INTERNATIONAL MONETARY FUND

THE WORLD BANK

Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward

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February 22, 2005

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LIST OF ACRONYMS AND ABBREVIATIONS

AAA	Analytical and Advisory Activities
AML	Anti-Money Laundering
BCP	Basel Core Principles for Effective Banking Supervision
CAS	Country Assistance Strategy
CCE	Coordinated Compilation Exercise for Financial Soundness Indicators
CFT	Combating the Financing of Terrorism
CGAP	Consultative Group to Assist the Poorest
CMUs	Country Management Units
CPSIPS	Core Principles for Systemically Important Payments Systems
CPSS	Committee on Payment and Settlement Systems
ECCU	Eastern Caribbean Currency Union
FATF	Financial Action Task Force
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
FSSA	Financial System Stability Assessment
FSR	Financial Stability Report
FSRB	FATF-Style Regional Body
IAS	International Accounting Standards
IAIS	International Association of Insurance Supervisors
IEO	Independent Evaluation Office
ICM	International Capital Markets Department
ICP	Insurance Core Principles
IOSCO	International Organization of Securities Commissions
MFD	Monetary and Financial Systems Department (formerly MAE)
MFPT	IMF’s Code of Good Practices on Transparency in Monetary and Financial Policies
OED	Operations Evaluation Department
OFC	Offshore Center Program
ROSC	Reports on Observance of Standards and Codes
RSSS	Recommendations for Securities Settlement Systems
SMEs	Small- and Medium-size Enterprises
TA	Technical Assistance
UNCITRAL	United Nations Commission on International Trade Law

EXECUTIVE SUMMARY

1. **This paper reports on developments in the Financial Sector Assessment Program (FSAP) since the last Board review of the FSAP in spring 2003 and discusses staff views of the program's evolution.** The paper focuses on the experience and discusses possible evolutionary changes that can be adopted. Reviews of the FSAP by the Independent Evaluation Office (IEO) of the Fund and by the Bank's Operations Evaluation Department (OED) are expected to be finalized by end-2005.

2. **It is proposed that the key features of the program—in particular its joint Bank-Fund nature and the voluntary country participation—remain unchanged.** The refocusing in the program proposed in the last review resulted in cost savings in the Fund and an increased role of the Bank in low-income countries. The paper suggests maintaining this new balance, while furthering the proposals of the last review, in particular on post-FSAP follow up, and on the treatment of developmental issues in low-income countries. The paper clarifies the concept of FSAP updates and proposes to bring the publication policy for the FSAP closer in line with general publication policies for Board documents.

3. **The FSAP is a major initiative in the financial sector work of the World Bank and the International Monetary Fund.** It provides inputs into the Fund's surveillance and the Bank's financial sector dialogue, and is the main vehicle for Bank-Fund collaboration in the financial sector. It helps provide a framework for the delivery of financial sector technical assistance (TA) and other follow-up work by the two institutions, and by other donors, multilaterals, and the countries themselves. The program is the main vehicle for assessing observance of international financial sector standards and codes. The large number of such assessments allows the Bank and the Fund to also provide feedback to standards setters on possible improvements in their core principles and assessment methodologies.

4. **The program helps sensitize country authorities to the relevance and importance of financial system diagnosis and formulation of sector strategies.** Based on post-FSAP feedback from the authorities, the main perceived benefit of the FSAP in high-income countries with global financial systems is that it offers an independent check-up of the health of the financial system, its infrastructure and regulatory framework from an international perspective. In low- and medium-income countries, the FSAP is also seen as a tool that helps identify gaps and issues that need to be addressed to develop a more diversified, competitive and inclusive financial sector.

5. **About 120 countries, two-thirds of the membership, have participated or requested participation in the program.** An emphasis on systemically important countries in initial assessments scheduled so far means that most of the remaining members have relatively small financial systems. Thus, going forward, initial assessments will be characterized by more emphasis on development issues and a further increase in the relative role of the Bank. Country participation varies significantly across regions, ranging from under-representation of East Asian economies to a virtually complete coverage of European countries. Going forward, Fund staff proposes annual reporting to the Fund Board on participation in initial assessments and updates, to help increase awareness about the

program. The Bank Board is asked whether it would be interested in discussing a representative sample of FSAs and receiving semi-annual technical briefings on the program.

