is most important. Some, but not all, later vintages of FSAPs appear to have improved on the prioritization of recommendations. One recent "good practice" example of effective prioritization is the FSAP Update for Armenia (April 2005).

While there was no major loss in candor across earlier stages of the FSAP process, candor was sometimes lost at the critically important stage of integration with Article IV surveillance reports. The detailed

[1]Part of the work on financial cross-border issues is expected to take place in the context of regional FSAP exercises, especially for cases involving currency unions. A regional FSAP has recently been conducted for the Eastern Caribbean Currency Union countries, while similar exercises are planned or being discussed for some African and European countries. Given the very recent nature of the experience with regional FSAP exercises it is too early to assess their results.

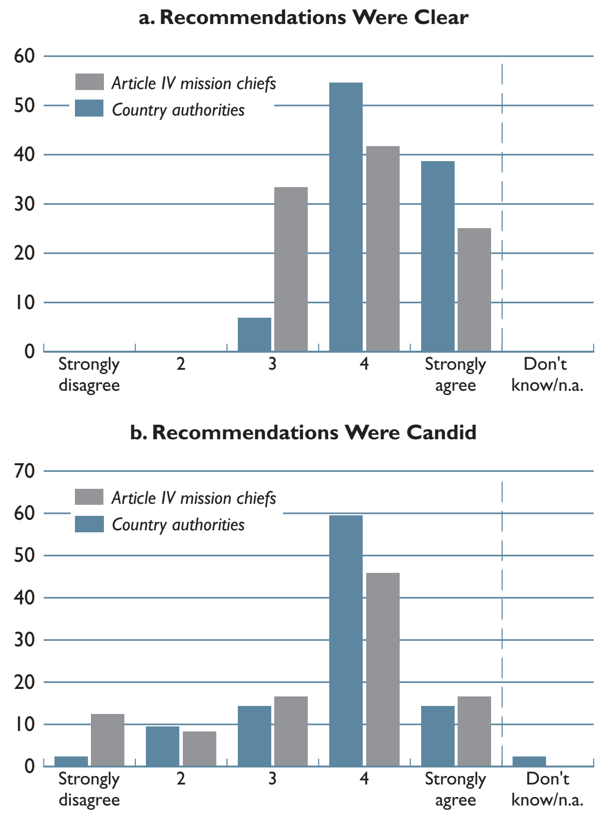
[2]The forthcoming IEG report discusses further the effectiveness of FSAPs in assessing financial sector development issues.

review of documents produced at different stages of the FSAP process in the 25-country sample suggests that there was no significant loss of candor in the messages between the FSAP aide-mémoire and the FSSA. Moreover, there did not seem to be any significant difference in the level of candor between published and unpublished FSSAs. The informal presentations made to the authorities at the end of FSAP missions (PowerPoint presentations, etc.) that we were able to review were generally blunter, with more market-sensitive information, than any of the written assessments. This approach seems appropriate.

There was, however, a "loss in translation" in a number of cases between the messages of the FSSA and those incorporated in the staff reports for Article IV surveillance. This is critically important: as will be discussed further in the next section, when this happened the Board discussion tended to focus on the issues discussed in the Article IV report, crowding out problems that were flagged only in the FSSA, even though the latter report was also available to the Board. The following factors appear to have influenced how well key FSSA messages were integrated into the Article IV report:

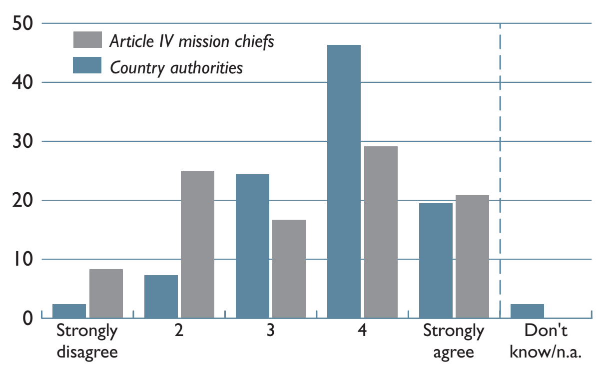
- *Degree of country ownership.* In those cases where the authorities viewed the FSAP exercise as an opportunity to provide an independent judgment on weaknesses in financial sector policies and institutions and to catalyze reform plans, there tended to be a strong coincidence of interests in having the FSAP messages forcefully emphasized in the Article IV dialogue and staff reports (e.g., Costa Rica, Chile, and Mexico). However, when the authorities disagreed with key conclusions of the FSAP team, presentation of these conclusions in surveillance reports was often much more muted. The strongest example of this among our case studies was the Dominican Republic, which reflected, in part, a failure of the internal review process to ensure that surveillance reports reflected the key FSAP messages (see Box 4.2). Survey results support the conclusion on the importance of country ownership and suggest that a desire to avoid sending adverse signals was also important (see Figure 4.4).
- *Degree of integration between the work of FSAP and area department teams.* Weak country ownership of FSAP conclusions did not result in a loss of candor when there was close agreement between the diagnoses of the FSAP and area department teams. For example, the authorities in Japan and, to some extent, Germany did not agree with some important messages in their respective FSSAs, but surveillance reports reiterated these messages cogently.

Figure 4.2. Views on Whether Recommendations Were Clear and Candid
(In percent)



Sources: Q9.1 and Q9.2 of the survey of country authorities; and Q11.1 and Q11.2 of the survey of Article IV mission chiefs.

Figure 4.3. Views on Whether Recommendations Were Prioritized
(In percent)



Sources: Q9.3 of the survey of country authorities and Q11.3 of the survey of Article IV mission chiefs.

Box 4.2. Dominican Republic: The FSAP and the Subsequent Financial Crisis

The Dominican Republic provides an important example of the limitations of the FSAP process since a major financial crisis occurred shortly after the FSAP exercise was completed.[1] This raises questions about how effectively the FSAP diagnosed the vulnerabilities that led to the crisis and about how the IMF used the results.

The FSAP was undertaken in 2001–02, and the FSSA was discussed by the IMF Board in June 2002. In early 2003, a run on one of the largest banks—Banco Intercontinental (Baninter)—occurred, triggered by the discovery of massive fraud. The central bank initially provided substantial liquidity support but eventually intervened the bank, removing existing shareholders and management. Similar problems related to accounting malpractices and mismanagement surfaced in two other banks. These events cumulated into a major financial sector crisis, with an eventual cost estimated at between 14 percent and 17 percent of GDP.

The evaluation, drawing on a detailed review of IMF internal documents and extensive interviews, reached the following conclusions:

- The FSAP did not detect the immediate cause of the crisis, which involved the keeping of two sets of accounts by the banks involved. But FSAP exercises cannot be expected to detect accounting fraud, and are not a substitute for effective national audit and supervisory practices.
- The FSAP did diagnose severe and widespread vulnerabilities in the Dominican banking system, including an undercapitalized banking system, inadequate provisioning, overall weak compliance with BCP standards, and weak institutional capacity and judicial enforcement. Despite pressures from the then-government (which disagreed with the severity of the assessment), and the IMF area department (which recognized there were problems but thought the overall judgment too harsh in light of the Dominican Republic's then-favorable economic performance), the FSSA presented to the IMF Board conveyed this assessment quite candidly (although some of the language was toned down from the aide-mémoire and, especially, from the initial PowerPoint presentation to the authorities by the FSAP team).
- The 2002 Article IV surveillance report failed to reflect the major warning signs flagged in the FSSA. It confined itself to an acknowledgement that the authorities were in agreement with the key findings of the FSAP (a statement that papered over many substantial disagreements). The staff appraisal referred to progress in reforming the financial system, without giving an indication of the huge challenges and dangers involved.
- The June 2002 Board discussion (of both the Article IV reports and the FSSA) largely followed the emphasis given in the Article IV staff report and did not focus much on financial sector issues.[2] The FSAP deputy team leader was asked only a few technical questions at the Board meeting.[3]
- Thus, while the FSAP exercise was broadly successful in diagnosing many of the problems of the banking system (if not the extent of balance sheet problems hidden by accounting fraud), the surveillance process failed to utilize the assessment effectively. While the authorities began to implement some FSAP recommendations (such as adapting a new Monetary and Financial Law) with assistance from the Monetary and Financial Systems Department (MFD), the FSAP had little overall impact on the subsequent outbreak of the crisis. It is not possible to say whether a more effective integration of the FSAP with surveillance would have increased its impact, especially since the then-government had little ownership of the key messages and it was probably by then already too late to avoid the balance sheet problems at the heart of the crisis.

[1]A detailed discussion of the crisis is provided in the 2003 Article IV staff report.

[2]The subsequent Public Information Notice (PIN) spoke of the importance of "further strengthening the banking system" and said the Board "was encouraged by the progress made in reforming the legal and regulatory framework. . . ." Since the FSSA was not published, the PIN represented the only public signal with regard to IMF surveillance of the financial sector and did not convey an adequate sense of the existing vulnerabilities.

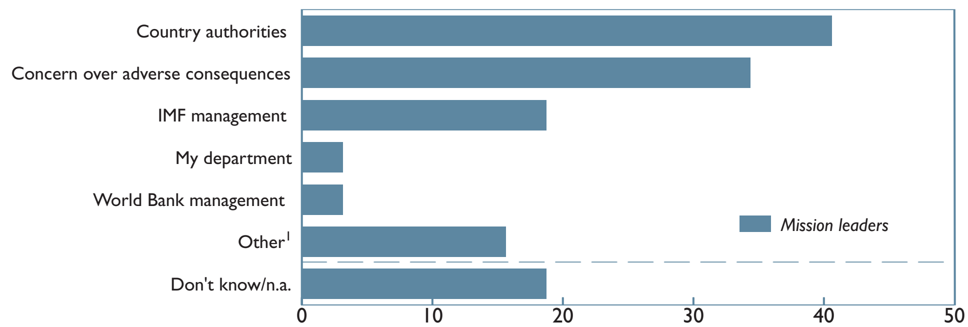
[3]The FSAP team leader was from the World Bank and the deputy team leader from the IMF.

The review of FSAP Updates broadly confirms the findings on initial assessments (see Box 4.3). Updates use the standard toolkit, and similar drawbacks in implementation are encountered. The articulation of findings and recommendations still presents weakness in prioritization, and integration into Article IV surveillance pertains more to reporting than expanding the overall macroeconomic assessment.

The Contribution of the "Joint" (IMF–World Bank) Nature of the FSAP

The principal rationales for making the FSAP a joint IMF–World Bank initiative were that, in light of the overlapping mandates of the two institutions on financial sector issues and the scarcity of techni-

Figure 4.4. Reasons for Noncandid FSAP Recommendations
(In percent)



Source: Q10 of the survey of FSAP mission leaders.
[1]Includes pressure from specific departments or individuals within the IMF or the World Bank.

cal expertise, considerable potential synergies could be attained by addressing stability and development aspects in a comprehensive manner and that combining the respective expertise of the two institutions would produce a more integrated analysis and set of recommendations. It was expected that these gains would outweigh any additional costs of coordination. The evaluation assessed whether these potential synergies are being achieved in practice. The primary focus is on the implications of the joint initiative for the IMF, but we also draw upon the conclusions of the parallel IEG evaluation.[3]

Organizing joint teams that include both IMF and World Bank staff members (as well as outside experts) has contributed significantly to the depth of analytical expertise and credibility of the findings in many, but not all, cases. Positive examples such as Chile, Costa Rica, India, Mexico, Russia, and Romania reflect cases in which the two staffs either contributed specific expertise not available in the other institution (e.g., World Bank staff often contributed substantial expertise on nonbank financial institutions, including insurance, and on corporate governance) or where the World Bank staff contributed in-depth country knowledge gained in the context of other sectoral or loan negotiation activities. Indeed, these examples of positive synergies were not limited to cases where "development" issues received a major emphasis in the FSAP but were also present in a number of cases where the focus was almost exclusively on stability issues, including the strength of the supervisory system (e.g., Dominican Republic, Jordan, and Slovenia).

Discussion of the relative weight to be given to stability and development issues was generally inadequate in earlier cases but there have been some improvements over time, both in the TOR initiating each FSAP exercise and in the FSAP aide-mémoire and FSSAs. This trend reflects the increasing emphasis on streamlining and prioritization following the 2003 review. Clear understandings with the authorities on priorities are critical. For example, the South African authorities wanted their FSAP to focus on an assessment of financial sector stability and the strength of the supervisory framework. Although financial development—especially how to expand the provision of financial services to the half of the population with little or no access—was a key policy issue, the authorities did not regard the FSAP as the most appropriate instrument for addressing such matters. Partly as a result, the sections of the report dealing with these issues were piecemeal add-ons and judged to be of limited value added by both the World Bank–IMF staff and the authorities. In contrast, a good example of well-explained—and appropriate—prioritization is Ghana. The initial FSAP (2001) focused primarily on stability issues because there were pressing issues to be addressed. The subsequent FSAP Update (in 2003) focused primarily on a strategy for financial sector development. In both cases, these priorities were agreed with the authorities. However, such examples are still the exception rather than the rule in the FSAPs for developing countries.

In contrast to the more comprehensive use of various indicators and assessment tools for financial sector stability, most FSAPs still present a more limited analysis of financial development issues includ-

[3]The results discussed here draw on the case studies for developing countries only. However, many of the FSAPs for industrial countries also address longer-term structural aspects and their implications for the stability and efficiency of the financial system (e.g., Germany and Japan).

Box 4.3. Assessment of FSAP Updates

Each of the 11 FSAP Updates completed in the post-pilot phase as of June 2005 was reviewed following a streamlined template based on the one used for the in-depth 25-country sample.[1] The key messages from this review were as follows:

- While the scope of the various Updates has been implemented flexibly, in line with the Board's guidance—from a comprehensive reassessment involving a 16-person team in Colombia to a narrowly focused review of a few issues, involving a 2-person team, in Iceland—there continues to be only limited discussion of the rationale for the scope of Updates. (As noted earlier, the Ghana TOR is one exception.)
- Thus, it is difficult to see how each of the FSAP activities fits into an overall strategy for financial sector surveillance in each country.
- While most Updates conducted a new round of stability assessments, including stress tests, in most cases there was little improvement in methodological approach; thus, in a number of cases, data limitations still forced a highly simplistic approach. This raises questions as to whether a greater ex ante assessment of changes in data availability might have concluded that updating such tests was not a high priority use of resources.
- Updates were generally effective in conducting an in-depth tracking of implementations in the specific sectors covered in comparison to other mechanisms of surveillance.
- In general, the review suggests that reasonably comprehensive Updates—encompassing all sectors of significant macroeconomic importance—were needed to provide an overall assessment of progress in implementation to address identified vulnerabilities and remaining challenges.
- The limitations on what can realistically be expected from Updates of different scope and depth (e.g., that narrowly focused Updates cannot be expected to provide an in-depth assessment of progress in sectors that fall outside of its scope) are not adequately signaled. Stronger "health" warnings on these limitations and the necessary qualifications to any conclusions are still needed.
- The degree of integration of findings into surveillance reports appears to be broadly similar for Updates as for full FSAPs. The principal messages are reported but there is often little integration into the overall surveillance assessment. Slovenia is a "good practice" exception.
- Inadequate prioritization of recommendations remains a problem in most cases.

[1]The 11 Updates completed in the post-pilot phase are: Armenia, Colombia, El Salvador, Ghana, Hungary, Iceland, Kazakhstan, Peru, Senegal, Slovenia, and Uganda. Under the category of Updates, there are different exercises, ranging from comprehensive to more focused. The term "Update" is now used for this entire range of exercises.

ing access to financial services. Tools for the analysis of such issues remain less well developed.[4]

While the degree of emphasis on stability and development issues varied substantially (and appropriately so) across countries, our overall judgment is that the degree of integration between the two was generally quite good but with significant shortcomings in a minority of cases (see Table 3.1). What constitutes a "best practice" approach to such integration? The standard is perhaps clearest in those cases where substantial reform of the financial sector, and related policies, is needed to remove longer-term impediments to growth but where the process of reform (i.e., getting from "a" to "b") itself could entail substantial risks of increased financial sector stability. In such cases, we would expect to see a clear analysis of such potential risks and of strategies for minimizing them (although not necessarily a very detailed blueprint). Among our sample countries, the FSAPs for Chile, Costa Rica, and India provide examples of such "good practice" approaches. In contrast, the Tunisia FSAP does not quite meet this admittedly high standard (although subsequent IMF technical assistance did contribute to such a strategy) and the Philippines FSAP provided little effective integration of the two aspects.

The evaluation suggests no evidence that the joint approach has led to a "watering down" of messages in order to achieve consensus between the World Bank and the IMF. Indeed, the in-depth country reviews indicated two cases (Dominican Republic and, to a lesser extent, Russia) where World Bank staff helped to resist pressures that arose within the IMF's internal review process to tone down the FSAP messages on some aspects.

[4]The 2003 joint review of the FSAP by staff from the Bank and IMF presented an annex that discussed issues of financial development. But an operational framework for the assessment of development issues is less advanced than for stability aspects. The IEG evaluation reaches a similar conclusion.

CHAPTER 5

How Well Has the IMF Used the FSAP Output?

The evaluation examined how effectively the IMF used the FSAP output in each of its three primary activities—surveillance, technical assistance, and program design.

Surveillance

The overriding message emerging from the evaluation is that the FSAP exercise has undoubtedly deepened the IMF's understanding of the financial sector and strengthened the quality of the surveillance dialogue on financial sector issues, but the IMF is not yet using the results as effectively as it might. In general, financial stability issues have not yet been fully mainstreamed into Article IV assessments. More specifically, the evidence collected during the evaluation suggests the following key messages (see also Annex 6).

The incorporation of FSAP results into Article IV surveillance has broadened the scope of monitoring of financial sector issues. The review of the 25 cases shows that the inclusion of the key FSAP results in the accompanying Article IV documents has in general been quite good—albeit with problems in about one-fifth of the cases (Table 5.1). Coverage of financial sector issues and vulnerabilities in Article IV consultations generally improved from the treatment before the FSAP. The survey results support these conclusions, indicating that the authorities have generally learned significantly from the FSAP, that it has improved their dialogue with the IMF, and that in most cases the depth of Article IV discussions on financial sector issues has improved. Similarly, survey results of Article IV mission leaders show that the FSAP has provided analytical insights into the financial sector that did not exist before, that it was usable for integrating results in Article IV consultations, and that it has improved Article IV discussion on financial sector issues (see Figures 5.1a to 5.1d). In contrast, a review of financial sector surveillance in a group of countries that have not undertaken FSAPs suggests more limited improvements, although the sample size is limited and the review is not intended as a comprehensive assessment of financial sector surveillance outside the FSAP (Box 5.1).

The Article IV process and the combined discussions at the Board often did not constitute a good platform to discuss FSAP results. In many cases, peer review—that is, discussion at the Executive Board—of financial sector issues has been weak. In a few extreme cases, the surveillance discussion failed to pick up on key messages in the FSSA (e.g., Dominican Republic). Even when there were no such dramatic gaps, many FSAP team leaders expressed disappointment that the Board discussion of financial sector issues had been, in their view, relatively perfunctory. Summaries of FSAP findings in many Public Information Notices (PINs) have also been generally rather inadequate or insufficient, with a quarter of cases showing very limited coverage (Table 5.1). Several factors seem to contribute to such an outcome:

- The cautious language used in most FSSAs. If there were no obvious "red flags," then financial sector issues tended not to be the focus of Board discussion. Clearly, there can be occasions where devoting limited Board attention to the financial sector may be the appropriate response even after an expensive FSAP exercise—if the FSSA suggests no significant concerns and there are more pressing problems in other areas. However, the 25-country review suggested many cases where a more in-depth discussion would have been warranted.

- The traditional focus, and expertise, of both area departments (who draft the Article IV surveillance reports) and the Board is on macroeconomic policies. With Board discussions focusing on issues in the Article IV reports, failure to adequately integrate FSAP results into those reports has tended to lower the prominence of financial sector issues, even when the FSSA did spell out the issues.

- When there were disagreements between area department staff and the FSAP team, either on the fundamental diagnosis or, more commonly,

Table 5.1. IEO Assessments of the Use of FSAP in Surveillance[1]

Criteria	Mean Score (On scale of 1–4)	Percentage of Ratings Indicating Some Problems (I.e., ratings of 3 or 4)
Degree of integration of FSAP findings into Article IV staff report	1.85	20
Coverage of financial sector issues in summing up of Board discussion/PIN	2.07	25
Extent of follow-up of recommendations in subsequent Article IV reports	1.85	13
Intensity of coverage over time in surveillance reports[2]	1.68	14
Reporting on country-specific constraints and limitations[3]	2.73	56

[1]IEO assessors rated each of 25 FSAP cases vis-à-vis the above criteria. Each aspect was rated on a four-point scale (with 1 being the highest). To minimize subjective judgments, the evaluations were guided by a detailed template of what would be expected to achieve specific ratings for each category (see Annex 3 for details).

[2]This criterion assesses the extent to which Article IV surveillance reports in years subsequent to the FSAP continue to cover financial sector issues.

[3]This criterion refers to whether the FSAP/Article IV captured the country-specific constraints.

on the relative emphasis to be given to different policy issues in surveillance reports, the views of the area department generally prevailed. In a number of cases, this led to a downplaying of financial sector issues (e.g., Dominican Republic, Korea, Russia). In the event of such disagreements, the internal review process for surveillance was often not successful in forcing an effective integration of FSAP issues into a comprehensive surveillance assessment.

- The FSAP team leader typically played only a secondary role vis-à-vis area department and Policy Development and Review Department (PDR) staff at Board surveillance discussions. Many team leaders we interviewed reported being asked only a small number of relatively narrow technical questions, even when they were prepared to elaborate further on important financial sector issues.

In terms of follow-up, the financial sector content of surveillance in years following the FSAP has tended to diminish, but generally remained better than before the FSAP. The 25-country studies generally show some waning in the intensity of coverage of FSAP issues in subsequent Article IV consultations but not a full "mean reversion" to the treatment encountered before the FSAP (see Table 5.1). Interviews with staff and authorities also suggest some falling off in quality of dialogue but not back to pre-FSAP levels. Surveys of authorities and Article IV mission leaders indicate that Article IV consultations were indeed the preeminent vehicle for follow-up on the FSAP. However, interviews and country reviews show that effective follow up was more difficult when the FSAP did not give a clear sense of priorities between different measures.

The availability of adequate technical expertise within surveillance teams has been the major constraint on the effectiveness of follow-up activities when complex issues are involved. In many cases when the surveillance team lacked the necessary expertise, tracking the implementation of FSAP recommendations has taken a "checklist" approach of enumerating measures rather than appraising whether underlying vulnerabilities have been addressed.[1] Focused assessments, with expert assistance from MFD (or International Capital Markets Department), have done a more thorough analysis of implementation of recommendations in particular areas.

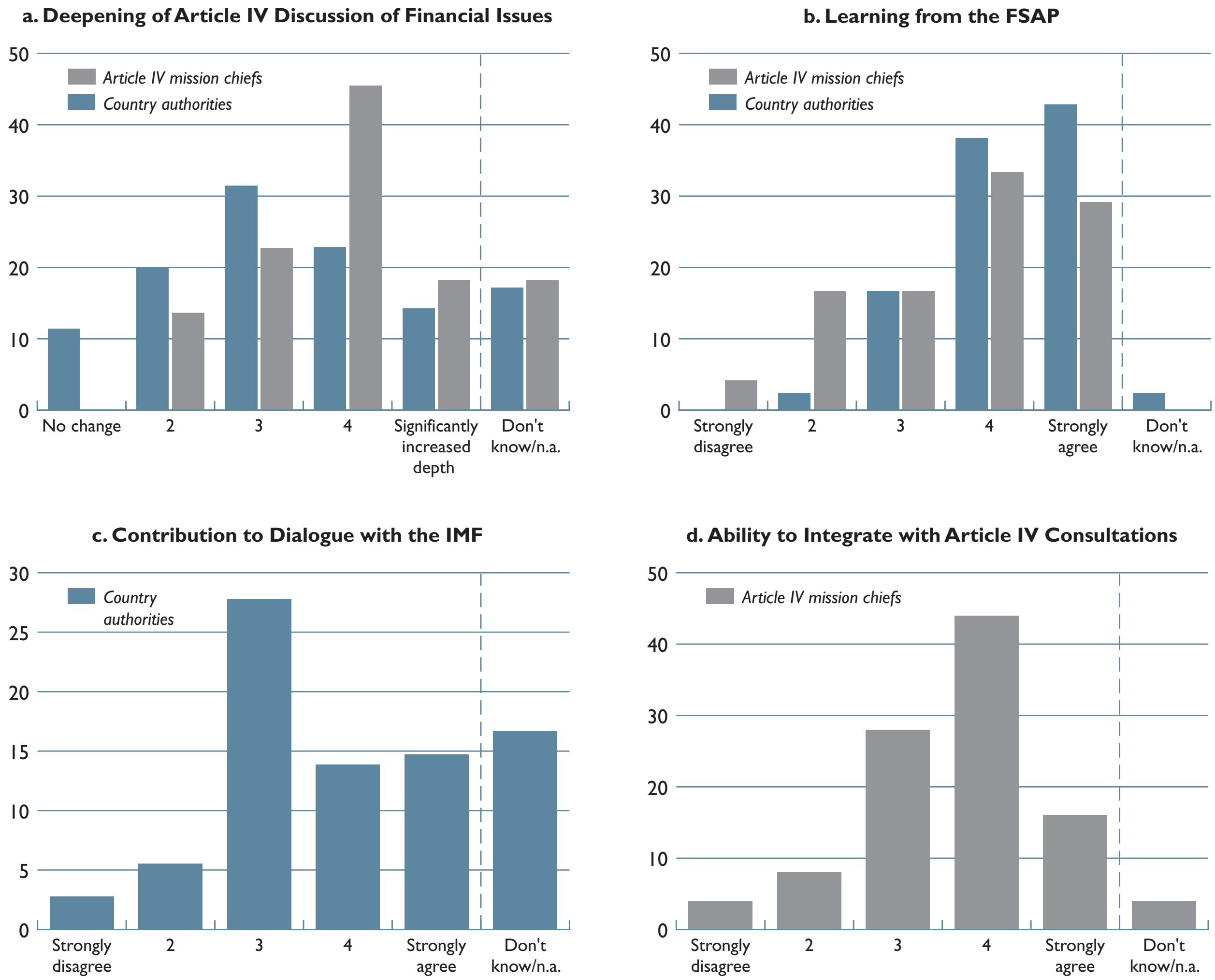
Only FSAP Updates appear to have had the capacity to undertake an in-depth tracking of implementation in specific areas; in the case of comprehensive reassessments, they also were able to take a broader view of how vulnerabilities had been addressed and of remaining challenges (see Box 4.3).

