Independent Evaluation Office Announces Release of Report on the Evaluation of the Financial Sector Assessment Program (FSAP)

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Independent Evaluation Office

of the International Monetary Fund

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February 3, 2006 - The Independent Evaluation Office (IEO) of the International Monetary Fund (IMF) today released the report ***Evaluation of the Financial Sector Assessment Program (FSAP)***.

The 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 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). The IMF's Executive Board discussed the evaluation report on January 27. Directors agreed with the evaluation's key conclusion that the FSAP 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, and that the main challenges relate to its "mainstreaming" into bilateral and multilateral surveillance and to ensure participation by countries where financial surveillance is most needed (see **Summing Up** of the discussion, pdf file).

The IEO concludes that the FSAP is a distinct improvement in the IMF's ability to conduct financial sector surveillance. The program 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 of standards or analysis of particular issues. 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 suffice to ensure coverage of systemic and vulnerable countries where a strengthening of financial sector surveillance may be 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.

Key Findings and Recommendations

The evaluation's major findings and related recommendations are focused on three key themes: (i) enhancing incentives for participation, clarifying priorities, and strengthening the links with surveillance; (ii) steps to strengthen further the quality of the FSAP and organizational changes within the IMF; and (iii) the working of the joint IMF-World Bank approach.

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

Priority setting within the FSAP is potentially complicated because of the initiative's multiple objectives. In practice, the multiplicity of objectives has not so far prevented priority being given to countries of systemic importance and/or with potential financial sector vulnerability concerns, when these have volunteered. This is because country participation has been paced and the multiple objectives have not yet involved constraints requiring hard choices. But going forward, the evidence does suggest increasing tensions not so much because a minority of systematically important countries have not yet volunteered (although they certainly should be encouraged strongly to do so), but because a significant number of countries that should be high priority candidates for updated assessments have been reluctant to participate in a timely manner.

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.

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, 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.

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.* 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.

ii) Improving the Quality and Impact of the FSAP and Organizational Changes

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.

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." This would include for example clearer prioritization of recommendations and candid discussion of the potential consequences, more systematic inclusion of cross-border/financial sector issues, and greater involvement of the authorities in the overall process, including a written response.

Recommendation 5. *Introduce changes in the organization of IMF mission activities to utilize scarce financial sector technical expertise more effectively in the surveillance process.* This may require 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.

iii) Joint IMF-World Bank Nature of the FSAP

The evaluation has found that the joint teams of IMF and World Bank staff members (as well as outside experts) have contributed significantly to the depth of analytical expertise and credibility of the findings. But if steps to strengthen incentives for participation are successful, then more concrete guidelines will be needed on how to manage tradeoffs between more frequent update assessments of countries of systemic importance and/or potential financial vulnerability and assessments of countries with less developed financial sectors. 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.

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.* Establishment of such a framework will 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.

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