6. **As updates gradually become the major part of the program, it is important to sharpen their concept.** The balance between countries participating in initial assessments and those returning for updates is changing, reflecting the increased coverage of membership by initial assessments. Going forward, it is proposed that an update start with a stock-taking exercise using the previous FSAP findings as a benchmark and review stability, structural, and development issues covered in the previous assessment, focusing on areas where there have been significant developments. The scope can be tailored regarding depth of that review and the additional elements to be examined.

7. **FSAP assessments continue to be comprehensive, while the scope and depth of coverage is now better tailored to country circumstances.** In particular, assessments of low-income countries with small financial systems have devoted relatively more effort to explaining why specific markets are missing and broad access to financial services is limited. Assessments have identified the most important structural and capacity-building needs, which are often rooted in a country's broader legal and institutional frameworks. In reviewing common findings of FSAPs, assessments in several cases, and for countries of differing income levels, point to the need for regional analysis and solutions. Finally, recent FSAP reports show substantially increased coverage of anti-money laundering/combating the financing of terrorism (AML/CFT), reflecting the increased interest in these issues since the last Board review.

8. **A range of tools is used for follow-up monitoring of financial systems.** These include FSAP updates, specialist participation in Article IV or Bank missions, MFD’s backstopping support of Article IV missions, and off-site monitoring through FSIs and other information. The reorganization of MFD has helped in better integrating the FSAP into ongoing financial sector surveillance. Nonetheless, coverage of financial sector issues in surveillance has not yet been at par with that of other main areas. Steps to remedy this situation include increased MFD participation in Article IV consultations, increased backstopping from headquarters, and a pilot project for improving Article IV financial sector surveillance, initiated in late 2004. Given the increasing cross-border linkages in several regions, Bank and Fund staff have been working on regional financial sector projects that would build on individual country FSAP findings and provide a regional perspective.

9. **Increased efforts of the Bank, Fund, and outside donors and other cooperating institutions are devoted to FSAP follow-up TA, but could still be more systematic.** Experience suggests the need for flexibility in the way the TA follow-up is accomplished, particularly to improve country ownership. In cases where implementation of FSAP recommendations would benefit from TA, approaches could include follow up meetings convened by the authorities with staff assistance, to which other donors—notably the FIRST initiative—could be invited also. Such meetings have already begun. For the Bank, integration of FSAP findings in country strategies and lending programs is an ongoing challenge, because of the multi-year nature of CASs and the difference in timing between the FSAPs and CAS preparation. Nevertheless, significant FSAP follow-up assistance has been

embodied already in lending and advisory services. These mainstream Bank activities increasingly reflect FSAP findings.

10. **Since the last review, overlapping documentation has been reduced and document review has been strengthened.** As a result, the time needed for completing the FSAP documentation has declined.

11. **Staff is expanding the analytical tools for assessing financial sectors.** The Compilation Guide on Financial Soundness Indicators (FSIs) has helped to clarify the definitions of FSIs used in FSAPs. Work is underway in the Bank to compile an additional set of indicators to help measure the functioning of financial markets, their level of development and accessibility, and the institutional environment. Recent FSAPs have used more sophisticated stress tests, increasing the use of scenarios and contagion effect calculations. Demand-side surveys and corporate sector assessments are being developed and used to strengthen the developmental aspects of the assessment. Similarly, templates have been developed to address issues of governance of banks and the legal and institutional framework for dealing with bank insolvency. The Financial Sector Assessment Handbook and seminars are under preparation to disseminate diagnostic tools used in financial sector assessments.

12. **The balance of resources used in the program over the past two years is more equally distributed between the Bank and the Fund.** The Fund has curtailed the resources used on high-income country assessments and used fewer experts for standards assessments, notably in countries where the relevant sector, market, or infrastructure is nascent or a high degree of non-compliance is expected. The gradual evolution of the program from resource-intensive initial assessments to updates, smaller size of the financial systems undergoing initial assessments, and streamlined procedures have allowed the Bank to play a relatively larger role in the program, within an unchanged overall resource envelope for the program. This rebalancing is consistent with the proposals in the last review.