Integration with Technical Assistance Activities

Technical assistance (TA) was always expected to play an important role in follow-up support to help country authorities implement measures to address

[1]An observation made by many of those interviewed, both within and outside the IMF, was that IMF surveillance teams were able to "ask the first question" in following up on complex financial sector issues, but often did not have the necessary background to pursue a more in-depth dialogue.

Figure 5.1. Views on Article IV Discussion of Financial Sector Issues
(In percent)



Sources: Q22, Q7.5, and Q12.7 of the survey of country authorities; and Q24.1, Q9.1, and Q22.4 of the survey of Article IV mission chiefs.

vulnerabilities and development needs identified by the FSAP initiative. The expected links became even more explicit following the 2003 and 2005 FSAP reviews.[2] The evaluation reviewed how well IMF activities were aligned with these objectives, with the following conclusions:

(1) The FSAP and associated ROSCs have become increasingly important drivers of IMF TA in the financial sector, with a substantial proportion going to emerging market countries (Table 5.2). For example, in 2005, the emerging market country group received about half of FSAP-related TA, whereas it received only about 30 percent of overall IMF TA. However, the size of such TA remains small (15 person-years in FY2005), which suggests that the effectiveness of the FSAP as an input to TA provision by other donors is likely to be of even greater importance as an influence on its overall impact.

[2]At the time of the 2003 review, Directors noted that assessments provide a baseline that help set priorities for subsequent work and called on the staff to make suggestions on the appropriate time frame and sequencing for the implementation of FSAP recommendations while taking into account the authorities' capacity constraints. In concluding the 2005 FSAP review, Directors urged staff to make TA follow-up more systematic and supported the idea of having, in appropriate cases, tripartite meetings among country authorities, staff, and possibly other donors on TA matters. (See "The Acting Chair's Summing Up: Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward" (Buff/03/42, March 24, 2003).)

Box 5.1. Financial Sector Surveillance Outside the FSAP

For comparison purposes, the evaluation reviewed the treatment of financial sector issues in the context of Article IV surveillance for a group of systemically important countries that have not undertaken an FSAP.[1] The results suggest that—in terms of scope of coverage, depth of analysis, and overall view of financial sector standing—financial sector surveillance was significantly less comprehensive than in countries that undertook FSAPs. Of course, this is not particularly surprising given the generally more limited resources available for financial sector analysis in such cases and the results should not be viewed as a test of counterfactual in which the resources utilized in the FSAP were instead made available for alternative surveillance modalities.

- The scope of financial sector issues analyzed in Article IV reports is narrower than in those countries that had an FSAP. The analyses mostly comprise banking sector issues and, depending on the country, may include some other topical themes (e.g., mortgage lending, corporate issues). The limited scope of analysis inevitably left out large and significant segments for those countries with relatively complex systems as well as the assessment of linkages and potential spillover vulnerabilities.
- The depth of assessments and intensity of analysis were significantly less than in a typical FSAP (e.g., on the regulatory and supervisory frameworks, accounting and auditing standards, payment systems, safety nets). But, in those cases where expert assistance (from MFD or other qualified staff) was included in the surveillance team, the depth of the analysis on the specific issues covered increased markedly.
- There is generally a lack of an overall assessment of financial sector standing and vulnerabilities.
- Moreover, reported discussions with the authorities on financial sector issues (and reports on difference of views if any) are in general cursory or absent.

More generally, although a full review of financial sector surveillance outside of the FSAP is beyond the scope of this evaluation, our interviews with IMF staff and a brief review of steps taken so far suggest that progress in establishing a framework to enhance financial sector surveillance outside of the FSAP has been limited. Draft guidelines on financial sector surveillance were initially prepared over a year ago but have not been finalized because of area department concerns that they called for more than departments could deliver with existing resources. Consequently, the strategic guidance on the scope and objectives of enhancing this component of surveillance remain unclear. A 10-country pilot exercise is under way to gain further experience with enhanced financial sector surveillance, with the initial results expected to be available by late 2005/early 2006.

[1]The sample of countries analyzed was China, Malaysia, Spain, Turkey, and the United States. The review covered the last two cycles of Article IV consultations and program reviews where applicable. The assessment used a template that considered: (1) scope of coverage; (2) detail and specificity of the analysis; (3) overall assessment of financial sector standing and vulnerabilities; and (4) reported influence in discussions with the authorities. See Annex 8 for further details.

(2) A review of the 25-country sample suggests that many FSAPs have shortcomings as a platform for organizing follow-up TA. To provide a good platform, one would expect the FSAP to provide the following three components (although not a detailed blueprint): (a) an overall prioritization (i.e., which recommendations are most important); (b) a sense of sequencing (i.e., how the various recommended actions would fit into an overall timeline, taking account of other reforms); and (c) some judgment on implementation capacity. The evaluation reviewed each of the 25 countries vis-à-vis these criteria (Table 5.3). For emerging market and PRGF-eligible countries, where TA provision is more likely to be an issue, the results suggest significant shortcomings in more than half of the cases. In some cases, the sheer number of recommendations deemed to be priorities runs the risks of dispersing the attention and overwhelming the implementation capacity of the authorities (e.g., Egypt, Kazakhstan). However, tracking the results over time suggests some improvement. Among FSAPs completed recently, that for Chile represented a "good practice" basis for planning future TA provision—containing well-prioritized and sequenced recommendations, along with an assessment of implementation capacity. These findings are consistent with the survey results. When asked to select the area in which the FSAPs has been *least useful*, the identification of TA needs was selected first among the various options by the highest number of authorities (close to 60 percent of those responding).

(3) Within individual countries, available evidence suggests that in most cases, post-FSAP TA provided by the IMF was broadly in line

Table 5.2. Post-FSAP TA by the Monetary and Financial Systems Department[1]

	Fiscal Year					
	2000	2001	2002	2003	2004	2005
In number of person-years	1.1	1.8	3.6	7.1	10.2	14.7
In percent of total MFD TA	1.3	2.7	4.5	8.5	12.6	18.4
			(In percent)			
Allocation of TA resources by country type[2]						
Advanced economies	0	2	6	2	0	0
Emerging market countries	23	68	34	28	39	45
PRGF-eligible	76	26	54	33	38	40

Sources: TIMS database and IEO estimates.
[1]Excludes TA in support of off-shore financial centers and AML/CFT assessments.
[2]Percentage of MFD TA resources allocated to FSAP follow-up work. Does not add to 100 percent because of resources allocated to regional entities.

Table 5.3. FSAPs: A Good Platform for Follow-Up TA? Summary Evidence from Desk Reviews
(In number of countries)

		Main Recommendations Are					Capacity to Implement Is Assessed	
		Prioritized			Sequenced			
Country Type	Total Number of Countries	Full	Partial	Little or none	Yes	No	Yes	No
Advanced	6	1	3	2	2	4	3	3
Emerging	15	2	8	5	6	9	8	7
PRGF-eligible	4	. . .	2	2	. . .	4	3	1

Source: IEO review of 25-country sample.

with the areas of main FSAP recommendations.[3] The IMF provided TA in the financial sector to 14 out of 25 countries in the in-depth sample and in all but 2 (India and Tunisia), there appears to have been a reasonable alignment. However, since many recommendations were not well prioritized, this is a test with a relatively low threshold.

(4) There is no clear institutional framework for linking FSAP recommendations to plans of action for TA delivery that coordinate the activities of all important donors (see also Box 5.2). Clearly, the country itself should ideally play the lead role in such coordination efforts and has done so in cases where substantial domestic capacity on financial sector matters exists (e.g., Chile). In countries that lack such capacity, however, a clear coordinating framework is frequently lacking.

(5) MFD has introduced procedures designed to provide a better interface between FSAP teams and TA follow-up work, but it is too early to judge the results. The approach calls for the holding of quadripartite meetings between World Bank and IMF mission chiefs, IMF TA area chief, and Bank TA chief to identify possible areas of TA, evaluating suggestions on which institution should take the lead (including FIRST),[4] and subsequently to establishing contacts with the authorities and other donors with a view to help draw up a post-FSAP TA agenda. However, such meetings have been held for only a small group of countries and it is too early to judge the results.

[3]In a number of cases, IMF TA was not focused on implementing specific recommendations but was still closely aligned with the FSAP because the country-requested TA was focused on strengthening domestic capacity to implement various risk assessment techniques (such as stress testing).

[4]The Financial Sector Reform and Strengthening Initiative (FIRST) is a multidonor trust fund launched in April 2002, which was envisioned to serve both as a source of funding and coordinator of TA with the IMF, World Bank, and other providers in the financial sector area to avoid duplication of efforts and the provision of conflicting advice. The World Bank and the IMF, besides being members of its Governing Council, were to submit to FIRST TA requests from countries in connection with the FSAPs and ROSCs.

Box 5.2. Views of Other Donors and TA Providers on FSAPs and Their Follow-Up[1]

Interviews with a range of donors and other agencies suggested generally positive feedback on the FSAP, although their use of the results was often limited. Donors noted that they themselves had very limited resources to carry out research and analysis on the scale of the FSAP; hence, they expressed great interest in being able to access the information from the FSAP, as it could help them to identify priorities. The use of the FSAP varied by donor, sometimes even within a donor agency, in part because much of the access to FSAP findings was dependent on informal dialogue between individual staff members at the donor agencies and the corresponding World Bank and IMF staff, rather than through a formal process of informing donors. Most interviewees cited the FSAP as a useful source of background information even when, in practice, the FSAPs had limited influence on their programs. They had concerns about access, timeliness, relevance, and feedthrough into an overall strategy.

Access. Donors generally only have access to published FSSAs and FSAs. In some cases, donors are given access to a small part of the FSAP report that is directly pertinent to the piece of aid they are being asked to fund, but since the donors cannot read the full report, it is hard for them to gain perspective on the overall strategy or the relative importance of requested assistance. Even the multidonor trust, the Financial Sector Reform and Strengthening Initiative (FIRST), which was set up specifically to provide follow-up to the FSAP, has had a difficult time accessing information needed to design programs.

Timeliness. Given that FSSAs and FSAs only become available to donors when they are published, and the lags can be long after the start of the initial mission, the information is not available on a timely basis, particularly given the lead times that donors need to plan their own programs.

Relevance. A number of donors felt that not enough emphasis was placed on development issues in FSAPs for developing countries, and that too much time was spent on ROSCs or other issues that, in their view, were not as relevant. The donors also felt that the FSAPs did not always reflect the realities on the ground, including a failure to address political economy issues.

Lack of a follow-up strategy. Many donors were frustrated that the FSAPs rarely led to the development of an overall strategy for financial development with a clear action plan that could be implemented by the authorities with donor assistance. This frustration of donors in crafting appropriate follow-up is confirmed by feedback from the country authorities in the survey; only 13 percent of authorities agreed with the statement that they had "received support from other international financial institutions/donors to implement the FSAP recommendations."

Steps that donors thought could help improve the effectiveness of donor coordination included (1) greater advance notice about the timing of FSAPs, so that donors can adjust their own program timetables accordingly; (2) better and more timely access to reports; and (3) greater consultation with donors who are active in the financial sector during the FSAP mission, including presentation of key findings.

The latter suggestion in particular highlights the obvious tensions between the FSAP as a (prudential) assessment vehicle and as a catalyst for design of follow-up lending and technical assistance activities. While blurring unduly the assessment role of the FSAP is probably undesirable, donors' comments and suggestions do underscore the need for a clearer framework on how follow-up activities will be coordinated.

[1]The IEG, as part of its parallel evaluation of the FSAP, had primary responsibility for discussing the views of donors and TA providers on the FSAP. This box draws on the results of interviews conducted by IEG assessors.

One issue that affects coordination within the IMF is the policy adopted by MFD that FSAP mission chiefs should not subsequently be involved in the provision of TA to the same country.[5] The rationale for this policy is that assessors should not be influenced by any considerations that they might create a subsequent demand for their own technical advice. The cost is a potential loss of continuity in familiarity with the country's problems, a point noted by a number of country officials interviewed.[6, 7]

[5]As part of a policy aiming to establish a clear demarkation of where FSAP work concludes and where follow-up TA starts, FSAP mission chiefs in the IMF are now asked to prepare a note highlighting FSAP recommendations and priorities for the use of TA wing managers. These notes are based on the FSAP aide-mémoire, ROSCs, and FSSA, but are not supposed to flesh out a TA program and assess countries' implementation capacity. This requirement has been in effect only since early 2005.

[6]The demarkation imposed by MFD in the other direction—namely, that TA mission chiefs should not subsequently lead FSAPs to the same country, since they would to some extent be assessing their own activities—is even stronger, and is well justified for conflict of interest reasons. In practice, FSAP mission chiefs are largely drawn from the "surveillance wing" of MFD. Other FSAP team members can and do sometimes participate in TA missions.

[7]The World Bank has no such policy; indeed, in a number of the 25 country cases, there were examples of subsequent TA plans or other lending activities being discussed during the FSAP exercise.

Links with IMF-Supported Programs

In the review of the FSAP that followed the initial pilot stage, the IMF Board called for the strategic components of FSAP assessments to be reflected in IMF-supported programs.[8] This section reviews how the IMF has been using the findings and recommendations from the FSAP in its program-related work by drawing on two types of evidence: (1) a cross-section analysis of developments in program conditionality in financial sector areas, and its links with FSAPs, for all programs over the period 1995–2003; and (2) a review of those (7) countries in the detailed 25-country sample where there was significant program activity following an FSAP.[9] The focus is on program conditionality.

The extent of conditionality on financial sector issues has increased markedly since the financial crises of the late 1990s, but cross-country evidence suggests that underlying developments in the extent of financial sector liberalization, rather than the existence of an FSAP per se, have been the main influence on the number of conditions. The total number of conditions per program-year related to financial sector issues rose markedly during the 2001–03 period compared with the average of the previous five years (Table 5.4). The issues covered include dealing with problem banks; regulatory, institutional, and legal aspects of financial sector reforms, including central bank audits; and the establishment of business environment supportive of private sector growth (e.g., judicial reform, bankruptcy procedures).

An econometric analysis (see Annex 9) suggests that, without controlling for factors influencing whether countries engage in FSAPs, the existence of an FSAP increases the total number of program conditions in financial sector areas. However, when an index measuring the extent of financial sector liberalization is included, their joint interaction suggests that the existence of a previous FSAP may actually reduce the total number of program conditions for countries whose financial systems are fairly well liberalized. In other words, for liberalized systems the greater knowledge about the financial sector derived from the FSAP seems to be associated with less program conditionality, whereas the reverse is true for nonliberalized systems.

A comparison of program conditions with the main FSAP recommendations in the in-depth country sample suggests a mixed picture with regard to alignment. The assessment of alignment in the seven country cases was based on a qualitative judgment of whether the specific conditions addressed the main vulnerabilities identified in the FSAPs and were focused on implementation of key recommendations. The results suggest the following, although the sample is relatively small:

- There was significant alignment in half of the cases (Cameroon, Dominican Republic, and Ghana). However, in two country cases (Brazil and Jordan), there was little overlap between program conditionality and key program recommendations.[10] For example, in the case of Brazil, while the program contained some important infrastructure issues, like bankruptcy and creditor protection legislation, in line with the FSAP, it also focused on the privatization of the remaining state-owned banks rather than on issues the FSAP had identified as more critical such as the restructuring of the systemically important federal banks or in steps to improve the supervisory framework.
- The degree of clarity and prioritization of FSAP findings and recommendations helped program design in some cases (e.g., Ghana and Cameroon), while in other cases (e.g., Dominican Republic), an effective plan of action had to be derived during the program negotiations because the prioritization of the FSAP recommendations was inadequate.

Table 5.4. FSAPs and Structural Conditionality in IMF-Supported Programs[1]
(Average number of conditions per program-year)

Policy Area	1995–2000	2001–03
FSAP-related[2]	3.2	5.4
Non-FSAP-related	10.7	12.2

Sources: Internal IMF data base on program conditionality (MONA).
[1]Includes all structural prior actions, performance criteria, and benchmarks in IMF-supported programs, normalized by the length of the program.
[2]Includes structural conditions associated with financial sector reforms, the resolution of problem banks, and fostering a business environment supportive of private sector growth.

[8]"Summing Up by the Acting Chairman: Financial Sector Assessment Program—A Review—Lessons from the Pilot and Issues Going Forward" (Buff/00/190, December 2000).

[9]The countries in the 25-country sample that meet this criteria are Brazil, Bulgaria, Cameroon, Dominican Republic, Ghana, Jordan, and Sri Lanka. Romania's program expired shortly after the FSAP (with a new program approved only in July 2004) and is excluded from the analysis.

[10]Sri Lanka and Bulgaria are intermediate cases. On the former, programs did follow up on many FSAP-related issues but the FSAP itself had been too vague on one major issue—the future of a major state-owned bank—that was a perennial issue in IMF-supported programs. On the latter, among the key FSAP recommendations, the program placed conditionality on bank resolution and privatization issues, but not on important identified weaknesses in bank supervision.

CHAPTER 6 Evidence on Impact of the FSAP

Clearly, attributing specific final outcomes within complex systems to particular activities such as the FSAP is extremely difficult. The approach taken in the evaluation was to ask two related sets of questions: first, what, according to those most directly involved, appeared to be the proximate contribution of the FSAP, in terms of how it influenced the policy debate or was used by the participants concerned; second, what has actually happened in terms of changes in key policies and institutions, even if any changes cannot be attributed directly to the FSAP?

Impact on the Policy Debate

Drawing primarily on interviews and the survey results, the principal conclusions are as follows (see Figure 6.1 and Annex 10):

- The greatest impact has been on within-government dialogue and in supporting the authorities' position in discussions with the legislature. In contrast, the use of the FSAP in general public debate has been very limited.[1]
- The most common value added of the FSAP was as an independent, external assessment of a country's financial system.
- The largest impact was in those countries where the government already had a high commitment to financial sector reforms (either for internal reasons or reflecting strong external incentives such as accession to the European Union (EU)).
- The impact on the policy debate was not confined to developing countries. Among advanced economies, officials interviewed noted that the FSAP had been instrumental in raising a number of "taboo" subjects (e.g., with regard to certain policies vis-à-vis the insurance sector in Germany) or in influencing an ongoing political debate (e.g., the institutional structure of the unified regulator in Ireland).
- In many cases, the main value added of the FSAP process was through the interaction of the FSAP team with high-level policymakers, not through the final report (e.g., Costa Rica, India, Mexico, Slovenia, and, to some extent, Russia).

Impact on Policies and Institutions

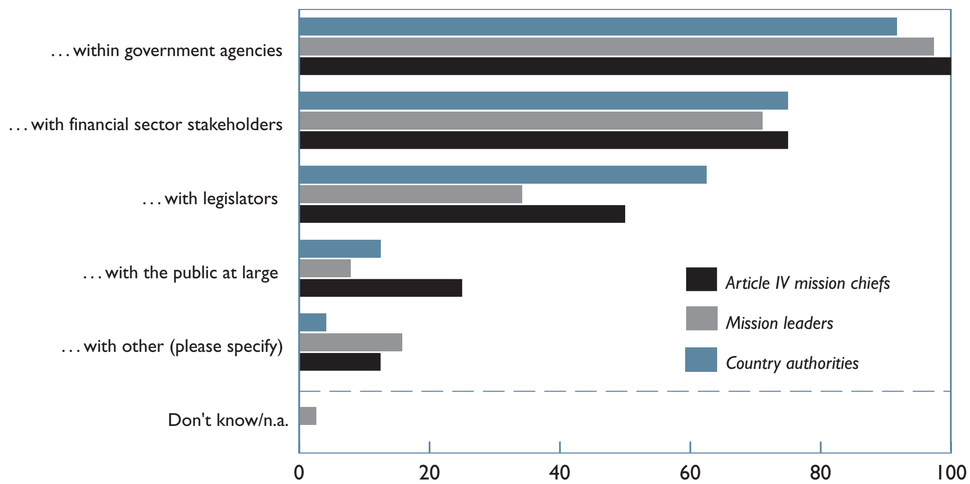
In terms of overall influence of the FSAP, the following messages apply to a wide range of countries (see also Figures 6.2a to 6.2c):

(1) There has been a change in the "culture" vis-à-vis approaches to financial sector risk assessments in many countries. While there have been a number of other major influences (e.g., the work of the BIS, Financial Stability Forum, Basel II), the FSAP initiative does appear to have played an important role in this change. For example, in 11 of the 25 countries reviewed in-depth for the evaluation, the authorities began to issue a Financial Stability Report (FSR) or to include stress-testing exercises in FSRs after the FSAP. Clearly, this does not prove causality, but our interviews do suggest that in a significant number of countries the FSAP created momentum for upgrading their stress-testing methodologies and improving the coverage and sophistication of the tests. While such effects were more common in developing and emerging market countries, FSAPs also appear to have made a contribution in advanced economies; for example, in Germany, Ireland, and Korea officials reported that a greater focus on risk-based assessments for the insurance sector was helped by the FSAP dialogue.

(2) The most commonly identified value added of the FSAP was as an independent expert "second opinion" on financial system and reform plans. In a number of cases, this contribution

[1] Germany was the most obvious exception in our sample. The FSSA's discussion of the "three-pillar" banking system received widespread attention.

Figure 6.1. Contribution to Policy Debate Through Discussions . . .
(In percent)



Sources: Q17 of the survey of country authorities; Q20 of the survey of FSAP mission leaders; and Q22 of the survey of Article IV mission chiefs. Multiple response question. Percentages refer to proportion of those who indicated an overall positive contribution.

increased the credibility of reform initiatives (including in the legislature).

(3) While direct attribution of policy and institutional changes to the FSAP alone is rarely possible, the in-depth examination of the 25 country cases has identified a wide range of cases in which significant changes did take place subsequent to the FSAP and in which there is some evidence that the FSAP was at least a contributory factor (Table 6.1). In each of the country cases, the evaluation traced through the chain of events that led to significant changes in policies and institutions (see Annex 10 for details). While the evidence is necessarily qualitative, and such changes always have complex causes, the FSAP does seem to have made a contribution in many cases.

(4) There were also a number of "missed opportunities" where the significant investment of resources in the FSAP did not, for various reasons, lead to timely enough changes to forestall problems. The most dramatic example was in the Dominican Republic where a banking crisis broke out less than a year after the FSAP (Box 4.2). The case of Korea and the post-FSAP problems with credit card companies also highlight the difficulties in capturing the extent of some vulnerabilities. Although the FSAP did not highlight the risks posed by credit card debt in particular, it did express concern about the risks stemming from the household sector and called for vigilance. The accompanying Article IV staff report expressed a more benign assessment of the situation with regard to the household sector.

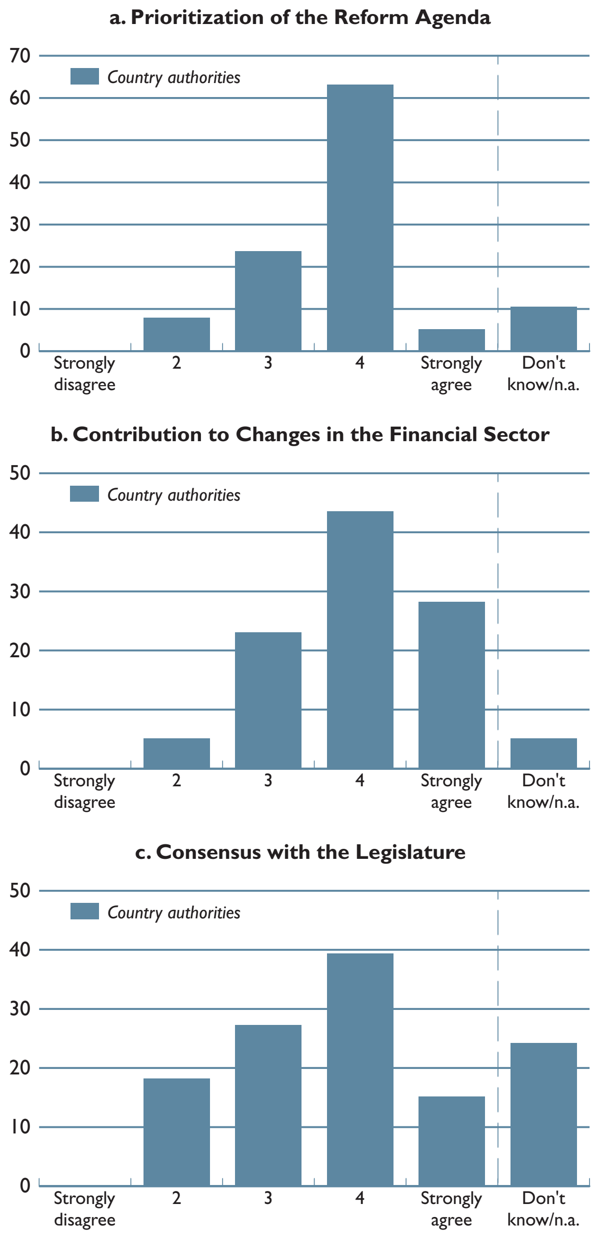
(5) Our interviews with the secretariats of the various standards-setting bodies indicate a high level of satisfaction with the feedback received from the IMF (and World Bank) on the standards through formal (e.g., IMF staff participation in various technical committees) and informal channels. The standard-setting bodies would like to see (a) franker language in the assessments when problems are detected; and (b) greater use of the FSAP results to draw cross-country lessons (along the lines of the 2004 paper "Financial Sector Regulation—Issues and Gaps").

Impact on Markets

While many authorities identified the "signaling role" to markets as one of their motivations for participating in the FSAP exercise, the impact of FSSAs on the views of financial market participants appears modest.[2] Our interviews with a wide range of market

[2]However, unlike the ROSCs, informing markets is not mentioned explicitly as an objective of the FSAP.

Figure 6.2. Overall Influence of the FSAP
(In percent)



Sources: Q12.2, Q12.3, and Q12.5 of the survey of country authorities.

participants indicate that most have limited knowledge of the contents of FSSAs, a conclusion reinforced by the results of the recent survey conducted in connection with the internal review of the standards and codes initiative. Use of FSSAs by credit-rating agencies appears to be somewhat greater, but they have used them only selectively.[3]

Within this context of generally limited impact, interviews with market participants suggested that effects are greatest in countries where overall transparency is the least; failure to participate in or to publish an FSSA was generally regarded as the most significant signal. While there is no econometric work on the impact of FSAPs per se, there are a number of econometric studies on the impact of ROSCs, and so on, which generally suggest a small impact, at best, on market spreads.[4]

Actions that could increase the FSAP signaling role, according to market participants, would include (1) easier access to published documents, including the FSSAs; in this regard, many of those interviewed criticized the IMF website as not user friendly; (2) more accessible, franker language in FSSAs and in Article IV staff report discussions of the financial sector; (3) greater focus on potential "problem" countries; (4) more timely published assessments; (5) eliminating the voluntary nature of the exercise, which a number of market analysts saw as creating a selection bias; and (6) more concise, summary assessments. On the latter point, many market participants expressed a preference for even greater use of quantitative ratings but going further in this direction could raise potential problems. As discussed earlier, the in-depth country reviews suggest that the loss of important qualitative information may already be a problem with how other users (including the authorities themselves) use the ratings on compliance with the various standards and codes.

[3]One exception is the Bulgaria FSSA, which appears to have been a significant element in the sovereign rating upgrade in 2002.

[4]Data limitations and other methodological problems suggest that too much weight cannot be attached to these results. See the background paper on "The Standards and Codes Initiative—Is It Effective?" (SM/05/252) for a more detailed discussion.

Table 6.1. Summary of Post-FSAP Changes in Policies and Institutions[1]

No.	Type of Policy and Institutional Change	Countries Where Such Changes Occurred
1.	Change of relevant financial law(s) or financial sector regulations. For example: • New law(s) or regulations. • Amendments to the existing law(s) or draft in process; changes to existing financial regulations.	Bulgaria Chile Costa Rica Dominican Republic Egypt Ghana Jordan Kazakhstan Korea Mexico Romania Russia Singapore Slovenia
2.	Institutional or organizational changes (e.g., introduction of new financial sector supervision arrangements or financial stability division within the central bank).	Bulgaria Ireland Kazakhstan Mexico Romania Slovenia South Africa
3.	FSAP either helped build up or created momentum for broader financial sector reforms and/or significant change of thinking about financial stability in a country (initiation or increase in speed, scope, and/or depth of financial sector reform).	Bulgaria[2] Egypt Ghana Jordan Korea Mexico Romania[2] Russia Slovenia[2]
4.	New product or practice regarding financial stability (e.g., financial stability reports, regular stress testing).[3]	Brazil Cameroon Germany Philippines

Source: Annex 10.

[1]This table summarizes the main types of changes that took place in policies and institutions after the FSAP in the 25-country sample. It is not suggested that these changes can necessarily be attributed to the FSAP since reforms in some cases started before the FSAP took place. However, in each case, the evaluation traced through the chain of events from FSAP recommendations to the domestic policy debate and to specific actions (see Annex 10 for details). A country is included only if there is some evidence—typically statements by officials interviewed during the evaluation—that the FSAP was at least a contributory factor in the process, including measures taken in anticipation of an imminent FSAP.

[2]Reforms linked with EU accession.

[3]List of countries only includes those not already mentioned in items 1–3.

CHAPTER

7 Lessons and Recommendations

Our overall assessment is that the FSAP represents a distinct improvement in the IMF's ability to conduct financial sector surveillance and in understanding the important interlinkages between financial sector vulnerabilities and macroeconomic stability. While an overall judgment on the cost-benefit trade-off will always be difficult for such activities because of the problems in quantifying the benefits, the evaluation concludes that the FSAP has significantly deepened the IMF's understanding of the financial sector in specific countries, helped articulate policy recommendations, prompted better discussions with authorities, and helped support policy and institutional changes. The evaluation also suggests that the joint IMF–World Bank nature of the exercise has been beneficial. Putting in place this major new initiative within a relatively short timespan represents a significant achievement.

The evaluation suggests some significant advantages of the present arrangements that should be preserved going forward: (1) an integrated approach to assessing financial sector vulnerabilities and development needs that could not be achieved by an ad hoc series of assessments of standards or analysis of particular issues; (2) an institutional link to surveillance that has greatly strengthened the operational relevance of the FSAP for IMF activities; and (3) an administrative mechanism to coordinate IMF and World Bank inputs that, while subject to some tensions, does appear to have improved coordination, with benefits for the quality of assessments. Thus, while a variety of channels to strengthen financial sector surveillance are clearly possible and would be relevant in particular country circumstances, the evaluation evidence does suggest that FSAPs and comprehensive Updates offer distinct advantages that would be difficult to replicate fully through other less comprehensive modalities. These advantages derive largely from the critical mass of expertise mobilized for an FSAP which enables comprehensive assessments of financial systems and interaction of country officials with a range of technical experts.

Despite these achievements, the initiative is at an important crossroads and there is a danger that some of the gains already achieved could be eroded without some significant modifications. The evaluation indicates two interlinked sets of problems. First, financial stability assessments have not yet been fully "mainstreamed" as a regular part of IMF surveillance. Second, looking beyond the stage of initial FSAPs, there are doubts that current incentives for participation and priority-setting procedures will be sufficient to ensure continuing coverage of the bulk of countries where strong financial sector surveillance is most needed. The evaluation also points to the need for changes in the way the IMF organizes its own activities in order to make the best use of scarce technical expertise as well as to a range of measures that would further improve the quality and effectiveness of FSAPs.

Therefore, the recommendations are organized around three key themes: (1) reconsidering incentives for participation, clarifying priorities, and strengthening the links with surveillance; (2) steps to maintain and strengthen further the quality of the FSAP and organizational changes within the IMF; and (3) the working of the joint IMF–World Bank approach. Consistent with the IEO's mandate, the recommendations are couched in terms of actions to be taken by the IMF, although, given the joint nature of the initiative, a number of them could require decisions by both the IMF and World Bank Boards.

Incentives for Participation, Clarifying Priorities, and Strengthening the Links with Surveillance

Priority setting within the FSAP was bound to be a complicated exercise for several reasons. First, the initiative has multiple objectives, partly reflecting its joint IMF–World Bank nature. The evidence from the evaluation suggests that, in practice, this has not so far prevented priority being given to countries of systemic importance and/or with potential financial sector vulnerability concerns, provided such countries agree to participate. However, greater clarity is needed on how the balance between IMF-driven and

World Bank–driven priorities will be resolved in the longer term, an issue we will return to later. Second, and probably of greater significance, there is clearly a tension between the voluntary nature of the exercise and the stated priority to be given to systemic importance and potential financial sector vulnerability. The evaluation evidence suggests this tension is increasing. The main problem is not that a minority of systematically important countries have not yet volunteered (although they certainly should be encouraged strongly to do so), but that a significant number of countries that should be high priority candidates for updated assessments have been reluctant to participate in a timely manner. The sharp tradeoffs between different objectives that one would expect the priority-setting processes to address have largely not occurred, because some authorities' reluctance to participate has in practice been implicitly accepted when drawing up the ex ante priority lists.

Therefore, key design choices going forward are (1) how strongly the objective of the FSAP initiative should be to focus assessments on countries where the IMF judges they are most needed as an input to its global surveillance; (2) how this objective can best be matched with effective incentives for participation; and (3) how this objective can best be meshed with other objectives of the initiative through effective priority-setting procedures. There appear to be three broad choices. The first is to maintain the voluntary approach with the current set of incentives. This approach is likely to yield a result in which the coverage of FSAP Updates does not include in a timely manner many countries that the IMF would consider as high priority candidates from a global surveillance perspective. The second alternative would be to shift to a mandatory approach. The evaluation suggests that FSAPs appear to have been more effective where the assessments were most "owned" by the authorities, which suggests that the voluntary nature of the exercise can convey important advantages and should be preserved if possible. The third approach, which we favor, would be to retain a voluntary approach to the FSAP but to strengthen further the incentives for participation, especially in cases where, in the IMF's judgment, financial sector assessments are necessary for conducting effective surveillance because of potential vulnerabilities and spillover effects to other countries.[1] At the same time, other instruments for conducting financial sector surveillance, through the regular Article IV process, would also be strengthened, with the choice of the mix of instruments to be used taking into account each country's circumstances.

In addition, the evaluation shows that the IMF is not yet using the FSAP results as effectively as it could in its overall surveillance activities. There also appear to be substantial differences of view within the IMF on what is the appropriate expected scope for financial sector surveillance outside of the FSAP. For example, the long delay in finalizing revised guidelines on financial sector surveillance reflects disagreements on what could reasonably be expected from such surveillance, given likely resource constraints. Moreover, the organization of financial sector surveillance outside the FSAP was also subject to different views, including on whether expertise should be centralized (i.e., in MFD and ICM) or decentralized (i.e., at the area department level).

These findings suggest the need for changes in how country choices for financial sector assessments are made and in how those assessments are mainstreamed into IMF surveillance. Our proposed approach contains the following mutually supporting elements: country-specific strategies for financial sector surveillance that choose between a range of modalities for such surveillance, including FSAPs and Updates, based on sharper criteria for priority setting (Recommendation 1); strengthened incentives to encourage comprehensive assessment exercises when they are judged necessary for effective surveillance, albeit within a still-voluntary framework for the FSAP (Recommendation 2); and strengthened links between FSAPs and Article IV surveillance (Recommendation 3). The overarching idea is that, to maintain its strong relevance to the IMF's global surveillance objectives, financial sector assessments and their updates should cover most countries of systemic importance and/or with potential financial vulnerabilities in a timely manner. Both the incentives for participation and priority-setting criteria should be set with this objective in mind, and the IMF should take stock periodically of progress toward explicit benchmarks of achieving adequate country coverage.

> ***Recommendation 1.*** *The IMF Board and management should refine the criteria for setting priorities on IMF resource inputs into financial sector surveillance, including the FSAP. Based on these priorities, IMF staff should indicate, as part of its medium-term planning, what components are needed for strengthening financial sector surveillance in each country, drawing upon a range of possible modalities. These strategies would*

[1]The 2005 FSAP review took some steps in the direction of enhancing incentives to participate by calling for a more active promotion of Updates "through outreach programs and active encouragement by both Board [and] management and staff." As a step to create greater awareness, IMF staff proposed "instituting annual reporting to the IMF Board on country participation in initial assessments and updates" similar to the IMF's "Quarterly Report on the Assessment of Standards and Codes."

form the basis for more explicit accountability on results.

- The current list of factors to be taken into account in setting priorities, including geographic diversity, is quite long. So far, the relatively broad nature of the criteria has not been a major problem because the main focus has been on encouraging countries to participate—especially those judged important for global surveillance—rather than on meeting hard choices between competing demands. Going forward, however, if incentives for participation are strengthened successfully, clearer guidance will be needed on how to manage the resource tradeoffs between, on the one hand, following up at relatively frequent intervals on vulnerability issues in countries of systemic importance (or where there are warning signs concerning the financial sector) and, on the other hand, a more extensive examination of financial sector development issues in lower income countries. Such guidance will need to be accompanied by a clear division of primary responsibilities between the Bank and the IMF, within the existing coordinating framework (see Recommendation 6).
- In calling for staff to indicate country-specific plans to guide financial sector surveillance, we do not propose the preparation of additional documents. Rather, such strategies could be included either in area department work plans or in Article IV reports. They should address two basic questions: (1) how much priority and emphasis should be given to financial sector issues in surveillance (in some countries, the answer would be that these issues are a relatively low priority) and (2) what is the frequency, scope, and modality of assessments that would best fit each country's circumstances and the relative priority accorded to these issues. In the process of elaborating the strategy, which should be a collaborative effort between area departments and MFD, the systemic importance and macro-relevance of potential financial sector vulnerabilities should be considered explicitly.[2]
- While the particular scope of FSAP assessments will vary according to country circumstances, an approach that emphasizes more frequent assessments using a variety of modalities interspersed with relatively infrequent and more comprehensive assessments, akin to the initial FSAP, may often be more effective. In some cases, the more frequent assessments could build upon countries' own self-assessment exercises.
- While the evidence from the evaluation does not allow us to draw concrete conclusions about the merits of more explicit product differentiation between types of FSAPs,[3] greater tailoring of the assessments to individual country circumstances should be an explicit objective of the country strategies—a process that is already under way. For instance, a broad range of ROSCs may be needed in some countries whereas in others it would be appropriate to cover at most the banking sector.
- In many cases, these country-specific plans will involve stronger efforts to "mainstream" financial sector assessments into regular Article IV surveillance. In some cases, following an initial FSAP, it may be appropriate for subsequent Article IVs to focus periodically on financial sector issues. This would be a natural outcome of management's intention of making Article IV reports more focused, dealing only with issues of critical importance: where domestic or international aspects of financial stability are of critical concern they would naturally form such a focus.
- Area departments should be held accountable for delivering on the country-specific plans, as part of the ongoing efforts to strengthen the monitoring of surveillance effectiveness.[4]

Recommendation 2. *To strengthen incentives and drawing upon these country-specific plans, IMF management should clearly signal to the Board those countries that it sees as the highest priorities for FSAPs and Updates, irrespective of whether these countries have volunteered. These lists should be the basis for periodic discussions by the Board of country-specific priorities.*

- Also, in cases where there are indications of potential financial sector vulnerabilities in systemically important countries that have not volunteered for an initial assessment or Update, IMF

[2]Existing priority-setting processes have already moved some way in this direction, with periodic (typically every six months) meetings between MFD and each area department to discuss work program priorities; ICM attends these meetings.

[3]For example, the idea of "developmental FSAPs" that would focus on institutional and market access issues was discussed at one point but no such specific categorization was ever introduced and hence cannot be evaluated.

[4]This is consistent with the emphasis the IMF Board placed on clearer benchmarks for assessing the effectiveness of surveillance and the staff disseminating to the Board multiyear country work programs, articulated around a limited set of priorities (see the Summing Up of the Board discussion following the 2004 Biennial Surveillance Review, PIN 04/95 of August 24, 2004). Enhanced financial sector surveillance was one of the benchmarks established by the Board.

management should indicate to the Board where it proposes to call for an intensified analysis of financial sector issues as part of the regular Article IV surveillance.

- Since it is not possible to predict whether this proposed strengthening of incentives will be sufficient, coverage of the FSAP should be reviewed again after several years, with the emphasis on the adequacy of surveillance potential. The key benchmark should be inclusion of FSAPs and/or updates for the bulk of countries signaled as high priorities for such coverage in the strategic plans. If the Board concludes at that time that coverage is falling significantly short of this benchmark, consideration should be given to shifting to a more mandatory approach.

Recommendation 3. *Strengthen the links between the FSAP and surveillance by mainstreaming FSAPs and follow-up work into the IMF's regular surveillance activities.* This means incorporating the assessment of financial sector standing and vulnerabilities into the overall macroeconomic assessment of the country in a way that fosters a greater understanding of stability; policy recommendations that are set in a coherent framework combining macroeconomic and financial sector analysis; more meaningful discussion of financial sector issues with authorities; and enhanced peer review discussion at the Board. Steps that could be taken in this direction include the following:

- As noted above, where financial stability issues are judged to be of high importance—either as a result of the findings of an FSAP or because of the potential global systemic importance of country's financial system—they should be a major focus of an Article IV consultation. This would have obvious implications for the composition of the Article IV team.
- The internal review process should be strengthened to ensure that key messages on macro-financial stability are fully reflected in Article IV surveillance reports. A short (1–2 page) section in each FSSA that summarizes—in candid language—the main macro-relevant findings from the FSAP and the potential macroeconomic consequences arising from any major identified financial sector risks would assist this process.
- FSAP team leaders should be given a greater "voice" at the time of Board discussions, including an opportunity to summarize briefly what they see as the key FSAP findings with macroeconomic relevance.
- The Board itself should seek to give greater attention to financial sector issues in its surveillance discussions when the FSSA flags significant macro-relevant issues. If the potential implications for surveillance arising from the financial sector assessment are not sufficiently clear, the Board should encourage the staff to elaborate.
- Steps should be taken to identify and disseminate cross-cutting messages that arise in a number of FSAPs.[5] As part of this effort there is scope for integrating the macro-relevant findings of such assessments into multilateral surveillance Board papers and presentations, including informal presentations to the Board, similar to the World Economic and Monetary Development sessions, and for greater sharing of cross-country experiences in the context of FSAP reviews.

Improving the Quality and Impact of the FSAP and Organizational Changes Within the IMF

While the evaluation concludes that the overall average quality of the FSAP exercises is quite high, several shortcomings were identified. The most systematic shortcoming was the insufficient attention paid to cross-border financial linkages and their potential consequences. In addition, problems were encountered in many FSAPs with inadequate prioritization of recommendations, as well as insufficient indication of the degree of urgency of implementation. These problems hampered effective follow-up by both surveillance and technical assistance. Moreover, while the application of various analytical tools significantly strengthened the overall quality of the assessments, problems were encountered in a number of areas, of which the most frequent included (1) a tendency to understate the potential consequences of identified weaknesses in supervisory standards, especially with regard to de facto enforcement rather than de jure regulations; (2) presentations of the results of stress-testing exercises that tended to overstate what the exercises could say about the soundness of financial systems, given the data and methodological difficulties usually encountered. In some cases, these difficulties were compounded by a reluctance to investigate the potential consequences of politically sensitive shocks; (3) in a minority of cases, there was insufficient integration of the

[5]The 2004 staff paper on "Financial Sector Regulation—Issues and Gaps" was one good example.

macroeconomic and financial sector components of the assessment; and (4) many authorities would have liked to see greater efforts by FSAP teams to understand the political economy context of their country and to structure recommendations—especially those concerning wide-ranging reforms—with this context in mind. More generally, the need for greater staff continuity in follow-up on financial sector issues (both in surveillance and technical assistance) was a refrain heard frequently.

Addressing these issues will require steps to improve FSAP quality, in most cases by applying more widely what is already "good practice" (Recommendation 4) but also a number of organizational changes within the IMF to use scarce expertise on the financial sector and related capital market issues more effectively (Recommendation 5).

> ***Recommendation 4.*** *Implement steps to improve further the quality of the FSAP and strengthen its impact.* In most cases, these steps would involve applying more systematically what is already current policy or "good practice:"
>
> - Clearer prioritization of recommendations, along with a candid discussion of the potential consequences of not addressing key weaknesses.
> - Steps to improve the quality of stress-testing analysis, especially in emerging market and low-income countries. These steps should include more candid judgments on the quality of data available for the assessments, and stronger "health warnings" about the limitations to be placed on any results. While it is neither possible nor desirable to prespecify the precise types of shocks to be considered in particular country circumstances, it would be helpful to have greater transparency about the circumstances in which types of shocks that are likely to be politically sensitive will be analyzed.[6]
> - The greatest need is to include cross-border, financial sector linkages more systematically into the FSAP analysis. This will require, inter alia, greater ICM involvement, including at the TOR stage, in countries where cross-border linkages are of substantial importance.[7]
> - The Financial Sector Liaison Committee (FSLC) should ensure that FSAP team and deputy team leaders have adequate experience for the difficult challenges they face; if necessary, it would be better to reduce the number of FSAP missions rather than accepting any weakening in the quality of team leaders.

The evaluation indicates that the follow-up to the FSAP has been strongest in cases where the authorities have been most directly involved (i.e., have had some ownership of the FSAP results). Therefore, steps that enhance the involvement of the authorities in the process should be considered. We have the following menu of suggestions, but do not propose them as concrete recommendations so as to avoid prescribing specific procedural approaches that may not be well suited to all country circumstances:

- Engage the authorities at an early stage on the objectives and scope of the FSAP, including the specific terms of reference.
- Informal discussions of the key FSAP results with high-level officials, before reports are drafted, appear to have been highly effective in many cases and should be used for (1) a candid presentation of potential vulnerabilities; (2) a discussion of how to maximize the feasibility of various reform proposals; and (3) follow-up plans.
- The precise modalities for such discussions would vary by country, and could include separate visits by core members of the FSAP team once the authorities have absorbed the key messages or discussions in the context of Article IV missions, with relevant Bank staff invited to participate.
- The authorities should be invited (but not required) to provide a brief written response indicating where they agree and disagree with key recommendations and what their proposed plan of action is. Where appropriate, this response could be appended to the FSSA.

> ***Recommendation 5.*** *Introduce changes in the organization of IMF mission activities to utilize scarce financial sector technical expertise (especially in MFD and ICM) more effectively in the surveillance process.* One message from the evaluation is that the scarcity of financial sector and capital markets expertise is a major constraint on the effective follow-up in subsequent surveillance of major issues raised by FSAPs.[8] While efforts to

[6]For example, greater ex ante transparency about the circumstances in which the consequences for the banking system of sovereign debt events should be analyzed would be helpful, so as to avoid ad hoc decisions and unintended signaling about the expected probability of such events.

[7]Increased use of regional FSAPs are another option for incorporating better financial cross-border analysis, especially in monetary unions. Some regional FSAPs have already been undertaken (e.g., the FSAP for the Eastern Caribbean) or are under discussion (e.g., a regional surveillance exercise for the Nordic-Baltic region).

[8]In particular, the evaluation team's interviews with both ICM and area department staff indicated a widespread view that

improve area department staff training and experience on such issues is important, a model in which each area department relies primarily on such "in-house" expertise would probably not be efficient and would risk reducing the broad "cross-country" perspective that many of those interviewed said was a particular potential value added of IMF financial sector surveillance. While these organizational issues involve many additional factors beyond the scope of this evaluation, they may require further changes in the way surveillance missions are organized, in the direction of a model in which the area department is the strategic coordinator of relevant specialist inputs provided by functional departments.[9]

Joint IMF–World Bank Nature of the FSAP

The evaluation suggests that the joint nature of the exercise has brought considerable advantages in practice. In particular, organizing joint teams that included both IMF and World Bank staff members (as well as outside experts) has contributed significantly to the depth of analytical expertise and credibility of the findings in many, but not all cases.

Going forward, however, greater clarity will be needed on how trade-offs between the objectives and priorities of the two institutions are to be handled within the FSAP framework. More specifically, if steps to strengthen incentives for participation, discussed in the earlier recommendations, are successful, then more concrete guidelines will be needed on how to manage trade-offs between more frequent updated assessments of countries of systemic importance and/or potential financial vulnerability and assessments of countries with less developed financial sectors. The division between stability and some development aspects of the financial sector is not clear cut, and the IMF clearly has an interest in many aspects of the latter. Nevertheless, there are trade-offs between, for example, devoting resources to assessing vulnerability in financial systems and identifying strategies to make financial services available to underserved sectors or groups. The approach we suggest (in Recommendation 6) is to keep the present institutional arrangements, including joint FSAP teams but, within this structure, to clarify further the respective roles of the two institutions. This will also involve each institution taking the lead in priority setting in those situations where it has primary responsibility.

The evaluation also indicates that there is often a weak framework for formulating detailed action plans to follow up on the FSAP recommendations, and identifying coordinated technical assistance support for these plans. While the country itself should take the lead to formulate such action plans, the IMF (and World Bank) can strengthen their support by (1) better prioritization of recommendations in the FSAP (see Recommendation 4); (2) more explicit discussion of follow-up plans at the end of the FSAP exercise; and (3) a clearer framework for coordinating follow-up technical assistance (Recommendation 7).

Recommendation 6. *Maintain the current joint approach, but clarify further the distinctive contributions the IMF and World Bank can make, with the IMF taking the lead where significant domestic or global stability issues are present, and the Bank taking the lead where financial sector development issues are more paramount. Such clarity should include a clear delineation of primary responsibilities for setting priorities (and contributing resources).* It should also recognize the distinct contributions the two institutions can make to follow up action, with the IMF taking the lead where the main need is for policy advice and TA linked to stability issues, and the Bank where the main need is for institution building or financial sector restructuring with associated advice, analysis, and financing. Clearly, this delineation cannot be set in stone for any country since the issues that are most important will change as circumstances change and should be set as part of the country-specific strategy.[10] Moreover, we see the current coordinating framework for the joint approach, including a continued central role for the Financial Sector Liaison Committee, as a reasonably effective approach to ensuring that one institution taking the lead on certain issues and countries does not come at the expense of a reduced "buy in" of both institutions to the proposed strategy.

Recommendation 7. *The IMF, in conjunction with the World Bank and other technical assistance providers, should seek to establish a clearer framework for coordinating follow-up capacity-building technical assistance activities, based on the country's own action plans.* Clearly, the authorities should take ownership of identifying and

current arrangements were not utilizing ICM's expertise on capital market issues as effectively as possible, either in the FSAP or more generally in surveillance.

[9]The report by the Review Group on the Organization of Financial Sector and Capital Markets Work at the IMF (McDonough group) addresses these organizational issues in greater depth.

[10]As noted earlier, the case of Ghana represents a "good practice" example of how such changing priorities were handled.

coordinating such activities to the maximum extent feasible, and many countries may have no need for external involvement in establishing a suitable framework. However, evidence from the evaluation suggests that this is an area where many countries would like to see stronger support from the IMF and World Bank. Establishment of such a framework will also require a clearer understanding between the two institutions of the appropriate dividing line between the FSAP as an assessment vehicle and capacity building/development activities; at present, the IMF approach involves a sharper demarcation between the two activities than occurs in the World Bank.