I. INTRODUCTION[1]

13. **When the Executive Boards of the Fund and the Bank last reviewed the program in March 2003, Directors provided guidance on the program going forward and requested another review in the spring of 2005.** On that occasion, Directors observed that the FSAP exercise is a good example of effective IMF-World Bank collaboration, and noted that the FSAP has many benefits affirmed by participating countries. Notwithstanding these achievements, however, Directors noted that the program had become increasingly costly, especially for the Fund, partly due to a bunching of assessments of a number of systemically important countries, and an increase in the average number of international standards and codes endorsed by the Bank and Fund Boards ("standards and codes") assessed in detail. Directors endorsed steps to streamline the assessments, while tailoring the program to individual country circumstances, and increasing the focus on development needs and structural issues in low-income countries with small financial systems.[2]

14. **This paper provides information on developments in the program since the last review and discusses staff views on the program's evolution.** Given the upcoming external reviews of the FSAP by the IEO and by the OED, this paper takes the fundamental structure of the FSAP as given and focuses on evolutionary changes that could be put in motion while the IEO and OED reviews are being completed and their recommendations considered by the Boards.[3]

15. **The structure of the paper is as follows.** Section II reports on key developments since the last review. Section III provides an update on recent developments in the analytical tools of the FSAP. Section IV summarizes recurrent findings from assessments and updates and indicates how the program is being adapted to better address some of these findings. Section V includes a discussion of the program's link to other activities. Based on the discussion in the previous sections, Section VI includes proposals going forward. Section VII suggests issues for discussion.

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[1] The preparation of this paper has been overseen by the Bank-Fund Financial Sector Liaison Committee (FSLC), responsible for the coordination of the two institutions' financial sector work, including the FSAP.

[2] For the Fund's review, see *Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward*, SM/03/77, February 24, 2003, and *The Acting Chair's Summing-Up—Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward* (BUFF/03/42, March 24, 2003). For the Bank's review, see R-2003-0026, March 6, 2003, and OM2003-0024/1, March 20, 2003.

[3] For the plan of the Independent Evaluation Office evaluation, see the *Evaluation of the FSAP—Issues Paper* (www.imf.org/external/np/ieo/index.htm). For the plan for the Operations Evaluation Department, see *OED Review of the Financial Sector Assessment Program (FSAP)—Approach Paper* (http://www.worldbank.org/oed/ongoing_evaluations.html).

II. Report on Developments since the Previous Board Review

A. Status and Patterns of Country Participation[4]

16. **About 120 countries—two-thirds of the membership—have participated in the program or agreed to participate in the near future, including a majority of systemically or regionally important financial systems** (Table 1 and Appendix I). Since the 2003 review, 33 initial assessments have been initiated, which is broadly in line with the range of 17–19 per year, envisaged in the 2003 review. Some 25 countries have confirmed their future participation. To date, 14 countries have requested an update of their original assessment, of which 10 have been initiated.

17. **Subject to country authorities' decision to participate, scheduling of assessments has been based on the systemic importance of a country's financial sector, as well as other criteria given by the Board in past reviews.**[5] All G20 countries, with the exception of the People's Republic of China, Indonesia, Turkey, and the United States, have participated or formally requested participation in initial assessments. Many of the other systemically important countries have also been covered. The representation of low-income countries has been lower than their share in the membership, which reflects the initial emphasis on systemically important countries and the greater capacity of high-income countries to undertake the exercise (Figure 1). Participation in updates has been the highest for medium-income countries, because rapid changes in the financial systems of some emerging market countries have prompted the authorities to request updates earlier than other countries (Figure 2).

18. **The country coverage has implications for the program.** First, while the program was designed to be universal, most of the countries that have yet to volunteer have relatively small financial sectors. In many of them, development issues deserve high priority, implying a larger role for the Bank. Second, the balance between countries participating in initial assessments and those returning for updates will change with updates becoming the larger share. Thus, adjustments in the scope of both the initial assessment (particularly for small countries with less developed financial sectors) and of the updates will be required.

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[4] As used in this report, the term "country" includes territorial entities for which statistical data are maintained on a separate and independent basis, even though they are not states as understood by international law and practice. The ECCU, a currency union of six member countries and two territories, is counted as one FSAP assessment. The report covers only assessments under FSAPs, not for example Module 2 OFC assessments.

[5] These criteria are: (i) systemic importance of the country; (ii) external sector weakness or financial vulnerability; (iii) upcoming likelihood of major reform programs; and (iv) features of the exchange rate and monetary policy regime that make the financial system more vulnerable. Maintaining geographical balance among countries and balance across different levels of financial sector development is important. The time elapsed since the previous FSAP is also considered when scheduling an FSAP update.

19. **Country participation has varied significantly across regions, ranging from an under-representation of East Asian economies to a virtually complete coverage of European economies** (Figures 1 and 2).

- ***Only about a third of countries in East Asia have completed or requested initial assessments.*** Some large, systemically important countries, such as The People's Republic of China, Indonesia, and Malaysia, have not requested participation. No updates have been requested by countries in the region.

- ***In Sub-Saharan Africa, most of the larger countries have been covered.*** However, of the 22 smaller African countries, only 5 have volunteered so far.

- ***Assessments of Middle Eastern and North African countries have increased in the past two years.*** Participation has included countries with a broad range of financial systems by size.

- ***About 75 percent of countries in North, Central, and South America, and the Caribbean, have been covered***. However, the United States, the country with the largest financial sector in the world, has not requested participation. Also, assessments in Argentina and Uruguay have been interrupted by their financial crises.

- ***Virtually all European countries have gone through or requested an initial assessment.*** The exceptions are Turkey and Cyprus, although the latter participated in an OFC module 2 assessment (Appendix I). Four countries have had, or requested, an update.

20. **Staff have been working on ways to extend or adapt the program to include more regional analysis.** The program has already covered an assessment of a currency union (the ECCU). In addition, Fund and Bank staff, in close cooperation with regional financial bodies, have been preparing a regional project covering the six Spanish-speaking Central American countries. The project analyzes harmonization of prudential norms and regional consolidated supervision, the development of insurance and re-insurance products and markets, and regional norms for payments and securities settlement.

Table 1. Country Participation in the FSAP
(As of February 1, 2005)

Completed 1/		**Under Way**	**Future Participation Formally Requested**
Algeria	Kuwait	Albania	Australia
Antigua and Barbuda	Kyrgyz Republic	Argentina 4/	Bahrain
Armenia 3/	Latvia	Belarus	Bosnia and Herzegovina
Austria	Lebanon 2/ 3/	Belgium	Botswana
Azerbaijan	Lithuania	Cote d'Ivoire	Denmark
Bangladesh	Luxembourg	Ecuador 6/	Fiji
Barbados	Macedonia, FYR	Honduras 6/	Greece
Brazil	Malta	Italy	Jamaica
Bolivia	Mauritius	Kenya 6/	Madagascar
Bulgaria	Mexico	Mauritania	Paraguay
Cameroon 2/	Morocco	Moldova 6/	Portugal
Canada 2/	Mozambique	Nicaragua 6/	Qatar
Chile	Netherlands	Norway	San Marino
Colombia 2/ 3/	New Zealand	Pakistan 6/	Serbia and Montenegro 5/
Costa Rica	Nigeria	Romania 6/	Spain
Croatia	Oman	Rwanda	Thailand
Czech Republic	Peru 3/	Sudan	Venezuela
Dominica	Philippines	Trinidad and Tobago	
Dominican Republic	Poland 3/	Uruguay 4/	
Egypt	Russia		
El Salvador 2/ 3/	Saudi Arabia		
Estonia 2/	Senegal 3/		
Finland	Singapore		
France	Slovak Republic		
Gabon	Slovenia 3/		
Georgia	South Africa 2/ 3/		
Germany	Sri Lanka		
Ghana 3/	St. Kitts and Nevis		
Grenada	St. Lucia		
Guatemala	St. Vincent and the		
Hong Kong SAR	Grenadines		
Hungary 2/ 3/	Sweden		
Iceland 3/	Switzerland		
India 2/	Tanzania		
Iran 2/	Tunisia		
Ireland 2/	Uganda 3/		
Israel	Ukraine		
Japan	United Arab Emirates		
Jordan	United Kingdom		
Kazakhstan 2/ 3/	Yemen		
Korea	Zambia		

1/ An FSAP is defined as completed when the Fund board has discussed the FSSA and the FSA has been delivered to the Bank's EDs.
2/ The initial assessment was a part of the pilot program
3/ An update took place or was formally requested. The updates in Lebanon and South Africa were done only by the Fund, and focused on stability issues.
4/ Postponed.
5/ To be conducted as two assessments.
6/ The Fund board has discussed the FSSA, but the FSA has yet to be delivered to the Bank's EDs.