While details of the framework would vary from country to country, and should build upon existing institutional arrangements for donor coordination, the following steps could be considered:

- Building on the discussions with the authorities of their proposed follow-up plans, relevant IMF and World Bank staff (i.e., MFD, the Bank's Financial Sector group, and area/country departments) should meet and prepare a possible agenda of capacity-building and other technical assistance needs, with an indication of priorities whenever requested to do so by country authorities. (Such quadrilateral meetings have been held recently for a small number of countries.)[11]
- This agenda (along with the FSSA and FSA, as soon as release is cleared by the authorities) should be shared with other relevant TA providers as early as possible, and the IMF should seek to coordinate its own activities with these providers, using existing country-based coordination mechanisms wherever possible.
- MFD may wish to relax its approach whereby mission chiefs (and to a lesser extent other staff) who have participated in an FSAP assessment for a country are not involved in subsequent TA activities to that country. While the evaluation team was not able to assess fully the arguments in favor of such a demarcation, there are signs that it can adversely affect continuity and the transfer of knowledge in the IMF's own TA activities.

Finally, a few words about the *possible resource implications of the various recommendations.* We are not in a position to provide specific estimates of the possible net costs of implementing each recommendation, in part because to attempt to do so would involve specifying the particular approach to be taken in much greater detail—choices that are best left to IMF management. However, in our judgment, many of the recommended actions would have limited resource cost implications that could be absorbed within the existing envelope. (For example, drafting FSAP/FSSA reports in a way that prioritizes recommendations and highlights the key findings of greatest macroeconomic relevance for surveillance is largely a question of the relative emphasis and content of the reports and should not require additional resources per se.) However, several of the recommendations would probably require additional resources, although exact quantification is not possible at this stage: (1) strengthening incentives for participation in the FSAP could raise average costs per FSAP if it results in a larger proportion of comprehensive Updates (and initial assessments) being undertaken for countries with relatively complex financial systems; (2) strengthened coverage of cross-border issues in FSAPs would require some additional staff time and specific expertise, although there may be scope for achieving some economies of scale through regional FSAPs; greater attention to these issues would be needed in some, but not all, FSAPs; (3) greater lead time before FSAP missions—to allow for further discussion with the authorities at the TOR stage, more advance notice of information requests, and so on—could raise moderately the total staff resources per FSAP, although better advance coordination with the authorities is likely to yield net benefits overall; and (4) more systematic approaches to post-FSAP follow-up, including a clearer framework for coordinating subsequent TA, are likely to involve additional costs, especially if additional country visits are required. Some of these costs would fall on the TA functions of MFD (and the respective area department), rather than the FSAP initiative per se. If the thrust of these recommendations is accepted, more precise quantification of resource costs would need to be prepared as part of any plan for implementation.

More generally, the message from this evaluation is that the FSAP has proved to be a reasonably effective vehicle for enhancing the IMF's understanding of financial sectors, including for surveillance purposes. Going forward, the choices made on country coverage are likely to be one of the biggest influence on FSAP costs and will reflect strategic decisions on how central to strengthening financial sector surveillance globally the FSAP exercise is intended to be. Some of these choices would involve higher resource costs for the FSAP. Such decisions on overall resource allocation can only be made in the context of the IMF's broader medium-term strategy.

[11]Another approach that is in the pipeline for two countries with recently completed FSAPs is to organize a "post-FSAP TA providers forum" under the chairmanship of the FSAP country, bringing together the IMF, World Bank, and other potential donors to consider how to take forward post-FSAP TA plans. In one of these cases, FIRST may be commissioned to transform the FSAP action plan into a series of coordinated TA programs. While it is too early to evaluate such an approach, it appears to be a useful precedent in line with the thrust of this recommendation.

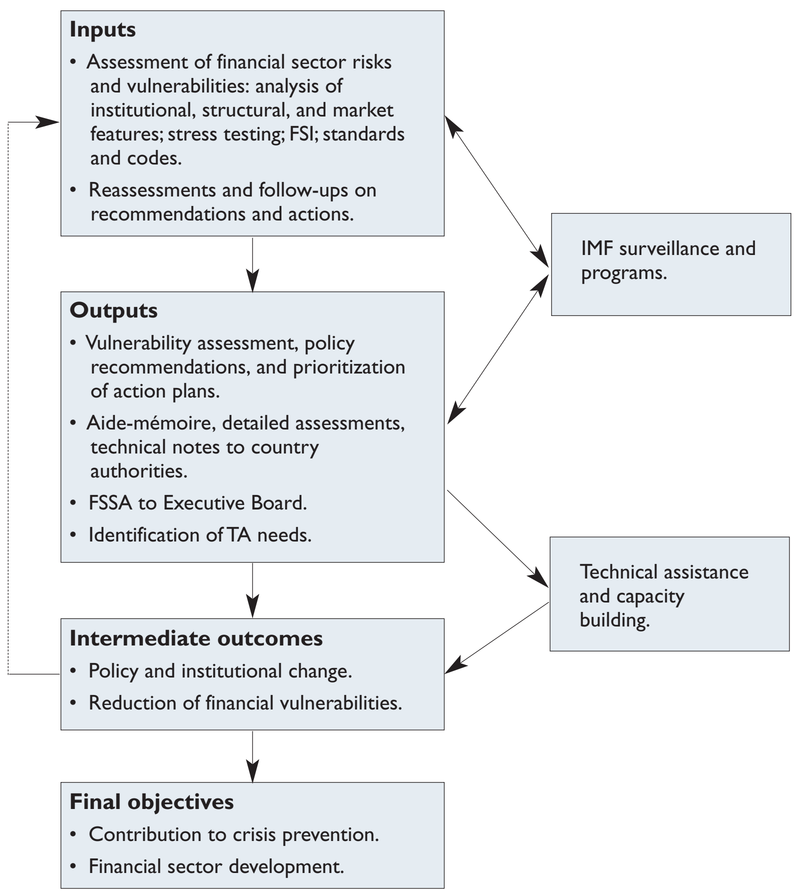
Annex I

Logical Framework for the FSAP Evaluation

The following chart shows a schematic version of a results chain (or logical framework) for the FSAP that guides the current evaluation.[1]

[1]See Duignan (2001) for a general discussion of evaluation methodologies.

The FSAP's Logical Framework



ANNEX
2 Survey of Stakeholders

As part of the evaluation, IEO and IEG undertook jointly a survey of the key stakeholders involved in the FSAP. This annex presents the methodology used for surveying the views of participants and a set of summary tables of various stakeholders' responses. The main findings from the surveys have been incorporated in the report. To ensure the confidentiality of survey responses, an external company was hired to administer the implementation and collection of results.[1] The surveys were conducted in the spring of 2005, to a large degree through an on-line modality.[2]

Population Surveyed

Survey questionnaires were sent to five groups of stakeholders, consisting of different users and producers of the FSAP:[3]

Authorities. A single survey was sent to the authorities of all countries that had completed an FSAP by the first quarter of 2005. Every effort was made to send the survey directly to the authorities in the country most directly involved with the FSAP.

IMF Article IV mission chiefs and area department division chiefs. The survey was sent to the relevant staff who worked on countries that had an FSAP.

World Bank country directors. The survey was sent to the relevant directors who worked on countries with an FSAP.

FSAP team leaders as well as deputies and co-leaders. Team leaders and co/deputy leaders are typically drawn one each from the IMF and World Bank.[4] FSAP updates were treated as a separate assessment from the original FSAP.

FSAP team members. The survey was sent to all team members from IMF and World Bank staff. External experts were not included.

Main Features of the Questionnaires[5]

- The outline of each questionnaire followed broadly the outline of the evaluation questions in the IEO and IEG Issues/Approach papers. The main components of each questionnaire related to inputs, outputs, outcomes, and process issues.
- There were about 30 questions for each group of stakeholders. Where applicable, the same questions were posed to different groups; a number of questions applied only to specific groups.
- Survey questions were mostly of the closed-end type. Many consisted of specific statements where respondents were asked to identify their views on a five-point scale (ranging from "strongly agree" to "strongly disagree"). Some questions had multiple choices, and others sought "yes/no" answers. Where applicable, the respondents were given the opportunity to choose a "don't know" option and to write in their response ("other, please specify"). At the end of the survey, all respondents were given the opportunity to provide comments on the FSAP.

Survey Response

The overall stakeholder response to the survey was quite high (53 percent of the net deliverable sample).[6] Significantly different response rates were obtained across groups; those from the authorities and FSAP leaders and members were the highest at around 60 percent (see Table A2.1). Tables A2.2–A2.10 summarize the results of the survey.

[1]The external company was Fusion Analytics LLC, Washington D.C.

[2]Participants were also given an opportunity to send their responses directly to Fusion Analytics by facsimile. Only a handful of authorities replied by fax.

[3]Stakeholders other than the authorities that had been involved with more than one FSAP were invited to submit a survey response for each country (up to a maximum of three).

[4]In advanced economies the IMF has responsibility for the FSAP.

[5]For those readers who are interested in seeing details of the specific questions and responses, a full version of each questionnaire and a summary of the responses is available on the IEO's website (at www.imf.org/ieo).

[6]Net deliverable sample is defined as the total target population minus those who could not be contacted for various reasons.

Table A2.1. Survey Sample and Response Rate

Survey	Original Unique Sample	Total Nonqualifying Sample	Net Deliverable Sample	Response Received	Response Rate[1] (In percent)
Authorities	81	5	76	45	59
IMF Article IV mission chiefs	83	9	74	27	36
World Bank country directors	57	3	54	14	26
FSAP team leaders	79	8	71	45	63
FSAP team members	289	41	248	148	60
Total	589	66	523	279	53

[1]Response rates represent the response received as a percentage of net deliverable sample.

Table A2.2. Motivation for FSAP
(In percent)

Reason	Authorities	IMF Mission Chiefs	World Bank Country Directors	Team Leaders
An independent assessment of the country's financial sector	80	70	57	82
Recommended by IMF/World Bank	42	56	71	40
To learn more about the country's financial sector	22	30	29	32
Concerns about financial vulnerabilities	24	15	50	26
FSAP is expected of every country	22	11	21	19
Signal to international capital market	18	19	14	40
Other peer countries have had FSAP	16	15	7	32
To facilitate lending by international financial institutions	9	15	21	18
Other	11	15	0	15
Don't know	0	4	0	2

Table A2.3. Quality of Analysis

(In percent, except for average rating)

	Authorities				IMF Mission Chiefs				World Bank Country Directors				Team Leaders				Team Members			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
1. FSAP provided analytical insight into country's financial sector that did not exist before	45	32	23	0	38	38	25	0	57	29	14	7								
Average rating[1]		**3.36**				**3.25**				**3.50**										
2. Analysis balanced financial sector stability issues with development priorities	48	41	11	16	44	39	17	28	35	50	15	7								
Average rating[1]		**3.41**				**3.33**				**3.36**										
3. Recommendations took into account unique country circumstances	40	40	20	0	46	46	8	0	57	29	14	7								
Average rating[1]		**3.23**				**3.46**				**3.57**										
4. Recommendations were prioritized	67	23	9	2	50	17	33	0	33	40	27	0								
Average rating[1]		**3.74**				**3.29**				**3.27**										
5. Recommendations were clear	94	7	0	0	67	33	0	0	53	33	13	0								
Average rating[1]		**4.32**				**3.92**				**3.73**										
6. Recommendations were candid	74	14	12	2	63	17	21	0	46	33	20	0	86	10	5	0	71	24	5	0
Average rating[1]		**3.74**				**3.46**				**3.53**				**4.29**				**3.90**		

Note: 1 = strongly disagree or disagree; 2 = neither agree nor disagree; 3 = strongly agree or agree; and 4 = don't know. For presentational purposes, the five-point scale used for the survey has been condensed to a three-point scale.

[1]Averages are based on the five-point scale that was used in the survey.

Table A2.4. Usefulness

(In percent, except for average rating)

	Authorities				IMF Mission Chiefs				World Bank Country Directors				Team Leaders				Team Members			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
1. Satisfaction with FSAP recommendations	81	16	2	0	59	29	13	0	54	27	20	0								
Average rating[1]		**3.93**				**3.63**				**3.47**										
2. Satisfaction with overall usefulness of FSAP	81	14	5	0	39	39	22	0	43	29	28	0	78	16	7	0				
Average rating[1]		**3.93**				**3.22**				**3.21**				**3.84**						
3. Most insightful FSAP components																				
a. Input into reform agenda		43				54				73				65						
b. Integrated financial sector analysis		71				50				47				84						
c. Financial standards and codes assessment		80				42				33				59						
d. Assessment of development priorities		21				29				27				52						
e. Anti-money laundering and CFT		18				13				7				11						
4. Most useful analytical component																				
a. Financial infrastructure assessment		66				54				33				66						
b. Stress testing		75				38				33				62						
c. Financial soundness indicators		59				38				40				43						
d. With public		14				4				13				26						
5. Three most useful FSAP areas	Objective evaluation of financial sector (58 percent). Integrated view of financial sector (16 percent). Learning best international practices (11 percent).				Objective evaluation of financial sector (62 percent). Identification of new financial sector risks and learning new analytical techniques (13 percent each). Enabling reforms by contributing to public debate (8 percent).				Objective evaluation of financial sector (40 percent). Integrated view of financial sector (31 percent). Identification of new financial sector development needs, prioritization of financial sector reforms, learning new analytical techniques, learning best international practices, and identification of TA needs (8 percent each).				Objective evaluation of financial sector (30 percent). Integrated view of financial sector, identification of new financial sector development needs, and prioritization of financial sector reform (13 percent each). Identification of new financial sector risks (12 percent).				Objective evaluation of financial sector (38 percent). Integrated view of financial sector (15 percent). Identification of new financial sector risks (12 percent).			
6. Three least useful FSAP areas	Identification of TA needs (58 percent). Enabling reforms by contributing to public debate (50 percent). Identification of new financial sector development needs (33 percent).				Improved coordination among regulators (52 percent). Enabling reforms by contributing to public debate (48 percent). Learning new analytical techniques (35 percent).				Enabling reforms by contributing to public debate (69 percent). Improved coordination among regulators and prioritization of financial sector reforms (39 percent each). Identification of new financial sector risks (31 percent).				Enabling reforms by contributing to public debate (48 percent). Improved coordination among regulators (41 percent). Learning new analytical techniques (34 percent).				Enabling reforms by contributing to public debate (46 percent). Improved coordination among regulators (40 percent). Learning new analytical techniques (28 percent).			

Note: 1 = strongly disagree or disagree; 2 = neither agree nor disagree; 3 = strongly agree or agree; and 4 = don't know. For presentational purposes, the five-point scale used for the survey has been condensed to a three-point scale.

[1]Averages are based on the five-point scale that was used in the survey.

Table A2.5. Outcome

(In percent, except for average rating)

	Authorities				IMF Mission Chiefs				World Bank Country Directors				Team Leaders			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
1. Financial sector vulnerabilities have been reduced since the time FSAP was completed	39	45	16	13	6	39	56	44	45	18	36	18	44	34	23	44
Average rating[1]	**3.26**				**2.11**				**3.09**				**3.27**			
2. FSAP generated negative public debate	10	3	86	10	5	5	91	9	7	7	86	7				
Average rating[1]	**1.59**				**1.50**				**1.79**							
3. FSAP strengthened strategic view on development of financial sector	52	37	10	2												
Average rating[1]	**3.43**															

	Authorities			IMF Mission Chiefs			World Bank Country Directors			Team Leaders		
	Yes	No	Don't Know	Yes	No	Don't Know	Yes	No	Don't Know	Yes	No	Don't Know
4. Has FSAP contributed to a policy debate in the country?	56	33	11	35	48	17	40	60	0	61	19	19
5. Form of policy debate												
a. Within government agencies		92			100			80			97	
b. Financial sector stakeholders		75			75			60			71	
c. With legislators		63			50			20			34	
d. Public debate		13			25			0			8	

Note: 1 = strongly disagree or disagree; 2 = neither agree nor disagree; 3 = strongly agree or agree; and 4 = don't know. For presentational purposes, the five-point scale used for the survey has been condensed to a three-point scale.

[1]Averages are based on the five-point scale that was used in the survey.

Table A2.6. Implementation

(In percent, except for average rating)

	Authorities				IMF Mission Chiefs				World Bank Country Directors				Team Leaders				Team Members			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
1. Extent of implementation of main FSAP recommendations	66	26	7	2	42	26	32	26	11	33	55	56	53	37	10	27	37	35	28	70
Average rating[1]		**3.60**				**3.11**				**2.44**				**3.45**				**3.09**		
2. Major reason for not implementing FSAP recommendations																				
a. Little political support		17				13				50				39						
b. Recommendations too recent		17				44				14				29						
c. Disagree with recommendations		28				17				14				9						
d. Difficulty in prioritizing		14				4				36				7						
e. Too many recommendations		8				4				36				3						
f. Other		42				17				21				9						

Note: 1 = strongly disagree or disagree; 2 = neither agree nor disagree; 3 = strongly agree or agree; and 4 = don't know. For presentational purposes, the five-point scale used for the survey has been condensed to a three-point scale.

[1]Averages are based on the five-point scale that was used in the survey.

Table A2.7. Follow-Up

(In percent)

	Authorities			IMF Mission Chiefs			World Bank Directors			Team Leaders		
	Yes	No	Don't know	Yes	No	Don't know	Yes	No	Don't know	Yes	No	Don't know
1. Was FSAP output published?	66	29	5	58	25	17	13	33	53	65	22	13
2. Reasons for not publishing FSAP output												
a. To keep it confidential		58			33			60			60	
b. To protect market-sensitive information		50			17			20			7	
c. Disagreement with recommendations		8			17			20			7	
d. Government does not publish such documents		8			33			20			0	
e. FSAP was a pilot		17			17			20			0	
f. Other		8			33			20			33	
3. Modalities of IMF follow-up of FSAP												
a. Article IV consultations		67			82						66	
b. Technical assistance		24			41						31	
c. IMF-supported program		21			18						26	
d. FSAP update		17			14						10	
e. Did not follow up		5			0						3	
4. Modalities of World Bank follow-up												
a. Nonlending activities		5						57			40	
b. Don't know/n.a.		42						14			43	
c. Lending		11						43			22	
d. World Bank facilitated technical assistance		18									37	
e. FSAP update		11						14			10	
f. Did not follow up		16						0			2	
g. Regular contacts with authorities								50				

Table A2.8. Role of the Executive Board and Management

(In percent, except for average rating)

	IMF Mission Chiefs				World Bank Country Directors				Team Leaders				Team Members			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
1. Focus of IMF Board discussion on main risks identified in FSA	11	58	31	37					52	24	24	48				
Average rating[1]		**2.74**								**3.29**						
2. Focus of World Bank Board discussion on main risks identified in FSSA					25	25	50	250	50	50	0	450				
3. Satisfaction with IMF's internal comments during FSAP process									14	28	58	2	13	29	58	15
Average rating[1]										**3.60**				**3.50**		
4. Satisfaction with World Bank's internal comments during FSAP process									49	29	22	18	45	31	24	37
Average rating[1]										**3.33**				**3.32**		

Note: 1 = not focused/very dissatisfied or somewhat focused/dissatisfied; 2 = neither focused/satisfied nor not focused/dissatisfied; 3 = completely focused/very satisfied or focused/satisfied; and 4 = don't know.

[1]Averages are based on the five-point scale that was used in the survey. For presentational purposes, this scale has been condensed to a three-point scale.

Table A2.9. Team and Process

(In percent, except for average rating)

	Authorities				IMF Mission Chiefs				World Bank Country Directors				Team Leaders				Team Members			
	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4
1. FSAP team's technical skills	92	7	0	2	59	27	14	9	78	21	0	7								
Average rating[1]	**4.14**				**3.68**				**4.00**											
2. FSAP process required too much data	59	21	21	0																
Average rating[1]	**3.67**																			
3. FSAP process provided significant lead time for preparations	46	42	12	5																
Average rating[1]	**3.41**																			
4. FSAP process was too time consuming	42	42	17	5																
Average rating[1]	**3.32**																			
5. Team leader was able to select a strong team													77	14	9	0				
Average rating[1]													**4.08**							
6. Joint IMF–World Bank FSAP is cost efficient													53	21	25	7				
Average rating[1]													**3.27**							
7. Joint IMF–World Bank team worked well together													82	9	9	14	62	23	16	16
Average rating[1]													**4.21**				**3.74**			
8. Team's access to information was adequate													81	16	3	0	83	12	6	0
Average rating[1]													**4.14**				**4.09**			
9. Team members had enough time to complete the work													67	16	17	0	64	17	19	2
Average rating[1]													**3.76**				**3.66**			
10. Team members had enough resources to complete the work													79	18	3	0	70	19	11	1
Average rating[1]													**4.03**				**3.88**			

Note: 1 = strongly disagree or disagree; 2 = neither agree nor disagree; 3 = strongly agree or agree; and 4 = don't know. For presentational purposes, the five-point scale used for the survey has been condensed to a three-point scale.

[1]Averages are based on the five-point scale that was used in the survey.

Table A2.10. General Aspects

(In percent)

	IMF Mission Chiefs			World Bank Directors			Team Leaders			Team Members		
	Yes	No	Don't know	Yes	No	Don't know	Yes	No	Don't know	Yes	No	Don't Know
1. Would it useful for the country to ask for an FSAP update?	58	33	9	31	35	35	39	46	14	65	33	2

	Voluntary	Mandatory	Don't Know	Voluntary	Mandatory	Don't Know	Voluntary	Mandatory	Don't Know	Voluntary	Mandatory	Don't Know
2. Should FSAP be voluntary or mandatory?	84	16	0	52	35	13	69	31	0	59	39	2

	2–3 Years	4–5 Years	Over 5 Years	Flexible	2–3 Years	4–5 Years	Over 5 Years	Flexible	2–3 Years	4–5 Years	Over 5 Years	Flexible	2–3 Years	4–5 Years	Over 5 Years	Flexible
3. Preferred frequency of updates	58	33	4	4	63	38	0	0	80	0	0	20	35	47	14	4

	Strongly Agree or Agree	Neither Agree nor Disagree	Strongly Disagree or Disagree	Don't Know
4. FSAP should focus more on development than on stability issues	32	32	37	5
Average	**2.72**			

Note: Averages are based on the five-point scale that was used in the survey. For presentational purposes, this scale has been condensed to a three-point scale.

ANNEX
3 Assessment Methodology for Country Studies

This annex presents the methodological approach used in the 25 case studies undertaken as part of the evaluation. The assessment comprised both a desk review component and the interview of key stakeholders, specifically:

(1) Systematic review of relevant documents using a detailed template (including all FSAP papers, Article IV and program documents, comments from review departments, Public Information Notices, and Executive Board minutes).

(2) Structured interviews with FSAP and Article IV mission leaders and World Bank staff;[1] and interviews with country officials.

The review of documents involved the use of a detailed template to evaluate specific questions (see Table A3.1). The template specifies detailed criteria for the assessment and comprises two types of results: qualitative assessments and ratings (in a four-point scale). Where ratings were required, the template describes what would be expected to warrant a specific rating.

Some broader questions, such as those regarding more general quality aspects of FSAPs, required combining several specific questions into a broader qualitative assessment that is discussed in the main report.

The full sample of case studies was combined into an overall database that permitted the analysis of specific questions and ratings by the various characteristic used in the sample selection, including vintage of FSAP, systemic importance of the country concerned, and so on.

Structured interviews with staff used a common set of questions across countries, tailored when necessary to the specific elements of the case. Interviews served two purposes: to triangulate evidence collected through other sources; and to obtain evidence specific to the stakeholder's role in the FSAP process.

The interviews with country authorities were conducted by phone or in the context of a visit to the country.[2] The evaluation team visited 14 countries of the 25 case studies.[3] In these cases, the team held extensive consultations with a variety of country authorities, which typically included senior officials at the central bank, the ministry of finance, and various supervision agencies and regulatory bodies.

[1]Since IEO's evaluation of the FSAP was in parallel to that of the World Bank's IEG (meaning extensive collaboration on all aspects of inputs into the evaluation process), IEG staff was invited to attend these interviews. Conversely, IEG held interviews with World Bank staff where IEO staff was invited to participate.

[2]All country authorities were given an opportunity to provide feedback on their experience with the FSAP.

[3]Countries visited included Bulgaria, Cameroon, Costa Rica, Germany, Ghana, India, Ireland, Japan, Jordan, Korea, Romania, Russia, Slovenia, and South Africa.

Table A3.1. Criteria and Coding Scheme for Desk Reviews[1]

I. Inputs, Effectiveness, and Efficiency Assessment	
A. Scope of financial sector coverage across countries	
1. Did terms of reference (TORs) discuss criteria for prioritization of issues?	Yes/No, describe.
2. Did FSAP discuss reasons for scope and depth of sectoral coverage?[2]	Yes/No, describe.
3. Which sectors were covered?	List all covered sectors.
4. Were the critical sectors as defined in question (5) adequately analyzed (or what was the degree of coverage)?	Rating: Each important sector should be rated separately. Adequate analysis means a judgment if the sector is analyzed according to its relative importance in the economy.[3] Rating scheme is the following: (1) Comprehensive; including (where appropriate) market structure, compliance with standards and codes, stress testing, governance issues, legal and institutional aspects, etc. (2) Some aspects not covered adequately (without a clear explanation of why) or only partially discussed. (3) Several aspects not covered, partially discussed. (4) Focus only on just a few aspects (without proper explanation), cursory discussion across the board.
5. Did the internal review process (comments by IMF/World Bank departments) discuss appropriateness of scope and depth of sectoral coverage in FSAP?	Yes/No, describe.
6. How was the overall financial sector covered in FSAP?	Rating: (1) The overall financial sector got full attention; trends, strengths, and weaknesses were analyzed; its structure, role in the economy, and development needs explained in details. (2) Overall financial sector is assessed but the coverage and depth of analysis could be better.[4] (3) There is relatively little mention of the overall financial sector analysis. (4) There is no analysis of the overall financial sector but only separate sectors are covered (like banking, insurance, etc.).
7. Do documents discuss the need for an FSAP reassessment or focused update?	Yes/No, describe.
8. According to your judgment, please select the appropriate category for the country.	Rating: (1) Macro conditions are stable and expected to remain so, no major weakness was identified, the regulatory and supervisory frameworks are commensurate with the path of financial development, etc. (2) Macro conditions are stable, no systemic risk, but some sectors have vulnerabilities or in the process of development. This would require follow up (operational support and more frequent—albeit focused—reassessments (updates)). (3) There are some macro/systemic risks, sectoral vulnerabilities and major development needs, which would require systematic follow up (operational support and more frequent, fuller reassessment). (4) Major macro or financial sector vulnerabilities and development needs requiring follow up and intense monitoring of the situation.
B. Cooperation between IMF and World Bank	
9. Do documents specify how were sectoral responsibilities divided?	Yes/No, describe.
10. Keeping in view TOR, was the emphasis in documents more on financial development issues or on stability issues?	Describe.
C. Modalities and toolkit for identification of risks, vulnerabilities, and development needs	
11. Were the evaluated risks (possible domestic shocks) and development needs linked clearly to country conditions?[5]	Yes/No, describe.

Table A3.1 *(continued)*

12. Has FSAP taken into account regional and global risks (external shocks), trends, and their possible impact on a country?	Rating: (1) Full integration into risk assessment (e.g., stress testing including terms of trade, global interest rates, etc., where applicable), explaining linkages and potential transmission mechanisms. (2) Partial integration (i.e., covering some sectors or risks) with cursory explanation of linkage. (3) Cursory reference to regional/global risks. (4) Complete lack of reference to regional/global risks.
13. Do the documents discuss the regional or global implications of the domestic (country) financial sector risk?	Yes/No, describe.
14. Has the analysis been cast broadly enough to capture less obvious vulnerabilities (e.g., transfer of risks between government and financial sector, perceptions of implicit government guarantees)?	Yes/No, describe.[6]
15. Were the financial sector vulnerabilities analyzed in questions 15–19 integrated in the overall assessment?	Yes/No, describe.
16. Has the overall assessment considered explicitly the linkages between financial development and stability issues (i.e., potential complementarities and trade-offs)?	Rating: (1) Thoroughly discussed, reflected in overall assessment, and integrated into recommendations and prioritization criteria. (2) Linkages discussed and incorporated in some specific sectors, but not well integrated into overall assessment. (3) Some aspects of linkages considered in some specific sectors. (4) Little or no reference to linkages.
17. Have other mechanisms of financial sector surveillance/reviews/assessments discovered new risks and vulnerabilities after FSAP?	Yes/No, describe.
18. Was the rationale for the choice of certain analytical tools and methodologies used in FSAP made explicit (were they explained)?	Yes/No, describe.
19. Were the available data for the FSAP sufficient (both quantity and quality)?	Yes/No, describe.
20. If the data were not sufficient (in quantity and/or quality), was this considered to be of major importance for the findings/assessment (significantly hampering analysis or even obstructing the assessment altogether)?	Yes/No describe.
21. Standards and codes (S&C). Do reports discuss extent to which S&C are appropriate for country conditions?	Yes/No, describe.
22. Do the documents discuss reasons for selection of assessment of S&C?	Yes/No, describe.
23. How did the assessments of S&Cs feed into the overall analysis?	Rating: (1) Fully and main conclusions were well integrated into the overall assessment. (2) Main findings were embedded into the analysis, but not completely, (3) Assessment of S&C was mentioned but some findings were "mechanically" incorporated into the assessment. (4) S&C were barely mentioned or not mentioned at all into the overall analysis.
24. Has the assessment of S&C dealt with the distinction between de jure and de facto implementation of regulations?	Yes/No, describe.[7]
II. The Outputs: Articulation of Findings and Recommendations	
25. Were findings and diagnosis in the FSAP clear and candid for the overall financial sector and major sectors analyzed?	Rating: (1) All issues and sectors are clearly/unambiguously explained and linked to specific aspects of financial risks and vulnerabilities. FSAP overall assessment addresses directly and prominently the more pressing and systemically important findings. (2) Some issues/sectors are not stated/analyzed clearly enough (open to interpretation) or the logical implications are not fully spelled out. The overall assessment is broadly clear and candid but some risks are reflected less prominently.

Table A3.1 *(continued)*

	(3) Some important, systemic risks or sectors are not reflected prominently in the overall assessment or they reflect a different sense of urgency/importance than in other parts of the report (inconsistent/disconnected tone of findings). (4) Overall assessment does not reflect major systemic risk/sectors or there is a major inconsistency or disconnection in the tone of findings with other parts of the report.
26. Were the importance and consequences of findings explained?	Rating: (1) The systemic importance of findings is clearly stated, including linkages involved. The consequences of lack of action to correct the vulnerabilities are well explained and their potential for macroeconomic impact is considered. The implications of implementing the recommendations are clearly analyzed. (2) The potential systemic/macro impact of some vulnerabilities and implications of recommendations are not well explained or consequences limitedly addressed. (3) Major vulnerabilities identified are not linked to systemic or macro consequences. (4) There is a general lack of sense of importance or consequences of findings.
27. Were the issues and clarity/candidness in the FSSA aligned with those in the FSAP?	Rating: (1) Full coherence of FSSA and FSAP findings and recommendations. Only information that is clearly market sensitive (on individual financial institutions) is left out. (2) Broadly consistent. Some sectors or systemic issues not fully treated on similar basis (less prominence or downplayed importance). (3) FSSA does not adequately reflect FSAP findings, though some are mentioned. (4) There is a major difference between both documents.
28. Have the FSAP recommendations been clear?	Rating: (1) All recommendations are clearly/unambiguously explained and linked to specific findings. (2) Some recommendations are not stated clearly enough (open to interpretation) or the linkage to findings is not fully spelled out. (3) Some major recommendations linked to systemic risks are not clearly stated. (4) General lack of clarity and linkage to findings in recommendation plan.
29. Have the FSAP recommendations been usable (e.g., specific as opposed to general)?	Rating: (1) All recommendations have a high degree of specificity and can be linked to concrete and well-identified actionable reform agenda. (2) Some recommendations lack proper specificity to identify concrete actions. (3) Many recommendations lack proper specificity to identify concrete actions, or some key recommendation of systemic importance are not specific enough. (4) Complete lack of specificity in most recommendations.
30. Have the FSAP recommendations been prioritized (laying out a strategic agenda with attention to sequencing needs)?	Rating: (1) The assessment emphasizes the need to address those vulnerabilities that are more pressing and of systemic importance. For each sector it specifies which measures are most urgently needed, and what is the interplay and sequencing of recommendations. It also sets priorities for medium-term, institutional reforms. (2) Good degree of prioritization but some sequencing issues not well addressed. (3) Some prioritization exist but it is unclear and partial. (4) Complete lack of prioritization.
31. Have the FSAP recommendations taken into account "technical" country specific capacity constraints (ex ante constraints)?	Yes/No, describe.[8]

Table A3.1 *(continued)*

32. Were recommendations in FSAP followed up consistently in IMF/World Bank programming, operations (technical assistance, lending and analytical work), updates or other forms of financial sector surveillance (programs, Article IV)?	Rating: (1) All recommendations were followed in subsequent operations, assistance and documents. (2) Main recommendations were followed up, but not all or not fully. (3) Some recommendations were followed up, but neither consistently nor the major ones. (4) No recommendations was followed up in documents after the FSAP.
33. Has the FSAP led to a better understanding of future World Bank/IMF assistance needs for a country?	Yes/No, describe.
34. Has the subsequent World Bank/IMF assistance matched the identified needs and recommendations by FSAP?	Yes/No, describe.
III. Outcomes: Policy and Institutional Change and Strengthening of Financial Sector	
35. Have recommended actions/reforms been effectively carried out by country authorities? In answering assess if the momentum for reforms has picked up after the FSAP (or after an FSAP update for cases where this is applicable).	Rating:[9] (1) They were completely carried out, all recommendations were fully implemented in scope and in "spirit." (2) To a large degree (major ones were accomplished). (3) To some degree, only some recommendations were implemented, but most major were left out. (4) No recommendations were carried out.
36. Do documents give ex post reasons and constraints for lack of financial sector reform (and implementation of recommendations)?	Yes/No, describe.
37. Have FSAP influenced World Bank/IMF supported program design?	Yes/No, describe.
38. Have FSAP updates evaluated the implementation of initial FSAP recommendations?	Yes/No, describe.
39. Did FSAP/Article IV mention constraints and limitations of what can be expected from FSAP?[9]	Rating: (1) Aim and constraints of FSAP are well explained and country specific limitations are given. (2) Main FSAP constraints are explained in documents (major points, major constraints) but could be better, more explicit. (3) Some constraints are mentioned but they are neither well explained nor comprehensive. (4) No constraints are mentioned.
IV. Integration with IMF Surveillance	
40. How is FSAP included in Article IV (staff report, especially staff assessment, sometimes Selected Issues papers)?[11]	Rating: (1) FSAP findings (financial sector surveillance) are fully included and well embedded into Article IV (meaning full integration and especially the main messages and the "spirit" of financial sector surveillance). (2) FSAP (financial sector surveillance) is integrated, main points are reported, but could be more comprehensive, could be better explained, could use stronger arguments, etc. (3) FSAP (financial sector surveillance) is mentioned (typically in one or two paragraphs), but is not integrated, main messages are not well transmitted, and one is under the impression that the financial sector is "mechanically" implanted in the Article IV, without reflecting the main messages/spirit of the report. (4) FSAP (financial sector surveillance) is not mentioned at all.
41. Are FSAP Updates (only Updates, not FSAP itself) findings discussed and reported during Article IV consultations?	Yes/No describe (where applicable).
42. Have Article IV, programs, and TA assessed implementation of reforms?	Yes/No, describe.
43. Are the linkages between the macroeconomic variables and financial sector (both ways) well integrated in Article IV?	Yes/No, describe.

Table A3.1 *(concluded)*

44. Has the intensity of coverage of financial sector issues in the Article IV consultations waned with time (in subsequent Article IV) after the attention received initially with the FSAP?	Rating scheme: (1) Intensity has stayed strong, in accordance with recommendations (there is a possibility that there are not much to report if there were no major problems). (2) Relatively strong, but with time has somewhat waned. (3) It has faded to a significant degree (mean revert). It is mentioned but more pro forma, less in substance. (4) Has disappeared from the "radar screen" immediately after the FSSA/Article IV discussion.
45. How was the FSSA reported and discussed at the Executive Board meeting? Does the PIN reflect FSSA main findings?[12]	Rating: (1) FSSA findings were fully reported and discussed at the board and reflected in PIN. (2) Main findings were reported and discussed in PIN but more attention should have been paid. (3) Only some issues were briefly reported without the "core" findings reported to the Board and reflected in PIN. (4) Board did not discuss the FSSA at all or only marginally and the same with PIN.
46. Evaluate the overall FSAP/FSSA documents presentation.	Describe.

[1]The matrix was a combined template used together with the World Bank's IEG. Questions pertaining exclusively to the role of the World Bank that were the focus of the IEG evaluation have not been included.

[2]FSAP comprises the aide-mémoire (or main report), assessment of standards and codes, and all other volumes that might be prepared after the missions.

[3]For example, a small sector in the economy does not require sophisticated stress tests. But even if relatively small, a sector can be comprehensively analyzed and get a relatively high rating.

[4]Note separately the major weaknesses.

[5]Some examples of possible linkages are: Were the risks coherent with macro risks in Article IV? Do they take into account the degree of financial development of a country? Do they talk about past financial sector failures? Have they taken into account planned reforms in the financial sector? And liberalization/deregulation vis-à-vis regulatory framework. The evaluator should think whether there was a forward-looking appraisal of risks.

[6]Desk review is not fully appropriate to answer this question. Additional evidence for this will have to be collected by interviews, surveys, etc.

[7]This question should include issues such as past failures to follow up prearranged resolution mechanisms, proper regulatory framework but pervasive governance problems, etc. Desk reviews can only assess if reports address the issue that needs to be followed up in interviews (and other sources of evidence).

[8]For example, are the institutions qualified in professional, technical terms to implement recommendations? In assessing this question, it would be helpful to take into account the assessment of standards and codes that deal with institutional capacity of a country.

[9]This question cannot be fully answered from documents. It would require follow-up in interviews.

[10]FSAP limitations relate for example to difficulties to identify problems in individual institutions or fraudulent operations, political willingness to undertake preventative actions or implement pre-established mechanisms, etc.

[11]This requires checking Article IV before and after the FSAP. When answering try to assess if the possible important changes in a country are taken into account and if financial sector surveillance is done outside the FSAP.

[12]To answer this question, one should in all cases check the PIN. Where warranted, one should check the minutes of the Executive Board meeting and the so-called grays or Executive Directors' statements.

ANNEX 4

Additional Information on Priority-Setting Processes, Costs, and FSAP Organization

This annex supplements the discussion in Chapters 1 and 2 of the main report with additional information on arrangements for setting priorities; outcomes in terms of country and sectoral coverage; resource costs of the exercise; and some aspects of FSAP mission organization.

Objectives and Procedural Arrangements for Setting Priorities

While the criteria for setting FSAP priorities across countries and for the selection of topics covered within countries have been modified over time—in the direction of greater selectivity—the core of the approach remains unchanged.

For *country participation,* the IMF and World Bank Executive Boards endorsed a variety of criteria for setting priorities at the time of the initial review of the pilot stage, including a country's (1) systemic importance; (2) external sector weakness and financial vulnerability; (3) features of its exchange rate and monetary policy regime that make its financial system more vulnerable—such as inconsistencies with other macroeconomic policies; (4) likelihood of upcoming major reform programs (as reflected for example in the Bank's Country Assistance Strategy);[1] and (5) geographical balance among countries. It was noted that country selection should seek to maximize the program's contribution to the strengthening of national and international financial stability, and thus within any one year should give priority to systemically important countries (SICs). The SICs were defined as (1) countries whose capital markets intermediate the bulk of global financial transactions; and (2) emerging market economies whose financial systems have the potential to cause, or be subject to, undue volatility in cross border flows and financial system contagion. However, no explicit list of such countries has ever been made public.[2]

The criteria were revised by the Executive Boards in March 2003 to take into account the need to accommodate countries' requests for FSAP reassessments and updates while balancing the expectation that all member countries would benefit from the program. While noting the need to give continued priority to industrial and emerging market economies of regional or international systemic importance, priority for reassessments and Updates would be given to countries where there have been major developments in the financial system, or a lengthy period had passed since the last assessment. These criteria were further refined in the 2005 FSAP review by noting that the interval between assessments should be shorter for SICs, and for countries where there have been significant macroeconomic shocks to the financial system, or major reforms have taken place. Furthermore, an earlier update may also be appropriate in cases where important financial sector issues were not covered in the initial FSAP but are deemed to warrant an in-depth analysis.

A few things are worth noting with regard to these criteria. First, even though they are multidimensional and with no specific weighting attached—hence leaving room for discretion in their implementation—they clearly signal the major importance attached by the Executive Boards to having systemically important countries' participation, both in the initial assessments and the Updates. Second, in any given year, there is an expectation that priority should be given to these countries. Third, these countries should also be reassessed more frequently. Finally, the notion of systemic importance encompasses both regional and global dimensions.

[1]This criterion was not explicitly identified in the Chairman's Summing Up, but it was fleshed out in subsequent reports and internal memoranda.

[2]In a table listing the FSAPs that have been initiated through FY2003, the staff identified the following economies (among those in the list) as being systemically important: Argentina, Brazil, Canada, Germany, Hong Kong SAR, India, Japan, Korea, Luxembourg, Mexico, Russia, Singapore, Switzerland, and the United Kingdom. There was no complementary list identifying the systemically important countries that had not participated up to that point.

Box A4.1. Financial Sector Liaison Committee Guidelines for Country Selection

The Financial Sector Liaison Committee (FSLC) developed guidelines covering all stages of the FSAP process, including country selection and scheduling, FSAP teams leader selection, terms of reference for FSAP missions, and preparation, discussion, and transmittal of FSAP reports.[1] For country selection, the FSLC envisioned an iterative consultative process involving the regions in the World Bank and the area departments in the IMF. Consultation would be undertaken every six months to prepare rolling FSAP work plans covering the year ahead. These procedures were endorsed by both Executive Boards.

Under these procedures, IMF area departments and Bank regions would each identify candidates for inclusion in the program with no requirement for agreement at the initial stage. Countries were to be ranked in three groups, highest (1), high (2), and medium (3) priority in accordance with the criteria established by the Boards, with a view to generate "first-best" lists. Country authorities' willingness to participate in the program was not supposed to be considered at this stage. MFD, and its counterpart in the Bank, the Financial Sector Vice-Presidency (FSE), would then compile separate "first-best" lists to be discussed by the FSLC. Discussions would seek to reconcile differences in ratings, preparing a modified "first-best" list of countries that would be sent to departments and regions for comments. MFD/FSE would then send a final "first-best" list to their respective managements for approval, noting remaining differences. On the basis of the consolidated list approved by the two managements, and now taking into account other considerations (i.e., resources availability, timing for Article IV consultations), MFD/FSE would follow up on country participation to prepare operational lists for the coming year, based on countries responses.

In addition, country authorities may independently request participation in the FSAP, but in such cases the relevant Bank region and IMF area department need also to agree that the country is a suitable priority candidate for participation.

If a country's participation in the FSAP is considered to be of high priority by IMF and World Bank staff, but the country is reluctant to commit to participating, the staff can seek the assistance of Bank and Fund management in encouraging the country's participation.

[1]See, for example, the Attachment in "Progress Report on the Bank-Fund Financial Sector Liaison Committee" (SM/01/295, September 2001).

For *topic coverage,* FSAP policy documents sought to establish from the inception of the initiative "an approach to financial system assessments that is broadly consistent across countries, while allowing for difference in emphasis to reflect different country circumstances."[3] To this end, the staff of the IMF and World Bank developed a common template covering all important sector and issues, from both stability and developmental perspectives, but with the understanding that FSAP teams would tailor its application to country circumstances. Comprehensiveness was viewed as key to ensure that major vulnerabilities and financial sector needs are not overlooked. However, judgments on cost effectiveness and relevance were to be used to set the scope of work in each case.

The approach of comprehensiveness in scope but selectivity in depth of coverage was developed further in the 2003 review. This called for FSAPs to be more sharply focused and tailored to individual country circumstances while maintaining a broad overall assessment. The varying depth of analysis across sectors would be achieved along various dimensions including (1) the selection and timing of standards and codes (S&Cs) to be formally assessed—in principle to be limited to no more than three plus AML/CFT; and (2) the extent of quantitative analysis. Furthermore, in low-income countries with small financial systems, the approach called for greater focus on medium-term and structural issues. It was envisioned that topics and S&Cs that warranted an assessment but were not covered under an initial FSAP could be included in FSAP Updates.

The Financial Sector Liaison Committee, a joint committee of senior IMF and World Bank staff, was responsible for coordinating many aspects of the FSAP, including the selection and sequencing of countries (Box A4.1).

One key objective of the FSLC guidelines was to generate a "first-best" list of countries, with a view to identify a pool of countries in accordance with the criteria set by the Boards. This "first-best" list was considered a key input into the preparation of a working plan. In particular, area departments and regions were instructed not to be constrained in their selection by their understanding of country authorities' willingness or unwillingness to participate. This was important because the signaling of how the IMF and World Bank viewed the importance and priority of a particular country's participation was expected to influence incentives to participate. The survey results provide some support for this view.

[3]"IMF–World Bank Financial Sector Assessment Program (FSAP)" (SM/99/116, May 1999).

Table A4.1. "First-Best" Priority Lists for Initial FSAPs[1]
(In number of countries)

Ratings[2]	IMF area departments	FSLC-IMF	FSLC–World Bank	List to managements	Outcome[4]
	Source of Submission and Outcomes				
	Submission date: spring 2001 for FY2002				
SICs priority ranking					
1	10	10	4	. . .	. . .
2	4	7	2	. . .	. . .
3	5	3	3	. . .	. . .
Total	19	20	9	6	5
Non-SICs rated priority "1"	18	18	23	24	15
Memorandum item					
SICs remaining in pool[3]	21	21	15	. . .	. . .
	Submission date: spring 2002 for FY2003				
SICs priority ranking					
1	4	. . .	. . .	. . .	. . .
2	8	. . .	. . .	. . .	. . .
3	3	. . .	. . .	. . .	. . .
Total	15	. . .	. . .	4	4
Non-SICs rated priority "1"	11	. . .	. . .	15	11
Memorandum item					
SICs remaining in pool[3]	16	16	11	. . .	. . .
	Submission date: spring 2003 for FY2004				
SICs priority ranking					
1	5	0	2	. . .	. . .
2	3	2	1	. . .	. . .
3	1	1	0	. . .	. . .
Total	9	3	3	3	3
Non-SICs rated priority "1"	14	4	14	14	13
Memorandum item					
SICs remaining in pool[3]	12	12	9	. . .	. . .
	Submission date: spring 2004 for FY2005				
SICs priority ranking					
1	3	3	2	. . .	. . .
2	3	3	1	. . .	. . .
3	0	0	1	. . .	. . .
Total	6	6	4	2	1
Non-SICs rated priority "1"	15	13	11	16	14
Memorandum item					
SICs remaining in pool[3]	9	9	7	. . .	. . .

Sources: IMF internal memoranda, and IEO staff calculations.
[1]See main text for definition of systemic importance (SIC).
[2]Countries are classified by area departments in the IMF and regions in the World Bank into three groups: highest priority (1), high priority (2), and low priority (3) for participation in the FSAP, based on the criteria laid out by the Executive Boards.
[3]The number of SICs that have not had an FSAP up to that point.

Outcomes for Country and Topic Coverage

The evaluation undertook a detailed examination of how this process worked in practice based on a review of internal documents and interviews with staff involved.[4] Tracking each stage of the process suggests the following (see Tables A4.1 and A4.2):

[4]The documentation is somewhat fragmentary, particularly for FY2003 and FY2004, and an attempt was made to reconstruct country ratings based on e-mail communications.

Table A4.2. "First-Best" Priority Lists for FSAP Updates[1]

Ratings[2]	IMF area departments	FSLC-IMF	FSLC–World Bank	List to managements	Outcome[4]
	Source of Submission and Outcomes				
	Submission date: spring 2003 for FY2004				
SICs					
1	0	. . .	. . .	. . .	. . .
2	1	. . .	. . .	. . .	. . .
3	0	. . .	. . .	. . .	. . .
Total	1	. . .	. . .	2	0
Non-SICs rated priority "1"	3	. . .	. . .	7	4
Memorandum item					
SICs remaining in pool[3]	5	5	4	. . .	. . .
	Submission date: spring 2004 for FY2005				
1	3	2	3	. . .	. . .
2	1	1	0	. . .	. . .
3	0	0	0	. . .	. . .
Total	4	3	3	4	3
Non-SICs rated priority "1"	3	2	3	4	3
Memorandum item					
SICs remaining in pool[3]	9	9	8	. . .	. . .

Sources: IMF internal memoranda and IEO staff calculations.

[1]See main text for definition of systemic importance (SIC).

[2]Countries are classified by area departments in the IMF and regions in the World Bank into three groups: highest priority (1), high priority (2), and low priority (3) for participation in the FSAP, based on the criteria laid out by the Executive Boards.

[3]The number of SICs that had an FSAP at least three fiscal years earlier than the one for which the submission is being prepared. Given time lag of completing Updates, this implies an overall lag of at least four years between an FSAP and an Update.

[4]Number of countries that had an FSAP during the corresponding financial year.

- The share of SICs that are given the highest rating by IMF area departments has fallen over the period FY2002–05.[5] The reasons are not fully clear, but in some cases area departments appear to be accepting countries' reluctance to volunteer.
- In effect, each institution has the ability to "block" countries appearing on the joint priority list that is signaled to the two managements. This has led to some cases of countries not been signaled as priorities for FSAPs because of concerns that to do so might disrupt the broader relationship with the country.[6] Thus, when a country was rated 1 by one institution and 3 (or not rated at all) by the other, typically that country was not included in the working plan of the FSLC. This was the case with Turkey and Malaysia, which were rated 1 in three successive submissions by IMF area departments, but were either rated 3, or not rated by the World Bank regions. For the FY2005 submission, these countries were dropped from the ratings.
- The share of SICs that are being flagged as high priorities for Updates is very small. One-third or less of the "pool" of SICs where the lag between initial FSAP and completion of Update would be at least four years are being signaled as "high priority."
- A very high proportion of nonsystemically important countries rated as the highest priority were included in that year's program.

In sum, while all SICs that volunteer for the program are implemented in a timely manner, the

[5]One reason why the IMF list submitted to the FSLC has many more "high-priority" ratings than does the similar list from the World Bank is because the former includes advanced economies (including the G-7).

[6]The FSLC uses the ratings given by the regions and area departments in the preparation of the working program. For example, whenever a country is rated 1 by both a region and area department, it is highly likely that it makes into the list, followed by those rate 1 by one of them and 2 by the other. For countries for which the IMF is solely responsible, for example the G-7, generally it suffices to have a rating of 1 to make it into the working program. The evidence shows that there are some exceptions to these working rules, reflecting at times the fact that country authorities have indicated their preference not to participate or to do so at a later date. There are also cases where a country is rated low by an area department or region, but it is nevertheless included in the working plan reflecting the drive to achieve geographical and developmental diversity, or because of a substantial lag since it volunteered.