Figure 1. Initial Assessments by Development Level and by Region
(In percent of all countries in the category)

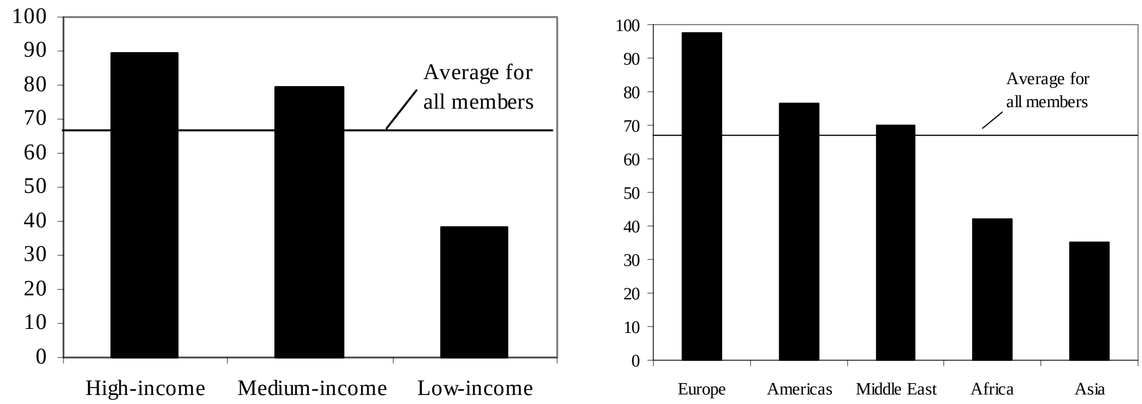
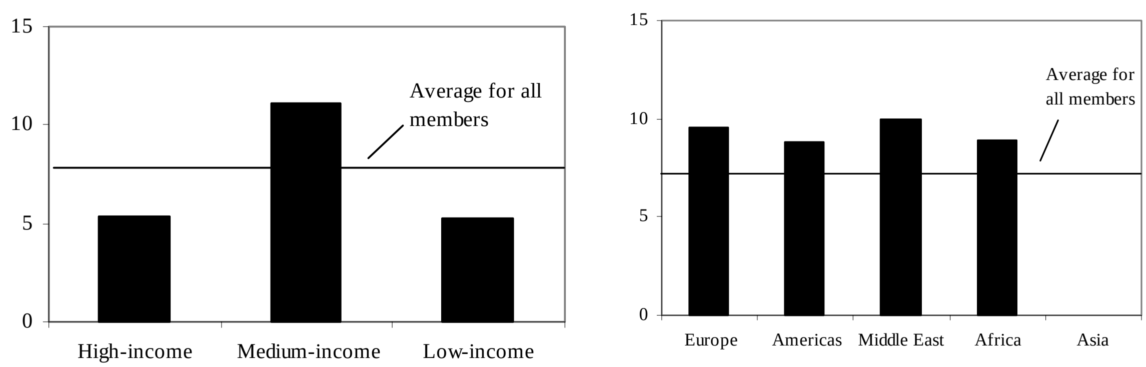


Figure 2. Updates by Development Level and by Region
(In percent of all countries in the category)



B. Publication Trends

21. **The Board documents summarizing the FSAP findings have been published for a majority of assessed countries.** All high-income countries assessed since the pilot program have published their Financial Sector Stability Assessments (FSSAs).[6] Overall, 68 percent of countries that participated in the program decided to publish the FSSA, in line with the publication rate of Article IV reports.[7] Because of the higher publication rate of

[6] Publication was not an option in the pilot.