Table A4.3. Formal Assessments of Standards and Codes by Country Type[1]
(In average number of standards and codes)

Standards and Codes FSAP Vintage	Country Type[2] Advanced	Emerging	PRFG-eligible	Total
Basel Core principles				
Pilot	1.00	1.00	1.00	1.00
Pre-2003	1.00	1.00	1.00	1.00
Post-2003	1.00	1.00	0.89	0.97
CPSIPS				
Pilot	1.00	0.63	1.00	0.75
Pre-2003	1.00	0.90	0.81	0.90
Post-2003	0.50	0.73	0.33	0.52
IAIS				
Pilot	1.00	0.50	0.50	0.58
Pre-2003	1.00	0.70	0.31	0.66
Post-2003	0.88	0.18	0.00	0.31
IOSCO				
Pilot	1.00	0.50	0.50	0.58
Pre-2003	1.00	0.67	0.38	0.66
Post-2003	0.88	0.36	0.22	0.48
MFP				
Pilot	1.00	1.00	1.00	1.00
Pre-2003	1.00	0.97	0.88	0.95
Post-2003	0.38	0.55	0.56	0.48
Memorandum item				
Total average number per country, excluding AML/CFT				
Pilot	5.00	3.75	4.00	4.00
Pre-2003	5.50	4.37	3.50	4.36
Post-2003	4.00	2.75	2.00	2.86
Total	4.91	3.88	3.04	3.88

Sources: MFD database and IEO estimates.
[1]Includes all completed FSAPs and those in which at least a first mission has taken place through June 2005.
[2]Advanced as per World Economic Outlook classification, PRGF-eligible as per PDR classification, and emerging all other countries.

number of such "volunteers" is declining markedly, especially for Updates, and the current system is no longer providing an effective signaling of priorities independent of such countries' willingness to volunteer.

Finally, data on the number of detailed standards and codes assessed per FSAP indicate that the greater selectivity called for by the Boards has been implemented as planned (Table A4.3):

- The average number of standards assessed (excluding the AML/CFT) has declined to under 3 since the 2003 review.
- Fewer standards are being assessed in emerging market economies and even fewer (an average of only 2) in low-income countries.
- The banking standards (Basel Core principles) are assessed in almost all cases.

Resource Costs of the FSAP

To track costs of the FSAP for the two institutions, we combined data from the IMF (MFD) and World Bank on the expenses incurred on each FSAP (staff and experts' time plus travel costs, but excluding overhead). While there are some differences in the way the cost data are compiled in the two institutions, we do not think the differences are sufficiently great to affect the overall conclusions.[7]

[7]IMF data on staff resource costs are calculated from the amount of staff and expert time spent on each FSAP (obtained from the Budget Reporting System) and applying standard labor cost factors (salaries plus benefits) provided by MFD (at an average of about $200,000 per person-year). World Bank data are actual dollar budgetary expenses reported under the FSAP accounts. The IMF data do not include expenses associated with AML/CFT assessments, whereas the World Bank data include such costs. For

Table A4.4. Direct Cost of Initial FSAP Assessments for the World Bank and IMF[1]
(In thousands of U.S. dollars)

	IMF Average[2]		World Bank Average[3]		Total		
Country Type	Total	Of which: labor	Total	Of which: labor	Average[4]	Maximum	Minimum
Advanced							
Pre-2003	822	571	110	67	887	1824	321
Post-2003	591	371	36	25	600	939	438
Emerging							
Pre-2003	410	295	271	167	681	1469	267
Post-2003	367	280	321	223	689	1108	559
PRGF-eligible							
Pre-2003	396	287	259	155	656	1070	323
Post-2003[5]	408	294	285	146	693	824	459
All countries							
Pre-2003	488	349	244	151	710	1824	267
Post-2003	438	308	283	172	668	1108	438

Sources: MFD, World Bank Secretariat to the FSLC, and IEO estimates.

[1]Excludes overhead, but includes cost of experts and travel costs. Data for the FY2001–04 period (IMF financial year). The costs of noncompleted FSAPs (Argentina, Côte d'Ivoire, and Uruguay) are excluded from the calculations. The unit of observation is the completed FSAP, irrespective of the fiscal year in which the expense is incurred.

[2]Estimates based on the amount of time allocated to FSAPs, converted into U.S. dollars using a factor provided by MFD. Excludes the cost of AML/CFT assessments.

[3]The estimated average is based only on the FSAPs in which the World Bank actually participated.

[4]The reported values are not the sum of the corresponding values for the IMF and World Bank, as the latter does not always participate in FSAPs for advanced economies. Rather the estimates reported are total direct cost divided by total number of FSAPs.

[5]Includes costs for an FSAP undertaken in the Eastern Caribbean Currency Union, which covers six small countries. Excluding this FSAP from the calculations, the estimates for the first five columns would be $379,000, $275,000, $303,000, $129,000, and $681,000.

The main findings (see Table A4.4) are as follows:

- The average direct cost has declined by about 6 percent between the pre- and post-2003 review periods, with a 10 percent decline for the IMF partially offset by a rise in average cost for the World Bank.[8]
- The realized savings are driven by a sharp decline in the average direct cost of FSAPs in advanced countries, while the average direct cost of FSAPs in both emerging and PRGF-eligible countries have not changed much.[9]
- Resource savings generated by the reduction in the number of formal assessments of standards and codes in emerging and PRGF-eligible countries have been reallocated to other activities in the FSAPs for these countries.
- Post-2003, the average direct cost of FSAPs in emerging and PRGF-eligible countries is broadly the same (around $690,000), which is surprising.
- The IMF still incurred the larger share of FSAP costs for assessments in PRGF-eligible countries after the 2003 review (about 60 percent).
- FSAP Updates for which direct cost data are available suggest the potential for some savings

earlier cost estimates by the staff, see "FSAP—Indicative Fund Resource Costs" (SM/03/77, Supplement 4, February 2003), and "Financial Sector Assessment Program—Indicative Fund Resource Costs" (SM/05/67, Supplement 2, February 2005).

[8]The post-2003 review period corresponds to the latter part of FY2003 and FY2004.

[9]These statements and the data reported in Table A4.5 treat the FSAP for the Eastern Caribbean Currency Union (ECCU) as a single assessment. However, excluding this case does not alter the broad conclusions.

Table A4.5. FSAP Team and Deputy Leaders and Country Type[1]
(In number of FSAP led)

	World Bank		IMF	
	Leader	Deputy	Leader	Deputy
Advanced	. . .	1	21	20
Emerging	33	22	22	33
PRGF-eligible[2]	21	11	11	21
Total	54	34	54	74

Sources: World Bank FSAP website and IEO estimates.

[1]All completed or ongoing FSAPs and Updates through June 2005.

[2]Advanced as per *World Economic Outlook* classification, PRGF-eligible as per PDR classification, and emerging all other countries.

of resources, although this would depend on the type of reassessment. Estimates range between $45,000 for a very narrow Update (Iceland) to $342,000 for a significantly more comprehensive Update (Kazakhstan), which is half the average cost of initial assessment for a PRGF-eligible country.

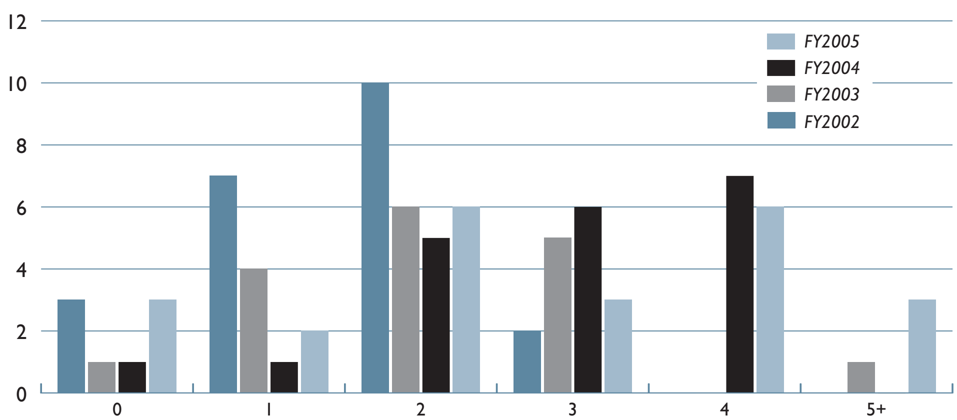
FSAP Mission Organization

The FSLC allocates FSAP team leadership responsibility between Bank and Fund staff. In practice, overall team leadership has been divided equally (Table A4.5). The IMF staff have led all FSAP teams to advanced countries, about 40 percent of teams to emerging market economies, and one-third of teams to low-income countries.

During interviews with the evaluation team, some senior Bank and IMF staff expressed concern over what they perceived to be the increasing appointment of team leaders with little experience. In their view, this runs the risk of lowering the quality of FSAPs as the task of mission leader requires the judicious combination of technical skills and balanced macrofinancial policy judgment necessary to form sound overall assessments.

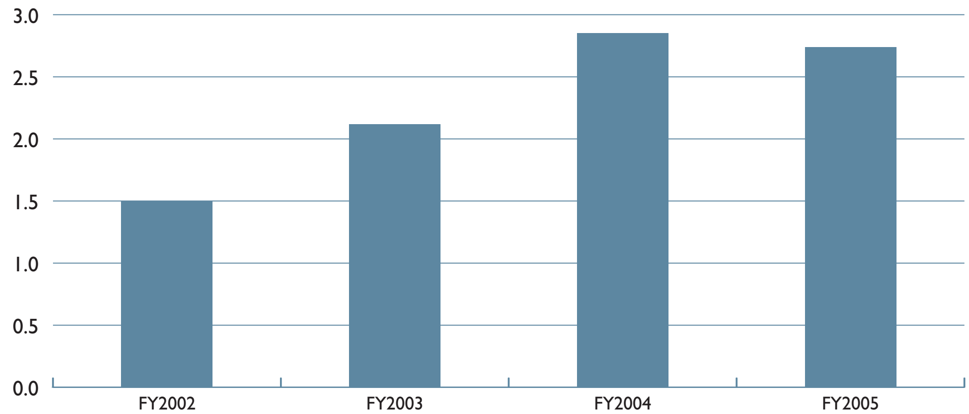
An examination of trends in the experience of FSAP team leaders (defined in terms of their participation in previous FSAP missions) suggests that there may be some basis for this concern. After rising steadily as the FSAP exercise matured, the "average" previous experience of FSAP team leaders began to decline again in FY2005 and the share of team leaders with no or very limited previous FSAP experience began to rise (Figures A4.1 and A4.2).

Figure A4.1. FSAP Mission Leaders and Experience[1]
(Number of prior FSAPs)



Sources: Travel Information Management System and IEO estimates.
[1]A "unit" of experience is participation in an FSAP either as a team member or in a leadership capacity.

Figure A4.2. Median "Units" of Experience[1]
(Prior FSAPs)



Sources: Travel Information Management System and IEO estimates.
[1]A "unit" of experience is participation in an FSAP either as a team member or in a leadership capacity.

ANNEX 5

Additional Background on Stress-Testing Methodologies Used in FSAPs

This annex provides additional information to supplement the discussion in Chapter 3, section on "Macroprudential Risk Analysis," drawing on a review of stress-testing approaches in the 25-country sample that was examined in depth. It begins with a brief summary of the approaches most often encountered in FSAPs, proposes a possible approach to providing "benchmarks" of methodological approaches that different country peer groups could aim for, and concludes with some comments on key areas that require greater attention.

Current Stress-Testing Methodologies

FSAPs incorporate stress-testing approaches of varying degrees of sophistication. However, in reporting results, most FSAPs rarely discuss the limitations of the methodologies used and the consequent need for caution in interpreting results. We summarize here the most common approaches used.[1]

FSAPs in low-income countries and some emerging market countries have frequently used credit-risk methodologies based on a simple static exercise that assumed (relatively arbitrary) increases in levels of banks' nonperforming loans together with assumptions on different provisioning levels. Usually the assessment is supplemented by a simple analysis of the direct effect of exchange rate risk, based on the application of different exchange rates to the net open position of the entire banking system. The results that can be extracted from these models are very limited.

Methodologies based on individual portfolios have been used in more advanced economies, which use highly disaggregated data from individual financial institutions (bottom-up approach). In order to conduct stress testing, one of the challenges of these models is to be able to translate the effect of a broad macroeconomic shock into a balance sheet of a financial institution. Usually this exercise requires a mapping of macro variables into a set of common risk factors that can be applied to stress individual balance sheets. Typically, institutions require two steps, one mapping from macro adjustment scenarios to a set of common risk factors, and another mapping from a set of common risk factors into all of the instruments in a portfolio. The results that can be extracted from these models are more precise in the risk measurement.

Methodologies based on aggregated portfolios have been used in some emerging market economies (top-bottom approach), that typically derive common parameters from all financial institutions in the data set through regression analysis. However, important differences have been found among the use of stress testing according to this methodology that seems to reflect a lack of a common view on certain issues such as the way in which the corporate sector or household sector risks should be included in the evaluation of the financial sector vulnerabilities.

A Possible Approach: Country Peer Groups

Stress-testing methodologies differ substantially among FSAPs, which can be attributed in large part to data constraints, relative sophistication of the financial system, cooperation from the authorities, time available for the analysis, and the judgment of the FSAP team.

While the need to tailor stress tests to country conditions is understandable, in our examination it has not been easy to find common elements among FSAPs' stress tests, except for many cases in which methodologies converge toward the most simple approaches.

From a more dynamic perspective, in a number of cases there are no significant methodological improvements between the FSAP and its Update three or four years later.[2]

[1]See Bank for International Settlements (2005); Blaschke, Jones, Majnoni, and Peria (2001); Jones, Hilbers, and Slack (2004); Sorge (2004); and International Monetary Fund and World Bank (2003).

[2]For example, Ghana, Kazakhstan, and Slovenia.

One possible approach to strengthening the methodological approach, and building greater cross-country knowledge, would be to develop good practices for conducting stress tests among various country peer groups. Such country peer groups would reflect common macroeconomic conditions, as well as the degree of sophistication of the financial sector of a country. This approach could help countries adapt their methodologies to good practices within groups with comparable capacity and data limitations. It would also help to recognize that stress testing practices can substantially differ between countries with widely varying levels of financial complexity. Standardizing a core set of methodologies, data sets, and sensitivity analysis within country peer groups could also help to develop benchmarks for cross-country comparisons, thus facilitating vulnerability analysis.

In addition, there is some room for standardization of certain shocks under certain circumstances. For example, one possibility would be that all noninvestment grade countries evaluate the potential effects of sovereign downgrade scenarios. Similar approaches could be used for shifts in exchange rate pegs. Greater standardization of such approaches across countries could help reduce their political sensitivity and help avoid an inadvertent signal that the IMF thinks such events are more probable in certain countries.

It would be useful for the FSAP to provide advice in the design of a road map for reaching the relevant country peer benchmark for stress testing, beginning with recommendations on the data that are necessary in order to run more appropriate stress testing. This could help countries to build financial infrastructure, collect data, and allocate resources to foster a better understanding of the vulnerabilities of the financial system.

Areas That Require Some Attention

Credit risk is the most important risk from the banking sector. In measuring credit risk, emerging markets should make efforts to move from static models to regression models that relate credit exposure to macroeconomic events in a systematic manner. It would be necessary to establish good practices for including corporate and household sectors' exposures within the regression approaches. Although the scenarios or events may not have an associated probability of occurrence, the interpretation of the stress testing results should provide an opinion of the relative importance of the different vulnerabilities (credit risk, market risk, commodity risk, etc.) of the financial system.

The size of the shocks should reflect exceptional but plausible events. In the 25 country cases, we found that, even in recent vintages, there is insufficient explanation for the size of the shocks and insufficient use of macro models to simulate the effects of the certain scenarios and events on economic and financial variables as outputs.[3] Although it is desirable that shocks be derived from macro models, some countries are not yet in a position to do so. In these cases, good practices should also be established for the simulation of scenarios and events, for example by considering methodologies that look at the joint empirical distribution of risk factors.

[3]For example, one scenario might include a sudden reversal of capital flows and a rapid depreciation of the exchange rate. Macro simulations of this scenario could produce effects on GDP growth, price level, interest rates, and the exchange rate. These outputs would serve as the basis of a stress test of balance sheets for individual institutions.

ANNEX 6

Use of FSAP Results in Article IV Surveillance

This annex presents the analysis supporting the findings in Chapter 5, section on "Surveillance," of the main report. The evidence is drawn from the detailed reviews of the 25 case studies and is structured around four evaluation questions: (1) Have FSAPs provided a good basis for their use in Article IV surveillance? (2) What has been the resulting coverage of findings in Article IV reports? (3) How was the integration of key FSAP findings into the overall macroeconomic assessment? and (4) What was the extent of financial sector surveillance after the FSAP?

Have FSAPs Provided a Good Basis for Their Use in Article IV Surveillance?

The evaluation criteria for case analysis comprised the following tests (the questions of the desk review matrix used are in parentheses):[1]

(1) Have FSAP results been articulated in a way that facilitates use in Article IV surveillance? More specifically:

- Have findings and recommendations been clear, usable, prioritized, with a view to consequence? (Questions: 31, 33, 34, and 35)
- Has there been an overall assessment of the financial sector? (questions: 8 and 20)

(2) Have domestic and external or global economic conditions fed into the financial sector assessment? (Questions: 15, 16, 17, and 18)

The results from the reviews of the 25 case studies show that:

- Over 80 percent of cases reviewed showed that FSAPs articulated findings well, with a general assessment of the financial sector standing, facilitating the use in Article IV surveillance. Findings and recommendations are generally clear and usable. Moreover, nearly half of the cases had a very clearly articulated overall assessment, with a good sense of consequence and priorities.
- Over 80 percent of cases reviewed showed that domestic and external conditions fed into the FSAP's analysis, with a third of cases showing a very clear and strong linkage to the financial sector assessment.

In good practice cases, the FSAP's articulation of the overall assessment has a comprehensive view of the structure, standing and trends in the financial sector. It sometimes presents also a body of analysis (including sectoral linkages, externalities, and potential spillovers) that facilitates the formulation of a broader assessment of macroeconomic vulnerabilities and a more comprehensive policy framework for recommendations (e.g., Costa Rica).

The instances where the FSAPs have fallen short of good practice involve an overall assessment that is not clearly conveyed or that lacks a clear indication of macro consequence and prioritization (e.g., Kazakhstan, Philippines). In these cases, there is a shift of what should be part of the FSAP's expert analysis onto the Article IV team.

What Has Been the Coverage of Findings in Article IV Reports?

The analysis covered desk review questions 50 and 51.

Over 80 percent of Article IV reports make a good coverage of FSAP results, and about half of the cases present many of the good practice characteristics. The good practice coverage of FSAP results in Article IV has a clear reporting of the main findings and recommendations, the importance and consequence of findings, and the associated priorities. It also presents the interplay of these findings with the nonfinancial sector (e.g., Japan), including potential fiscal liabilities, impact on or of monetary and exchange rate policy, and corporate and household sector implications. But in some instances the coverage

[1] See Annex 3 for the template of the desk review matrix.

Box A6.1. What Makes a Good Integration of FSAP Findings into the Overall Macroeconomic Assessment?

This box presents the key characteristics of good integration of the financial sector assessment into the overall macroeconomic assessment. Ultimately, a good integration is one that results in a greater understanding of macro/systemic vulnerabilities, a more comprehensive stability assessment, and a broader policy recommendation framework. We present here some good practice examples on the various characteristics.

- *Macro/financial/structural linkages are identified*. For example, in the assessment of Japan's macroeconomic situation, a framework with four interlinked pillars was considered, consisting of the financial and corporate sectors, and the monetary and fiscal frameworks.
- *Externalities are a key element of the assessment*. In the case of Japan, the analysis highlights the feedback effects from bank reforms (via improved lending position) to supporting the economic recovery, and from economic recovery (and strengthen regulation) to supporting the resolution of balance sheet problems. Thus, complementarities of policies are emphasized, leading to an assessment of the need for simultaneous adoption.
- *Risks and vulnerabilities are evaluated in a systemic manner*. For example, in Costa Rica, the implications of the exchange rate regime on dollarization and financial vulnerabilities are explicitly addressed. In Korea, the interplay of risks and vulnerabilities between the corporate and financial sectors is explicitly analyzed, considering potential externalities.
- *Broader policy framework for recommendations*. In Japan, drawing on the elements described above, policy recommendations comprised broader and more rapid financial sector reforms, accelerated corporate restructuring, a more aggressive anti-deflationary stance, and a framework for medium-term fiscal consolidation. The "big-bang" policy recommendation was based on the increased effectiveness that was expected from the joint implementation, whereby, for example, monetary policy would be more effective to end deflation if banks' balance sheets problems are resolved, which in turn build on corporate restructuring.
- *Enhanced discussions with the authorities based on the broader assessment and policy recommendations*. In the case of Costa Rica, the authorities indicated that the appropriate integration of the financial sector assessment with macroeconomic conditions and policies, as well as the comprehensive scope of recommendations for reform (including monetary/exchange rate, fiscal, and financial pillars) helped to form a good, integrated platform for discussions of policy and reform needs.

of FSAP results in Article IV reports has fallen short of good practice, with a cursory presentation of findings (e.g., Romania).

How Were the Key Financial Sector Findings Integrated into the Overall Macroeconomic Assessment?

The analysis covered desk review questions 50 and 53.

In three-quarters of the cases reviewed, the overall macroeconomic assessment has benefited from the FSAP, with an enhanced assessment of the standing of the financial sector and the areas of potential macroeconomic implications (see Box A6.1). In these cases, the main FSAP findings were reported and merged into the assessment of Article IV surveillance. Moreover, in a third of cases the contribution has been significant, whereby FSAP findings contributed to shaping the overall macroeconomic assessment (i.e., not only the main messages were presented but the findings about the financial sector were well embedded into the overall appraisal).

The instances where practice has fallen short of a good integration into the overall macroeconomic assessment involve a mechanical presentation of FSAP results in the Article IV report (e.g., just a summary table of results) with little integration of the main messages (e.g., Tunisia, Romania). Typically this consisted of reporting on financial vulnerabilities but not considering potential linkages, externalities, or policy complementarities.

What Was the Extent of Financial Sector Surveillance After the FSAP?

The evaluation criteria for case analysis comprised the following tests:

(1) Has Article IV/program work identified new vulnerabilities? (Question: 22)

(2) Has the intensity of coverage of financial sector issues been maintained after the FSAP? (Question: 54)

(3) Have Article IV, program, and TA activities assessed implementation of reforms? (Questions: 39 and 52)

The results from the reviews of the 25 case studies show that:

- In only a few cases, financial surveillance under Article IV or program work was able to identified new vulnerabilities or understand better the extent of some risks that were noted in the FSAP (e.g., Costa Rica). In terms of areas, these have included corporate sector vulnerabilities to interest and exchange rates (Mexico), bank vulnerabilities to interest rate risk through their holding of government bonds (Philippines), and risks stemming from links between banks and other financial institutions (e.g., investment funds). The analyses in most instances comprised new stress-testing exercises. In these cases, staff from MFD participated and contributed to the analysis.

- In over 80 percent of cases reviewed, the intensity of coverage in Article IV consultations has remained significant (excluding those with an Update and those too recent to have a subsequent Article IV cycle). Although in nearly half of the cases the intensity has waned over time (in terms of the depth and scope), there has not been a full mean reversion of the coverage of financial sector issues to that prevailing before the FSAP. But in some cases, the coverage of important issues highlighted in the FSAP was lost in time (e.g., Korea).

- With respect to tracking of progress in implementation of reforms, the general practice has been to report on measures taken by country authorities. But there has been very little appraisal of how significant those measures are to address the vulnerabilities identified in the FSAP. In terms of areas of coverage, there tends to be greater follow-up on traditional area of surveillance (e.g., issues related to exchange rate and monetary policy) and on the banking sector (as opposed to other segments of the financial system, which sometimes receive little or no coverage). In many instances, the scope of coverage has not followed the priorities assigned by the FSAP.

In nearly a quarter of the cases, the tracking was done more comprehensively and in greater depth; these either were cases where an Update took place or where MFD staff participated in the consultations. The cases that had expert assistance were also able to cover a broader spectrum of areas in the tracking of implementation under Article IV work.

Good practice in tracking of implementation of recommendations takes place under the FSAP Updates reviewed among the 25 case studies, where the assessments are the most comprehensive in scope and depth (e.g., Slovenia, Bulgaria). Updates present an overall assessment of progress, whereby the standing of the system and remaining challenges are rearticulated (see also Annex 7 on review of Updates).

ANNEX 7

Additional Information on Assessment of FSAP Updates

This annex presents the supporting analysis for the key messages on FSAP Updates that have been incorporated in the main report (see Box 4.3). The evaluation has analyzed all 11 Updates (completed by June 2005) of post-pilot FSAPs. The Updates for the countries that had the FSAP in the pilot phase were not considered since they may have been driven by factors specific to the inception of the initiative (e.g., FSSAs for pilot cases could not be published, even upon the request of country authorities). To conduct the desk reviews, a streamlined template was used based on the one applied in the detailed analysis of the 25 country studies. No additional interviews were held with staff or country authorities.[1]

The exercise has sought to provide evidence on two main aspects: (1) it analyzed what Updates have done so far in terms of the nature of the exercise (focused versus comprehensive reassessments), stock taking (assessment of implementation of reforms), and the extent to which they have taken a fresh look at vulnerabilities; and (2) it assessed the institutional use and integration with surveillance in Article IV consultations (see Table A7.1).

The issue of country selection for Updates is covered in the analysis of the priority-setting process (see Annex 4).

[1]Three of the countries with Updates were covered in the 25 case studies. For these countries, interviews with staff and authorities did cover their experience with the Updates.

Table A7.1. Assessment of FSAP Updates

Country (Financial Year)	Nature of the Assessment in the Update[1]	Extent of Stocktaking and Tracking of Implementation[2]	Degree to Which the Update Took a Fresh Look at Vulnerabilities	Integration with Surveillance and Coverage of Recommendations
Iceland (FY2003)	Focus is on stocktaking, with a particular emphasis on the reassessment of the BCP. The Update discussed the bulk of the financial system (although the team consisted of only 2 staff). A clear description of the rationale for the scope of the Update was lacking.	Stocktaking is most in depth in the case of the BCP and CPSS core principles (with recommendations centering on the former). There is an overall assessment of progress (even though several sectors received only a general coverage).	The FSSA provided an assessment of the external indebtedness of the Icelandic financial system (this topic was covered more in depth in an Annex to the 2003 Article IV Staff Report).	The accompanying Article IV Staff Report and PIN reflected the Update's main findings and recommendations. Prioritization and sequencing of recommendations are minimal.
Ghana (FY2004)	The Update has primarily a developmental perspective and presents findings and recommendations along three broad themes: competition, integrity, and fairness. But it has also a strong coverage of stability issues.	The tracking of implementation carefully covers the recommendations of the FSAP, and reports on the reasons for lack of progress. The FSSA presents a clear and candid overall appraisal of progress in implementation.	The emphasis of the Update is not on taking a fresh look at vulnerabilities (stress testing is replicated from the FSAP). But the analysis includes some topics that were not addressed in the FSAP (e.g., the effects of fiscal consolidation on bank profitability).	There is a cursory mention of the Update's findings in the Staff Report of the Article IV. However, accompanying program documents draw significantly from the Update. The PIN is cursory on financial sector issues and does not refer to the Update. The key recommendations are clear, well grounded in the analysis, and fairly specific in some cases.

Table A7.1 *(continued)*

Country (Financial Year)	Nature of the Assessment in the Update[1]	Extent of Stocktaking and Tracking of Implementation[2]	Degree to Which the Update Took a Fresh Look at Vulnerabilities	Integration with Surveillance and Coverage of Recommendations
Slovenia (FY2004)	The Update was comprehensive with a broad overall assessment. There is no explicit rationale for the scope and timing of the exercise (Slovenia's entrance into the EU and ERM2 has likely played a significant role).	Tracking of recommendations is in depth (but does not provide reasons for lack of progress).	The Update incorporates a rather detailed fresh look at vulnerabilities (e.g., the housing market, corporate governance, and macroeconomic risks linked to the entrance into ERM2).	The Article IV Staff Report integrates the Update well (the main findings and recommendations are included in a section on financial sector issues and in the staff appraisal). The PIN reports the main Update messages. Prioritization is good (with high specificity and detail of recommendations).
Kazakhstan (FY2004)	This exercise provides a comprehensive assessment of the financial sector, including banks, insurance companies, pension funds, and securities market. The Update has an emphasis on assessing what has hap pened since the FSAP. The FSAP was not very explicit about the rationale behind the timing and coverage of the exercise.	The Update reports on implementations of reforms. It provides a fairly in-depth update of reforms in the banking sector, while for other sectors there is more mechanical reporting.	Some new challenges are analyzed, but generally the coverage was similar to that of the FSAP. Stress testing did not improve on the methodology used in the FSAP.	Discussions of the Update in the Article IV Staff Report are only cursory (it only mentions the creation of the FSA). The PIN mentions only briefly the Update. The FSAP presented a wide range of poorly prioritized recommendations, and the Update does not provide a clearer order of the previous and new recommendations.
El Salvador (FY2004)	The reassessment is rather focused, with coverage of the banking sector, cross-border operations, payments and securities settlement, and central bank functions. On development issues, it covered microfinance. No rationale for the scope of the exercise was presented. The report presented an overall assessment of the financial sector standing, despite that the scope of analysis was rather focused.	The analysis of progress in implementation of reform was in depth for the core sectors of focus. Other financial segments received a more mechanical reporting on implementation. There is no overall assessment of progress in implementations.	Some new vulnerabilities are included, but the emphasis is placed on topics that were covered previously. Stress tests are largely similar.	Main findings and recommendations covered in Article IV reports. The PIN makes a general mention of the financial sector being generally in good health. Prioritization is not prominently discussed in the report.
Senegal (FY2005)	This is a focused Update. The terms of reference indicate that development issues will be the main focus.	The Update provides in depth follow-up on selected sectors: banking, microfinance, and legal issues. FSAP recommendations on other (smaller) sectors (insurance and pensions) are not followed up. There is limited explanation on the reasons for the lack of progress.	Stress tests are more elaborated than in the FSAP, but cover the same type of risks.	The Article IV Staff Report has limited coverage of the Update. The PIN does not mention the Update. Prioritization of recommendations is weak.

Table A7.1 *(continued)*

Country (Financial Year)	Nature of the Assessment in the Update[1]	Extent of Stocktaking and Tracking of Implementation[2]	Degree to Which the Update Took a Fresh Look at Vulnerabilities	Integration with Surveillance and Coverage of Recommendations
Colombia (FY2005)	The exercise has a broad coverage and the emphasis on stability and development issues is more balanced than in the FSAP (which focused on stability in the aftermath of financial turmoil). The Update is to a good extent a stocktaking exercise. No explicit rationale is mentioned for the timing and scope of the Update.	The analysis of progress in implementation of reforms is generally thorough. The reasons for lack of progress are generally well explained. No specific overall assessment of progress in implementations.	Efforts to capture new vulnerabilities were somewhat limited. Stress tests are largely similar to those in the FSAP.	The most important findings and recommendations are reported in the Article IV Staff Report. The PIN also presents the main messages. Prioritization is reasonably well done.
Peru (FY2005)	Overall, the Update provides comprehensive analysis of the issues raised in the FSAP, and of remaining vulnerabilities and developmental needs. The report indicates that, since the FSAP had focused on the resolution of financial sector problems, the Update would cover remaining stability and developmental issues.	The tracking of implementations is in depth, although findings are scattered through the document. The Update provides reasons for areas with a lack of progress.	The Update covers remaining vulnerability, but the implications of recent developments in the banking sector are not followed up in the analysis of risks.	The Update is adequately discussed in the second review of the Stand-By Arrangement. The PIN also conveys the main messages in the Update. Prioritization is somewhat weak; e.g., the overall assessment does not indicate the priority actions.
Armenia (FY2005)	The assessment is fairly comprehensive, taking into consideration the small size of the financial system (especially outside of the banking sector). The Update has a balanced focus on stability and development. The latter includes a detailed analysis of non-bank financial sector development	There is detailed tracking of implementation of FSAP recommendations. Progress is reported, but the reasons for lack of advancement are not always provided.	Some new sectors were covered: pension system and housing finance. The Update captured newly emerging risks related to the rapid credit growth and the monetary consequences of remittances.	The findings and recommendations have a prominent place in the accompanying PRGF document. The Update's main conclusions are well embedded in the document. Although the Update provides some sense of urgency, the list of recommendations appears too long for effective prioritization.
Hungary (FY2005)	The Update's nature comes close to a full reassessment, with the overall appraisal covering the broad financial system. The report was not very explicit about the rationale for selection and scope (the accession into the EU and ERM2 likely played a role).	The tracking of implementations of reforms is comprehensive across the sectors and standards and codes assessed in the FSAP. But the degree of depth across sectors varies, and the reasons for lack of progress are not provided.	A new look at vulnerabilities identified new risks (e.g., the growth of the nonbanking sector, the rapid growth of unhedged foreign currency borrowing by households and small and medium-sized enterprises (SMEs).	The coverage of findings and recommendations in the Article IV Staff Report is limited. The PIN only reflects on the risks from household and SME borrowing. Although recommendations are clear, prioritization is limited to a time classification of medium and long term.

Table A7.1 *(concluded)*

Country (Financial Year)	Nature of the Assessment in the Update[1]	Extent of Stocktaking and Tracking of Implementation[2]	Degree to Which the Update Took a Fresh Look at Vulnerabilities	Integration with Surveillance and Coverage of Recommendations
Uganda (FY2005)	The Update focuses on developmental aspects to improve improve financial intermediation, but also pays attention to overall financial stability. There is little discussion of the rationale behind the timing and scope of the exercise (the Update was conducted relatively soon after the FSAP).	The tracking of implementation of reforms is thorough and tends to provide the reasons when there is lack of progress. There is a concise overall assessment of progress in implementation of FSAP recommendations.	The Update does not explicitly conduct an assessment of new vulnerabilities. The stress testing is somewhat more sophisticated than in the FSAP.	The discussion of Update findings and recommendations in the accompanying PRGF review covers the most important findings. The coverage in the Article IV report is minimal (largely limited to a Selected Issues paper). The PIN discusses the main findings and recommendations. Prioritization of recommendations is largely limited to a classification of medium and long term (except those for the pension system that provide guidance on sequencing).

[1]This includes whether the Update was a focused or fuller reassessment (in terms of scope and depth), and what was the balance between stocktaking and new assessments and between stability and development aspects.

[2]The review comprised what was the level of detail of analysis and whether there was an overall assessment of progress in implementation of reforms, including their significance in addressing the vulnerabilities that the FSAP had identified.

ANNEX

8 Financial Sector Surveillance Outside the FSAP

This annex presents additional evidence on financial sector surveillance in countries that have not undertaken an FSAP, to supplement the discussion in Box 4.3 of the main report.

To assess the extent to which financial sector surveillance conducted exclusively under the aegis of Article IV consultations has been a good substitute for analysis and assessments under the FSAP, the evaluation reviewed the content of such surveillance in five systemically important countries that had not participated in the FSAP as of mid-2005 (China, Malaysia, Spain, Turkey, and the United States). For each country, documents for the last two Article IV consultation cycles (as well as any program documents, where applicable) were reviewed vis-à-vis four basic components. For each component, the standard of comparison was what one would normally expect to see in an FSAP assessment (see Table A8.1):

- *Scope of coverage*. The coverage in FSAPs is, by design, expected to be comprehensive.
- *Detail and specificity of analysis*. In FSAPs, the depth of analysis of specific sectors depends on the level of development and systemic importance—and can include stress testing, market infrastructure analysis, and review of the regulatory and supervisory framework.
- *Overall assessment of financial sector vulnerabilities*. A key value added of FSAPs is the ability to present an overall, comprehensive assessment of the standing and vulnerabilities in the financial sector—especially those of macro and systemic importance. This is perhaps the most important test of the exercise.
- *Reported discussions with authorities*. FSAPs are expected to lead to extensive and detailed discussions with authorities, including on differences of views on findings and on approaches to deal with vulnerabilities. The review of the five cases discussed here covers only what the staff reports say about the discussions. Actual discussions may have been more encompassing than reported.

Moreover, FSAPs are expected to lay out clear, usable, and prioritized recommendations. The review of these cases of financial sector surveillance outside of the FSAP suggests that none was able to generate a comprehensive set of prioritized recommendations.[1]

[1]Some of the cases reviewed have included recommended actions in staff appraisals. These have been at a relatively broad level of generality to deal with specific sectoral risks (e.g., China and Turkey on banking issues).

Table A8.1. Financial Sector Surveillance Outside the FSAP: Review of Selected Systemically Important Countries[1]

	MFD and ICM Participation[2]	Scope of Coverage	Detail and Specificity of Analysis	Overall Assessment of Financial Sector Standing and Vulnerabilities	Reported Influence in Discussions with the Authorities
China	MFD participation in 2004 (1).	Banking sector only.	Mostly description of situation with some notion of urgency; greater specificity in detailed 2003 Selected Issues paper on banking.	View on progress with banking reforms and how to proceed with stock and flow problems.	Strong recommendation to participate in FSAP to guide next reform steps.
Malaysia	MFD (1 in 2003 and 1 in 2004) and ICM participation (1 in 2003).	Banking and capital markets (Selected Issues paper on capital market trends); corporate sector analysis (Selected Issues paper in 2003).	Limited coverage and detail in Staff Report; Selected Issues papers have better specificity and descriptive analyses. Little original risk assessment.	Attempt to have an overall view but with limited supporting analysis (e.g., general statement that "financial system soundness has improved. . .").	Reporting of discussions mostly on areas of agreement.
Spain	MFD participation in 2004 (1).	Banking (and *cajas*).	There was increased coverage of banking sector in 2001 due to concern over exposure to Latin America. Some reporting of stress testing by authorities in 2003, but no coverage of other segments of financial system.	No integrated, overall assessment of financial vulnerabilities; separated reference to real estate risks and political influence in *cajas*.	Staff welcomed authorities' request of FSAP. Little reporting on discussions and exchange of views.
Turkey	MFD participation (1 in 2004; 2 in 2002).	Banking, corporate sector.	Review of crisis and reform program. Good detail on bankking (regulation and supervision). Detailed analysis of draft banking law (by IMF Legal Department).	View on remaining crisis-related reforms, little on overall financial sector standing.	Little reporting on discussions, mostly on areas of agreement.
United States	MFD (3 in 2004) and ICM participation (1 in 2003 and 1 in 2004).	Banking, government-sponsored enterprises, corporate governance, and defined-benefits pensions.	Limited original analysis of risks, regulations, and supervision; no coverage of large and important segments of financial sector and cross linkages. Greater depth in 2004 with detailed Selected Issues paper on large complex banking groups.	No overall assessment of financial sector vulnerabilities.	Mostly reporting on authorities' views; little reporting on discussions.

[1]The analysis covered the last two Article IV cycles and program reviews where applicable.

[2]Numbers in parentheses refer to the number of staff members from the Monetary and Financial Systems Department (MFD) and the International Capital Markets Department (ICM), respectively, who participated in the Article IV surveillance mission.

ANNEX 9

Additional Information on Links Between the FSAP and IMF-Supported Programs

This annex presents further details on the econometric evidence on the links between FSAPs and IMF-supported programs, discussed in Chapter 5, section on "Links with IMF-Supported Programs," of the main report.

The analysis examined the relationship between FSAPs and the total number of program conditions (prior actions, structural performance criteria, and benchmarks) on financial sector issues for all programs approved between 1995 and 2003. There were 93 programs approved over the period, of which 23 had FSAPs undertaken up to two years prior to the start of the program. This time frame was chosen to capture the notion that at least some of the FSAP's finding become dated after a few years and hence the relevance to guide program design on financial sector issues wanes over time.

FSAPs have been undertaken both in countries with relatively sound financial systems and countries whose financial systems would require significant reforms to improve their soundness and foster their development. To help distinguish between different types of countries, we use an index of financial liberalization. This index was developed by the IMF Research Department and it attempts to capture the extent of distortions in the operating framework of financial systems by assessing various characteristics (e.g., government-mandated credit allocation regulations, banking sector entry barriers).[1] The value of the index is normalized to the [0, 1] range, with 0 being a fully repressed system and 1 a fully liberalized system. Some properties of the data are presented in Table A9.1.

The econometric results are presented in Table A9.2. They show that both the FSAP and the combined variable FSAP*FSLI are statistically significant at the 90th percentile. In principle, having an FSAP would tend to increase the number of program conditions on financial sector issues. However, this effect would decline, and could in fact be reversed for those countries whose financial systems are less distorted. In other words, the fact that a country has undertaken an FSAP tends to result in one or more structural conditions in subsequent programs for countries with

[1]See Abiad and Mody (2003) for an explanation on a precursor to the index used in the regression reported in Table 2. The financial liberalization index covers such issues as the extent of free determination of interest rates, credit allocation by intermediaries, and entry barriers, certain features of the regulatory and supervisory frameworks, and capital account transactions regulations.

Table A9.1. FSAPs, Financial Liberalization, and Program Conditionality: Data Properties

	Number of Program Conditions[1]		Financial Sector Liberalization Index[2]	
	All programs	Of which: with FSAPs[3]	All programs	Of which: with FSAPs[3]
Maximum	48	20	0.90	0.90
Minimum	0	0	0.05	0.42
Mean	9.33	6.52	0.59	0.65
Median	6	4	0.61	0.61
75th percentile	13	10	0.72	0.77
Number of observations	93	23	93	23

Source: Internal IMF database (MONA).
[1]Number of program conditions on financial sector areas.
[2]Value of the index in the year preceding the start of the program.
[3]Data attributes for which there is both an FSAP and a value for the financial sector liberalization index.

Table A9.2. FSAPs, Financial Liberalization, and Program Conditionality: Estimation Results

Number of Program Conditions[1]	Coefficient	Robust Standard Error	z	*P*> |z|	[95 Percent Confidence Interval]	
FSLI[2]	0.54	0.72	0.76	0.448	–0.86	1.96
FSAP	1.39	0.77	1.81	0.070	–0.11	2.90
FSAP*FSLI	–2.99	1.29	–2.32	0.020	–5.51	–0.46
Constant	2.01	0.42	4.73	0.000	1.18	2.84

Poisson regression — Wald $Chi^2(3) = 8.4$ — Pseudo $R^2 = 0.042$

Number of observations = 93 — Prob > $Chi^2 = 0.039$

Source: IEO staff calculations.

[1]Number of program conditions on financial sector areas.

[2]Financial sector liberalization index = FSLI.

highly repressed financial systems, whereas there is no increase in structural conditionality following an FSAP in countries with more liberalized systems; indeed, for countries that already have open financial systems with few distortions, a previous FSAP is associated with fewer structural conditions. This could be interpreted as reflecting the fact that, in such circumstances, the FSAP contributes to greater understanding of the financial system and judgments that structural conditionality is not warranted.

ANNEX 10 Additional Information on Impact of the FSAP

This annex presents supporting evidence collected in the course of the evaluation on the impact of the FSAP process in each of the 25 case studies (see Table A10.1). The sources of evidence comprise mainly interviews with country authorities; interviews with staff and reviews of documents served a complementary role.

The purpose of the exercise has been to identify policy and institutional changes that have taken place subsequent to the FSAP. Several important methodological caveats should be noted:

- It is not possible to attribute any changes specifically to the FSAP given the complexity of the factors at work. Rather the aim is to examine (1) whether any changes have taken place (since if little has happened it is difficult to see how the FSAP could have had much impact); and (2) what qualitative evidence exists on how the FSAP might have contributed to the policy discussion and processes.
- Even when specific policy and institutional changes are identified, it is generally not possible to say, with available evidence, whether these changes have effectively addressed the vulnerabilities and developmental needs highlighted in the FSAP. Such a conclusion would require an in-depth assessment akin to another FSAP (e.g., this review can say whether or not a new law was passed, but it cannot come to a conclusion about the effectiveness of the new law).

Table A10.1. Evidence on Policy and Institutional Change

Country (Date of FSAP Completion)	Contribution to Policy Discussions	Evidence on Contribution to Policy and Institutional Changes[1]	Policy Process in General
Brazil (12/2002)	Senior officials indicated that the FSAP contributed to interagency discussions.	The *Financial Stability Report*, incorporating more comprehensive risk-based stress testing, launched. It also helped in enhancing the capacity of the government's debt management office. Some changes in the pension fund and insurance sector also took place. There was progress in restructuring some of the large federal banks and some steps have also been taken to upgrade financial sector supervision to best international practices.	According to former officials interviewed, the FSAP contributed to the design and launching of the Financial Stability Report and to improve the debt management process. Soon after the FSAP, there was an election and change in government which resulted in shifts in the priorities for the financial system: A number of officials interviewed said that this timing of the FSAP adversely affected its impact.
Bulgaria (7/2002)	The FSAP contributed to discussions by providing an agenda of modernization for the financial sector.	After the FSAP, a new bank insolvency regime was implemented, the Deposit Insurance Fund was strengthened, and central bank powers were enhanced. In the securities area, there were amendments to the public offering law.	According to authorities, the FSAP helped to build momentum at the central bank to enhance the financial sector regulatory framework. According to authorities and one rating agency, FSAP findings were instrumental to achieve an upgrade in the sovereign rating.

Table A10.1 *(continued)*

Country (Date of FSAP Completion)	Contribution to Policy Discussions	Evidence on Contribution to Policy and Institutional Changes[1]	Policy Process in General
Cameroon (6/2000)	The FSAP (together with the one for Gabon) contributed to fostering regional awareness and discussions on the need to strengthen prudential regulations and tighten enforcement.	At the national level, microfinance institutions are being relicensed, and a regulatory and supervisory framework is being put in place in collaboration with the regional banking commission. At the regional level, prudential banking standards have been brought closer in line to international standards, and a regional payment system continues to be developed.	The authorities indicated that the FSAP contributed to raise their awareness of the need for a major upgrade in the legal framework, in the broader context of improving transparency and governance.
Chile (8/2004)	According to senior officials, the FSAP contributed to discussions and coordination between the central bank and supervisory agencies.	Chile's is a very recent FSAP. The Capital Markets Reform II legislation has addressed some of the findings on corporate issues, insurance, and cross-sectoral financial oversight. Market risk regulations have been in troduced, commercial banks' restrictions to enter into derivative activities have been relaxed, and the legal protection to supervisors is being discussed in congress.	Senior officials indicated that they were already well aware of the issues raised in the FSAP, but that it contributed by providing a comprehensive view and a sense of priority and importance. Authorities reported that the FSAP was useful at a time when the central bank was setting up the *Financial Stability Report*.
Costa Rica (3/2003)	The FSAP contributed to interagency coordination efforts, to discussions with financial sector participants, and in informing discussions with legislators.	Political gridlock has historically interfered with a speedy reform process. The government submitted comprehensive legislation promoting financial reforms after the FSAP, but the legislation failed to pass in congress. Subsequently, the government has submitted some measures through piecemeal legislation.	Senior officials indicated that the FSAP findings and recommendations, as well as discussions by the FSAP team with various authorities, contributed to the piecemeal work after the failed attempt at a comprehensive financial reform.
Dominican Republic (5/2002)	Limited initial contribution as authorities did not fully share the FSAP's main findings and the sense of priority and importance. Substantial contributions during the program negotiations after the crisis.	Some FSAP recommendations were implemented in the postcrisis period, including a draft Monetary and Financial Law.	Financial crisis erupted following the FSAP, and attention was on crisis management. FSAP staff indicated that it contributed to improving the draft banking law.
Egypt (11/2002)	FSAP findings (e.g., on insurance) have been used by incoming officials as inputs in their discussions and formulation of sectoral reform agendas.	Reform progress has gathered momentum since mid-2004, including the enactment of new banking sector legislation, recapitalization of state banks, and appointment of new management, unification and floating of exchange rate, and announcement of a broad reform plan for the financial sector.	According to senior officials, the FSAP helped to raise the authorities' awareness of the need to assess the condition of state-owned banks and for wide-ranging financial sector reforms. In so doing, it helped rekindle the momentum for financial sector reform. The authorities indicated that the FSAP findings and recommendations were used as background for the formulation of the government's Financial Sector Reform Plan launched in mid-2004.
Germany (11/2003)	The FSAP contributed to a significant for public discussion of banking consolidation issues. It also raised some "taboo" issues in the insurance sector.	Stress testing started to be included regularly in the *Financial Stability Report.*	An official said the increased emphasis on stress testing was already under way, but the FSAP contributed to the momentum. The FSAP helped in the effort to create a new law on reinsurance companies.

Table A10.1 *(continued)*

Country (Date of FSAP Completion)	Contribution to Policy Discussions	Evidence on Contribution to Policy and Institutional Changes[1]	Policy Process in General
Ghana (6/2001)	The authorities indicated that the FSAP played a catalytic role in authorities' discussions on financial sector issues. It also provided a platform for policy discussion with the international financial institutions on financial sector matters.	Legislation was enacted granting independence and setting a narrower set of objectives to the central bank. But there has been little progress in the recapitalization of the central bank, the portfolio management practices of the social security administration, and the framework for contract and collateral enforcement. The exposure of banking system to a single major borrower was reduced, while its debt was restructured.	The authorities indicated that the FSAP served as a wake-up call, and helped build up consensus, for a timely adoption of corrective actions to tackle impending problems in the banking system. It provided an important building block in the development of the authorities' Financial Sector Strategic Plan.
India (6/2001)	The authorities indicated that the FSAP contributed to raising awareness of risks, informing authorities' discussions, and opening a space for coordinating different agencies' views and positions (Reserve Bank of India, Ministry of Finance, and state regulators).	There has been a gradual reform process involving a change in the paradigm of financial sector organization (from command and control to a more market structure) and regulation and supervision—a process that began before the FSAP and has continued thereafter.	According to senior officials, the FSAP served as a confidential second opinion to the authorities' reform plans—buttressing the case for reforms. The mere existence of the initiative stimulated the authorities to pursue reform efforts further and show progress in the assessment. But none of the specific actions taken can be attributed to the FSAP; internal self-assessments also played a significant role.
Ireland (8/2000)	The FSAP contributed to the debate on whether to create a single supervisory agency (IFSRA) under the umbrella of the central bank or Greenfield.	The IFSRA was created under the central bank's umbrella. Stress testing has been used more intensively for monitoring the household sector. Supervision of insurance sector shifted to risk-based assessments from exclusive focus on consumer protection.	Senior officials said the FSAP recommendations had a significant influence on the institutional location of the IFSRA and contributed importantly to the debate on insurance sector supervision.
Japan (8/2003)	The authorities considered that the FSAP contributed to greater international understanding of Japan's financial sector situation including a greater dissemination of knowledge about actual practices. A number of senior officials also indicated that it contributed to inform the dialogue between key agencies, but others expressed skepticism about its contribution to the domestic policy dialogue.	There has been good progress with the stock problem of nonperforming loans in large systemic banks. There has also been more accurate reporting of data and better risk management frameworks, amid tighter oversight by the Financial Services Agency. The adoption of changes in the corporate governance framework has been slower.	There are different views among senior officials on whether the FSAP contributed to informing the policy dialogue. Some expressed the view that there was too little discussion during the FSAP process about recommendations and policy alternatives that could better conform to country conditions and that therefore the overall impact was limited. Some others had a more positive assessment. All agreed that the most significant contribution to the domestic debate had come from the opportunity to have discussions on the assessment with respected experts.
Jordan (4/2004)	The FSAP influenced the thinking of a small group of key policymakers that had limited impact on discussions among various agencies and regulators because circulation of the report was highly controlled. There were no public discussion as the FSSA was not published.	Progress areas include the regulation for prompt corrective actions, bank corporate governance, a new manual on licensing banks, the conduct of regular stress testing by the Central Bank of Jordan, assessment of country risk in evaluation of banks, and other segments (payment systems, insurance sector, and securities markets).	According to senior officials, the FSAP made a very positive contribution to the momentum for reforms, to setting reform priorities, and to solidifying a culture of financial stability.