[7] The publication rate for stand-alone Article IV reports was 66 percent in 2002–03. See *The Fund's Transparency Policy—Issues and Next Steps* (SM/03/200, June 5, 2003).

high-income countries, the percentage of the Bank's Financial Sector Assessments (FSAs) posted continues to lag behind the FSSA (Table 2).

22. **Changes to the publication policy have allowed country authorities to publish the Technical Notes and the Detailed Assessments of Standards and Codes with permission of the Bank and the Fund and appropriate deletion of sensitive and confidential material; however, this option has been rarely used so far.**[8] Only four countries have published any of these documents. Staff expect more requests in the future as familiarity with this option increases. In addition to the general benefits of transparency and private sector recognition, publication of the detailed documentation can in some cases facilitate the provision of post-FSAP follow-up by outside donors.

23. **While public interest is difficult to gauge, external website usage statistics indicate interest in the published documents.** For example, for FSSA reports released in 2004, the average number of external website hits was 104 per month, up from 88 per month in 2002–03. In comparison, the average for other IMF country reports was 67 per month in 2004 and 63 per month in 2002–03.[9]

Table 2. Publication Trends 1/
(Published documents in percent of issued documents)

	2001	2002	2003	2004	2001–04 Total
FSSAs	65	67	73	71	68
FSAs	50	42	67	55	55

1/ Excludes the 12 pilot program assessments in 1999–2001, when publication was not an option. FSAs are not prepared for the high-income economies assessed by the Fund.

C. Progress in Implementing the Conclusions of the Previous Board Review

More precise scoping and selective use of standards

24. **In the 2003 review, Directors agreed that the program should allow for greater selectivity in the scope of assessments and for their better tailoring to country**

[8] In the Summary of Discussion of the Informal Meeting of the Executive Directors of the Bank and IDA, OM2003-0024, covering the March 20, 2003 discussion of the FSAP, paragraph 44 states "a large number of speakers supported the publication, on a voluntary basis, of Selected Issues Notes from the FSAPs."

[9] The statistics exclude visits from Fund staff, and include only the first successful request for a pdf file. Website usage statistics provide only an approximation of the actual usage and should be interpreted with caution. Also, the Fund's external website is not the only means of distribution for Fund documents, notably country reports. Similar statistics for the Bank's external webpage are not available, but the FSAP intranet site is the most heavily used of the Bank's financial sector sites.

circumstances.[10] From its inception, the scope of the FSAP has been comprehensive in terms of coverage. While maintaining the comprehensive nature of assessments, the changes since the last review were aimed at better identifying areas that required in-depth coverage, e.g., through a formal assessment of compliance with an international standard or through more detailed quantitative analysis.

25. **To implement greater selectivity and focus, the staff have worked closely with the authorities to decide which standards to assess in each case.** Generally, formal principle-by-principle assessments of compliance were not produced in countries where the relevant sector, market, or infrastructure was nascent or a high degree of non-compliance was expected. Instead, more emphasis was placed on the goals the standard provides, the analysis of obstacles faced by the sector, and the steps needed to overcome the obstacles and achieve the standard's goals. In countries where formal principle-by-principle assessments of compliance with standards were not produced, key issues relating to supervision and regulation have still been covered by other means.[11]

26. **On average, the number of standards assessed per FSAP has declined, as envisaged in the last review.**[12] Leaving aside the AML/CFT assessments, undertaken in virtually all recent FSAPs, the average number of standards assessed has dropped from 4.5 before the 2003 review to 2.9 since the review, in line with the last FSAP review's proposal to bring the number down to about 3. For banking, a formal assessment has still been included in virtually all assessments (Figure 3), while formal assessments have become less frequent in the areas of insurance, payments systems, transparency, and securities.[13]

27. **The number and type of standards assessed in an individual country have been based on the characteristics and depth of a country's financial sector.** Countries with advanced financial sectors generally have large industries and markets for which the principle-by-principle measurement of compliance with standards and codes is warranted. For countries with less-developed financial systems, relatively more effort was devoted to an analysis of factors explaining why markets are missing or offer limited access, and the nature

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[10] One exception to this approach is the inclusion of a comprehensive AML/CFT assessment as part of the FSAP as decided by the Boards in March 2004.

[11] This does not mean that countries were measured to a different standard. Instead, more emphasis was placed on the goals the standard provides, the analysis of obstacles faced by the sector, and the steps needed to overcome the obstacles and achieve the standard's goals.