Table A10.1 *(continued)*

Country (Date of FSAP Completion)	Contribution to Policy Discussions	Evidence on Contribution to Policy and Institutional Changes[1]	Policy Process in General
Kazakhstan[2] (12/2000)	The FSAP helped to build a road map of reforms for the capital market development.	There have been enhancements of banking supervisory powers. Consolidated prudential norms were introduced. A new regulatory framework for securities was implemented in 2003. Since 2005, International Accounting Standards are compulsory for financial institutions. A new insurance legislation was adopted in 2000 to better observe international practices. The payment system has been further reformed. A Financial System Authority was created.	Senior officials noted that the FSAP provided an impact to the various financial sector reforms as well as a broad road map of the necessary steps to develop the capital market. Subsequent IMF-supported program contributed to the development of more specific action plans.
Korea (3/2003)	According to the authorities, the FSAP contributed to strengthening the reform agenda within the government, and recommendations influenced discussions among various agencies. The FSAP contributed to explaining reforms needed and to support the position of the government in the National Assembly.	There has been important progress in reform implementation (e.g., Bank of Korea Act, payment system). There are still pending issues including the unification of supervisory functions and further advancing with risk-based supervision.	Senior officials expressed the view that the FSAP, as an expert review, contributed to the credibility of the authorities' reform program. It also helped with the prioritization of the reform agenda. The FSAP was an important contribution to the authorities' thinking about the nature of risks and regulation (e.g., in insurance and banking). According to officials, the FSAP also contributed to fending off pressures on directed credit to SMEs.
Mexico (8/2001)	Authorities said that the FSAP contributed to the government's internal debate on development banks, crisis resolution, and improvement in the management of the deposit insurance system.	Progress includes approval of the People's Savings and Credit Law, approval of the Securities Market Law, approval of the new Investment Fund Law, creation of a Federal Housing Institution, overhaul of development banks, reforms of credit institutions law, strengthening of bank regulation and supervision by enhancing the mandate of the Comisión Nacional Banacaria y de Valores, reforms to the pension system law, amendments to bank's capitalization requirements, approval of a law that regulates the operation of credit information institutions, approval of a law that regulates the operation of a new bankruptcy law, and approval of other reforms to promote development of institutional investors (with an environment of higher accountability and transparency).	According to senior officials, the FSAP served as a confidential advisor to the authorities, helping them to discuss their proposed reform agenda in a comprehensive manner with an expert team. They viewed the high-level discussions at the end of the FSAP mission, rather than the report itself, as having the most important impact. The timing of the FSAP mission (early on in the term of the new government, at the authorities' request) was an important factor contributing to the positive effect of the FSAP.
New Zealand (4/2004)	The FSAP helped to generate momentum for financial reform, and served to get the attention of authorities of the government and Reserve Bank. On many occasions, the Governor and the Finance Minister have used the FSAP findings in public speeches.	New Zealand's is a recent FSAP. Regular publication of the *Financial Stability Report* was started, including the use of stress testing. The areas of recent work by the Reserve Bank include (1) strengthening the ability to monitor risks by adopting a framework for independent reviewers of banks' systems and controls; (2) reviewing the disclosure regime, which includes a framework for strengthening market discipline; and (3) enhancing the capacity to manage financial stresses by operationalizing the Reserve Bank's lender of last resort role and determining options for responding to bank failures.	Authorities indicated that FSAP recommendations were a useful contribution to set the agenda for reforms in the banking sector. The Reserve Bank Governor adopted the FSAP recommendations as a road map for further improvements in the financial sector, and requested periodical updates of the state of implementation of the recommendations.

Table A10.1 *(continued)*

Country (Date of FSAP Completion)	Contribution to Policy Discussions	Evidence on Contribution to Policy and Institutional Changes[1]	Policy Process in General
Philippines (9/2002)	It is unclear whether the FSAP had any significant impact on policy discussions.	There has been little progress with enacting reform legislation on prompt corrective action powers and protection of supervisors. But stress testing is now part of supervision practices.	According to authorities, reform plans for the securities and exchange commission have drawn from the IOSCO assessment as input.
Romania (11/2003)	According to authorities, the FSAP encouraged discussion of financial stability issues within the government, but there was no significant public debate on the matter.	There is greater focus on stability issues and the overall financial system; and more attention to staff and building expertise. The central bank has been reorganized (new department and staff dedicated to financial stability issues). Stress testing is now a regular feature of supervision. The regulatory frame work for credit unions has been amended. Progress has been made in implementing the new banking law (on consolidated approach, corporate governance, bank internal controls, and definition of past due loans).	Authorities noted that the FSAP supported them in promoting attention on financial system stability. Authorities indicated that FSAP contributed significantly to securities regulation.
Russia (5/2003)	A press conference was held after the FSAP. According to authorities, FSAP results were used in discussion within the central bank, and in discussions in parliament to pass legislation.	There was a change in regulations concerning large exposure, connected lending, consolidated supervision, and amendment to the method for computing bank capital. Bankruptcy regulations were also changed. Supervision at the central bank started using regularly stress testing, and improving on methodology. Reform of accounting practices toward International Accounting Standards has received new momentum. Adoption of payments system action plan and implementation of Real Time Gross Settlement system.	Senior officials indicated that, although most issues were not new to them, the FSAP contributed significantly to the momentum for financial sector reforms. FSAP findings contributed to central bank's "Strategy of Banking System." They also said that improvements in use of stress-testing approaches as part of supervision stemmed directly from the FSAP.
Singapore (3/2004)	While issues raised in FSAP were not new to the authorities, the FSAP did contribute to increased discussion of them, especially within the Monetary Authority of Singapore.	According to senior officials, the adverse effects of the Central Provident Fund interest rates on the development of the life insurance market have started to be corrected. Authorities began to publish a Financial Stability Report, and stress testing is conducted regularly as a part of the exercises. Local capital requirements for banking sector were reviewed. A new risk based capital framework for the insurance industry was implemented.	According to senior officials, most FSAP recommendations have been implemented but they expressed that this should not be attributed the FSAP per se.
Slovenia (5/2001)	Senior officials indicated that the FSAP contributed to discussions at the central bank and among various agencies and institutions (e.g., on dynamic provisioning), and to inform the dialogue with parliament. There was little public discussion.	A Stability Unit (in charge of stress testing) was established in the central bank. There has been broad implementation of recommendations, including on connected lending, large exposures, market risk regulation, and governance criteria. Payments systems were upgraded.	According to authorities, the FSAP provided significant support to the authorities' reform initiatives in parliament. Other important contributing factors to the reform momentum include the EU accession and entering into ERM2 system.

Table A10.1 *(concluded)*

Country (Date of FSAP Completion)	Contribution to Policy Discussions	Evidence on Contribution to Policy and Institutional Changes[1]	Policy Process in General
South Africa (2/2000)	Authorities viewed the FSAP as part of their broader efforts to promote credibility by encouraging greater transparency of their policies and institutions.	Procedures for consolidated supervision were strengthened. Stress testing began to be be conducted on a regular basis and regular publication of a financial stability report began.	According to senior officials, the FSAP was useful in providing an integrated analysis and recommendations across the whole financial sector. Reserve Bank officials expressed the view that most reforms would have happened in any case, but that the FSAP helped accelerated the pace in some areas.
Sri Lanka (9/2002)	According to authorities, the FSAP assisted discussions within the central bank and contributed to coordination with other agencies. It helped to increase transparency of the policy stance.	Progress has been made in several areas: prudential norms were strengthened, banking supervision was enhanced, and financial indicators were improved across the entire banking system (including for the two large state-owned commercial banks).	Senior officials indicated that the FSAP was helpful to identify and raise awareness of vulnera bilities, to prioritize measures, and to support the reform momentum.
Tunisia[2] (6/2002)		Progress has been slow (including on the restructuring of state banks facing continued non-performing loan problems) amid preference for gradual reform efforts.	

[1]Policy and institutional changes refer to the identification of outcomes; it does not imply any attribution to the FSAP.

[2]A blank space indicates that evidence could not be obtained; it does not imply that there has been no impact.

ANNEX

11 Background Tables

Table A11.1. Completed and Ongoing or Planned FSAPs per Fiscal Year[1]

(As of October 2005)

2000	2001	2002	2003	2004	2005	2006
Initial FSAPs						
Colombia	Ghana	Gabon	Kyrgyz Republic	Macedonia, FYR	*Belarus*	*Jamaica*
Lebanon	Guatemala	Switzerland	Japan	Kenya	*Sudan*	*Spain*
Canada	Poland	Lithuania	Bangladesh	Jordan	*Norway*	*Namibia*
South Africa	Armenia	Luxembourg	Hong Kong SAR	ECCU	*Italy*	*Uruguay*
El Salvador	Israel	Sweden	Honduras	Kuwait	*Belgium*	*Guyana*
Hungary	Peru	Philippines	Malta	Ecuador	*Rwanda*	*Denmark*
Iran, I.R. of	Yemen	Korea	Mauritius	Azerbaijan	*Mauritania*	*Australia*
Kazakhstan	Senegal	Costa Rica	Singapore	Austria	Albania	*Bosnia and Herzegovina*
Ireland	Slovenia	Bulgaria	Bolivia	New Zealand	*Greece*	*Brunei Darussalam*
Cameroon	Iceland	Sri Lanka	Oman	Netherlands	*Trinidad and Tobago*	*Fiji*
Estonia	Czech Republic	Morocco	Germany	Nicaragua	*Serbia*	*Portugal*
India	Uganda	Nigeria	Mozambique	Chile	*Madagascar*	*Montenegro*
	Dominican Republic	United Kingdom	Tanzania	Saudi Arabia	*Paraguay*	*Turkey*
	United Arab Emirates	Slovak Republic	Romania	France	*Bahrain*	*San Marino*
	Latvia	Barbados	Algeria	Pakistan		
	Tunisia	Brazil		Moldova		
	Finland	Ukraine				
	Mexico	Russia				
	Croatia	Egypt				
	Georgia	Zambia				
Total: 12 (pilot countries)	**Total: 20**	**Total: 20**	**Total: 15**	**Total: 16**	**Total: 14**	**Total: 14 (preliminary)**
FSAP Updates						
	Lebanon	Hungary	Iceland	Ghana	Senegal	*Tunisia*
	South Africa			Slovenia	Colombia	*Guatemala*
				El Salvador	Uganda	*Georgia*
				Kazakhstan	Peru	*Poland*
					Armenia	*Ireland*
					Hungary	*Iran, I.R. of*
						Mexico
Total: 0	**Total: 2**	**Total: 1**	**Total: 1**	**Total: 4**	**Total: 6**	**Total: 7 (preliminary)**

Source: MFD's FSAP tracking system

Note: For FY2007, 10 initial assessments and 3 Updates are tentatively scheduled.

[1]The fiscal year runs from May to the end of April. The FSAPs for Argentina (FY2001), Côte d'Ivoire (FY2002), and Uruguay (FY2002) were not completed. The latter is scheduled to be restarted in FY2006. Ongoing and planned FSAPs are in italics.

Table A11.2. Countries Included in the 25-Country In-Depth Sample

Country	Type of Contact with Country Authorities[1]	Published FSSA
Brazil	Conference call	No
Bulgaria	Country visit	Yes
Cameroon	Country visit	No[2]
Chile	Conference call	Yes
Costa Rica	Country visit	Yes
Dominican Republic	. . .	No
Egypt	Interviews in Washington, D.C./IEG mission	No
Germany	Country visit	Yes
Ghana	Country visit	Initial assessment: No; Update: Yes
India	Country visit	No[2]
Ireland	Country visit	No[2]
Japan	Country visit	Yes
Jordan	Country visit	No
Kazakhstan	Conference call	Initial assessment: No; Update: Yes[2]
Korea	Country visit	Yes
Mexico	Interviews in Washington, D.C.	Yes
New Zealand	Conference call	Yes
Philippines	Conference call	No
Romania	Country visit	Yes
Russia	Country visit	Yes
Singapore	Conference call	Yes
Slovenia	Country visit	Initial assessment: Yes; Update: Yes
South Africa	Country visit	No[2]
Sri Lanka	Conference call	No
Tunisia	. . .	Yes

[1]All country authorities were offered an opportunity to provide feedback to the evaluation on their experience with the FSAP process. ". . ." means "not available."

[2]At the start of the initiative, pilot countries were not allowed to publish the FSSAs.

Table A11.3. Standards and Codes and Coverage Under the FSAP

Standards often covered in FSAPs	
Banking supervision	Basel Committee's "Core Principles for Effective Banking Supervision" (BCP).
Securities	International Organization of Securities Commissions' (IOSCO) "Objectives and Principles for Securities Regulation."
Insurance	International Association of Insurance Supervisors' (IAIS) "Insurance Supervisory Principles."
Payments systems	Committee on Payments and Settlements Systems' (CPSS) "Core Principles for Systemically Important Payments System."
Anti-money laundering and combating the financing of terrorism	Financial Action Task Force's (FATF's) "40+8 Recommendations."
Standards sometimes covered	
Monetary and financial policy transparency[1]	IMF's "Code of Good Practices on Transparency in Monetary and Financial Policies."
Corporate governance[2]	Organization of Economic Cooperation and Development's "Principles of Corporate Governance."
Accounting[2]	International Accounting Standards Board's "International Accounting Standards."
Auditing[2]	International Federation of Accountants' "International Standards on Auditing."
Other standards	
Data transparency[1]	IMF's Special Data Dissemination Standard and General Data Dissemination System.
Fiscal transparency[1]	IMF's "Code of Good Practices on Fiscal Transparency."

[1]Transparency standards: standards in these areas were developed and are assessed by the IMF.

[2]Standards concerned with market integrity: standards in these areas have been developed by relevant institutions and the World Bank is in the lead in undertaking assessments.

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Statement by the Managing Director
IMF Staff Response

Summing Up of IMF Executive Board Discussion by the Acting Chair

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Statement by the Managing Director on the Evaluation by the Independent Evaluation Office of the Financial Sector Assessment Program

Executive Board Meeting
January 27, 2006

This report is a valuable and timely contribution to a crucial debate. The Financial Sector Assessment Program (FSAP) has been a central component of the Fund's work on the financial sector since its inception in 1999, and the report provides a comprehensive and candid analysis and useful recommendations aimed at improving the effectiveness and efficiency of the FSAP and its integration with other Fund work. The accompanying staff statement provides a more detailed response to the IEO findings and recommendations, and confirms that there is a great deal of agreement on most issues.

The Board's consideration of this report will be a crucial input for us as we move to strengthen our work on financial sector surveillance, in line with one of the priorities identified in the medium-term strategic review. The work of the small group of senior staff currently examining ways of enhancing the effectiveness of surveillance, and our reflection on the report of the Review Group on the Organization of Financial Sector and Capital Markets Work (the "McDonough report"), will be other key inputs in this regard. I look forward to the Board's discussion of the IEO's report, and suggest that it may be most useful to focus, at this stage, on identifying key areas for improvement, leaving specific procedural changes—especially any with resource implications—to be decided in the context of a broader discussion of how the Fund's financial sector and capital markets work will be organized in the future.

Staff Response to the Evaluation by the Independent Evaluation Office of the Financial Sector Assessment Program

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The staff congratulates the Independent Evaluation Office for the comprehensive and candid analysis of the Fund-Bank Financial Sector Assessment Program (FSAP).

We endorse the IEO's key conclusion that the FSAP represents a distinct improvement in the Fund's ability to conduct financial sector surveillance and in understanding the key linkages between financial sector vulnerabilities and macroeconomic stability. Overall, we agree with most of the report's analysis and areas identified for improvement. Indeed, many similar points have been made in previous internal FSAP reviews, and efforts are under way on many of these fronts—including promoting the FSAP program more actively and encouraging country participation; strengthening the integration of FSAP in Article IV consultations, as a means of improving the monitoring of financial systems for surveillance purposes; enhancing the quality and organization of FSAP assessments and Updates (including through greater focus and selectivity); and making technical assistance (TA) follow-up more systematic.

The FSAP clearly constitutes a central pillar of the Fund's approach to financial sector surveillance. At the same time, we need to recognize that the resources in the area of financial sector surveillance are already stretched. The McDonough report and the broader strategic discussions may have implications for the relative emphasis to be given to the various components of financial sector surveillance. Thus, the inputs from all these exercises will need to be considered together.

At the heart of the IEO's recommendations lies the need to strengthen the links between the FSAP and surveillance (Recommendation 3) and to improve further the quality of the FSAP and strengthen its impact (Recommendation 4). Staff concurs, in particular, that the follow-up in Article IV missions of major issues raised by FSAPs is critical, and that improved follow-up may require adjustments to ways the Fund's financial expertise is utilized in surveillance. The most appropriate modalities to achieve this—including the merit of the specific proposals put forward in Recommendation 5—are being assessed as part of the medium-term strategic review.

We also agree strongly with the need to strengthen the incentives for members' participation in FSAP and FSAP updates (Recommendation 2). We thus support the report's call for Fund management and the Board to play a more active role in encouraging countries to volunteer. By contrast, the report in our view puts excessive emphasis on the need to refine the criteria for prioritization (Recommendation 1), and does not provide convincing evidence that prioritization mechanisms are inadequate. While selectivity is important, we think it can be achieved within the existing prioritization guidelines. Prioritization is particularly important as countries will increasingly need to volunteer for FSAP Updates. For its part, staff is continuing to refine the scope of Updates, make them a more focused exercise, and integrate them more closely into the Fund's work.

The staff is in broad agreement with the IEO's views on Bank-Fund collaboration on the FSAP (Recommendation 6). As noted by the IEO, the Financial Sector Liaison Committee (FSLC) has been reasonably effective in this regard, and could work to enhance further the alignment of each institution's contribution with its comparative advantage.

We share the IEO's view that it is important to improve coordination of follow-up TA activities, based on the country's own action plans (Recommendation 7). The staff already has taken steps in this direction, which include, as a result of the latest FSAP review, efforts to organize, in appropriate country cases, follow-up meetings on technical assistance among the authorities, staff, and possibly other donors. More generally, actions to improve coordination with authorities and their involvement are under way in response to the recommendations of the IEO evaluation of TA. As we go forward in strengthening TA follow-up to FSAPs, we will need to avoid excessively formal approaches that could both overburden the Fund and the Bank and reduce country ownership.

The Acting Chair's Summing Up

Evaluation by the Independent Evaluation Office of the Financial Sector Assessment Program

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Executive Directors commended the Independent Evaluation Office (IEO) for its insightful and comprehensive evaluation of the Financial Sector Assessment Program (FSAP). They saw the discussion of the IEO report as a key input into the Fund's efforts to strengthen financial sector surveillance, in line with priorities identified in the Fund's medium-term strategic review and in the McDonough report.

Directors agreed with the key IEO conclusion that the FSAP program represents a distinct improvement in the Fund's ability to conduct financial sector surveillance and to understand linkages between financial sector vulnerabilities and macroeconomic stability. Directors were encouraged by the IEO's assessment that FSAPs and FSAP Updates help articulate policy recommendations, prompt better discussions with authorities, and help support policy and institutional changes. Some Directors especially noted the report's finding that FSAPs often had an impact on the internal policy debates regarding relevant measures.

At the same time, Directors considered that the IEO report provided a balanced and candid assessment of areas for improvement. In particular, Directors concurred that the main challenges facing the FSAP relate to "mainstreaming" financial stability assessments as an integral part of the Fund's bilateral and multilateral surveillance, and to ensuring participation by those countries where a strengthening of financial sector surveillance is most needed. Directors recognized that resources available for financial sector surveillance are already stretched, and that any adjustments and improvements would need to take into account possible resource implications.

Most Directors agreed with the report's assessment that incentives to participate in FSAP assessments and FSAP Updates are critical for maintaining the effectiveness of the program. They were concerned that some countries that are systemically important and/or may have vulnerable financial systems still have not volunteered for initial assessments, and that some countries have been reluctant to volunteer for Updates. Although there was some discussion of the possibility of moving to mandatory FSAPs and FSAP Updates, most Directors considered that the voluntary nature of the FSAP should be maintained, and emphasized that FSAPs have been most effective in building capacity where they have been owned by authorites. A number of these Directors called on the staff to explore the reasons for nonparticipation and identify remedial actions. A few other Directors suggested that the most efficient way to ensure adequate coverage of critical financial sector vulnerabilities in member countries would be to ensure that the FSAP analysis is an integral part of regular Article IV consultations.

Directors welcomed the discussion in the IEO report on whether the criteria for prioritizing FSAPs and FSAP Updates are adequate in a context of scarce resources (Recommendation 1). While a few Directors considered that the IEO report does not provide sufficient evidence that current mechanisms are inadequate, many Directors agreed on the need for clearer guidance—including on the trade-off between assessments of vulnerability and development issues—as part of a medium-term strategy aimed at efficient resource allocation in line with the Fund's core mandate.

To align FSAP coverage better with the needs of surveillance, most Directors agreed with the IEO proposal that management should indicate to the Board which countries it considers the highest priorities for FSAP assessments and Updates (Recommendation 2). Annual reporting on country participation, as instituted following the 2005 internal FSAP review, could in this context provide useful information to guide discussion of priority cases. In addition, most Directors considered that Article IV staff reports should explicitly recommend an initial FSAP or FSAP Update in priority cases, although the way this was reported would have to be mindful of potential market sensitivities. Some Directors, however, cautioned against putting peer pressure on countries, as they judged that this runs counter to the voluntary nature of FSAPs. A number of Directors also pointed to the report's finding that the burden of FSAPs on the authorities is high, and stressed that reducing this burden through better planning and focus is critical for achieving increased participation.

Directors welcomed the report's call for deeper country-specific analysis of priorities for financial sector surveillance, and noted that staff has been taking steps in this direction, including through adoption of more focused FSAP assessments and Updates and increased use of scoping missions. Many Directors saw merit in the IEO proposal for staff to develop country-specific plans for financial sector surveillance. It was noted, however, that this proposal goes to fundamental questions as to how the Fund should conduct financial sector surveillance. Directors agreed that the proposal, as well as any possible adjustments to resource allocation and other modalities (including the frequency of FSAPs), would be considered in the broader context of the ongoing discussion on enhancing the effectiveness of Fund financial sector surveillance.

Directors concurred with the IEO recommendation to strengthen links between FSAPs and surveillance (Recommendation 3). Specifically, they underscored the need to follow up on key vulnerabilities and gaps relevant for stability and macroeconomic developments and respective recommendations raised in FSAPs/FSAP Updates in country work, and to integrate such issues into Article IV surveillance reports. To facilitate this, Directors agreed that each Financial Sector Stability Assessment should contain a short (1–2 page) section that summarizes in candid language the main macro-relevant findings of FSAPs and potential macroeconomic implications arising from key financial sector risks. Directors stressed that in cases where financial stability issues, including any potential global repercussions, are judged to be of high importance, they should be a major focus of Article IV consultations, and Article IV reports should convey candid and focused assessments in this area. Directors also agreed that it would be helpful if Article IV Board discussions themselves paid greater attention to significant macro-relevant issues raised by FSAPs. In this context, FSAP team leaders could be given greater opportunities to clarify macro-relevant FSAP findings during Article IV Board meetings.

Directors also encouraged the staff to explore how internal processes could be better targeted at the objective of enhancing the use of FSAP findings. They saw potential both to strengthen the internal review process to ensure integration of key FSAP findings in the surveillance process, and to identify and disseminate better cross-cutting messages from FSAP assessments, including through better integration in regional and multilateral surveillance.

Directors encouraged the staff to follow up on IEO recommendations to improve further the quality of FSAPs and strengthen their impact (Recommendation 4). They noted that recommendations should be clearly prioritized and the potential consequences of not addressing key weaknesses candidly discussed. Directors emphasized in particular the importance of treating financial sector and cross-border linkages more systematically in FSAP analysis in light of the growing importance of regional and global spillover effects as a result of financial globalization. They concurred that to improve the quality and clarity of stress-testing analysis, the reports need to contain more informative and candid discussions on methodological and data limitations and the staff should not refrain from carrying out analysis of politically sensitive shocks. Some Directors also called for clearer definition of the role of financial soundness indicators in FSAPs and for improved prioritization and sequencing of relevant ROSCs. Some other Directors stressed the need for the staff to have comprehensive knowledge of the domestic institutional background to ensure production of high-quality FSAPs aligned with country circumstances and priorities.

Directors discussed the implications of the publication policy of the Financial System Stability Assessment (FSSA) for the effectiveness of FSAPs. While some Directors considered that a move to presumed publication of the FSSA would enhance the impact of FSAPs on country authorities, donors, and market participants, many other Directors argued that such a move would not be consistent with the voluntary nature of the program.

Many Directors welcomed the IEO's recommendation to introduce changes in the organization of IMF mission activities to utilize scarce financial sector expertise, especially from MFD and ICM, more effectively in the surveillance process (Recommendation 5). Directors noted that this will be considered in the broader context of improving financial sector surveillance, as part of the medium-term strategic review. They took note of the message from the evaluation that the effectiveness of financial sector surveillance is constrained in important ways by the scarcity of financial sector and capital markets expertise. Directors also noted the IEO finding that, to date at least, only FSAP Updates appear to have had the capacity to undertake an in-depth tracking of implementation in specific areas.

While the view was expressed that the Fund should take the lead on all FSAPs, most Directors were in broad agreement with the report's recommendations regarding Bank-Fund collaboration (Recommendation 6). They concurred that the current joint approach, including the central role for the Bank-Fund Financial Sector Liaison Committee (FSLC), should be maintained. At the same time, further efforts should be made to take full advantage of the distinctive contributions that the two institutions can make—with the Fund focusing on stability issues and the Bank on financial sector development and institution building—including in the context of FSAP follow-up. Directors noted that the ongoing review of Bank-Fund collaboration will provide additional insights on the effectiveness of current coordinating mechanisms.

Directors concurred that there is room to improve the coordination of FSAP-related technical assistance activities, based on the country's own action plans (Recommendation 7). They noted that steps in this direction are under way in the context of past FSAP reviews, and in the broader context of the Fund's response to the recommendations of the IEO report on evaluation of technical assistance. These steps include the organization, in appropriate country cases, of follow-up meetings on technical assistance among the authorities, staff, and sometimes donors. At the same time, Directors cautioned against overburdening the FSAP with additional expectations regarding the assessment and planning of technical assistance needs, and against excessively formal approaches to follow-up that could overtax already stretched Fund resources and discourage ownership by the authorities.