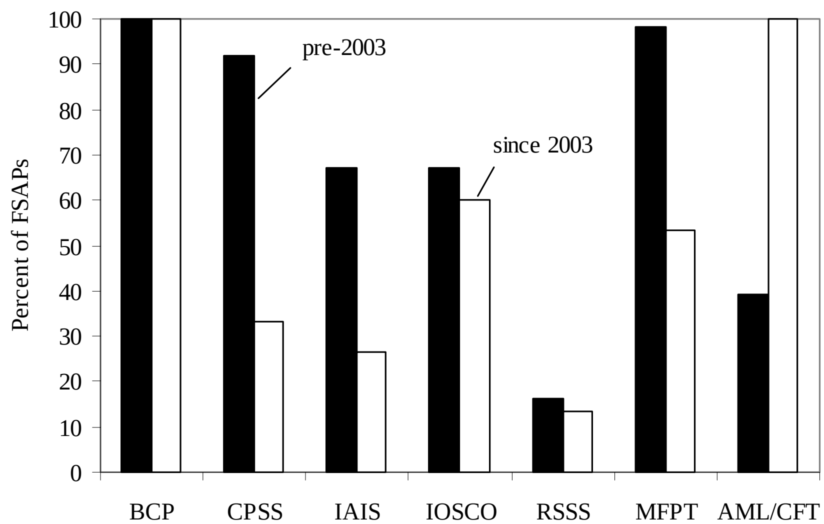
[12] The Boards will have an opportunity to review progress of the standards and codes initiative later in 2005.

[13] The relatively smaller decline in the frequency of IOSCO assessments compared with, for example, MFPT, CPSS, and IAIS, can be attributed to the fact that (i) the post-2003 period includes a higher proportion of euro-area member countries, where elements of MFPT and CPSS—but not IOSCO—have already been assessed at the area level; and (ii) the IOSCO issued a new methodology that the Bank and the Fund agreed to test.

of the top developmental needs.[14] Reflecting these factors, the average number of standards (excluding AML/CFT) per FSAP since the last review has been 4.3 for high-income countries and 2.1 for medium- and low-income countries.

28. **Procedures for the scoping of the assessment have been sharpened.** Determining the scope of the assessment, either the initial one or an update, requires a consultation between Fund and Bank staff, taking also into account input from country authorities. To improve the scoping process, a requirement was introduced in the Fund for mission leaders to propose the scope of each FSAP assessment and the resources needed for MFD's preliminary approval before the terms of reference are drafted. The Bank's team leaders similarly make suggestions for appropriate areas to be assessed. This new practice has improved the discussion of the assessment's scope and has allowed the authorities to make requests, particularly for the content of updates, where they often wish to have a deeper analysis of an area previously covered or request that new topics be addressed.

Figure 3. Observance of Standards and Codes Assessed in FSAPs 1/
(In percent of all FSAPs)



1/ The AML/CFT statistics include assessments done through FATF or FSRB evaluations.

Greater focus on developmental issues in countries with thin financial sectors

29. **The last review paper proposed a greater focus on medium-term and structural issues for low-income countries undertaking an assessment, implying a relatively greater role for Bank staff and experts.** Since the spring of 2003, the role of Bank staff has

[14] See the "Development Issues in the FSAP" attachment to the last review paper, available at http://finsec.worldbank.org/html/fsap_policy_papers.html.

been increased, and the FSAP teams have strengthened the examination of the reach, type, and quality of financial services to which broad portions of the population have access. More emphasis has been given to development topics—such as access to finance for firms and households, long-term savings, pensions, microfinance and housing finance. Scoping of the FSAP assessments took into account the trade-off between the formal assessment of standards and codes and an expansion of the depth of coverage of development issues.

30. **As a result, more coverage has been given to important development topics such as financial infrastructure, the contracting and informational infrastructure, enhancing the scope of financial intermediation and access to financial services.** In particular, recent aide-mémoire for African countries depicted financial sector vulnerabilities and gaps from a more developmental point of view, leading off with a discussion of improving the effectiveness and reach of the financial sector. The analysis for certain medium-income countries looked at ways to broaden and diversify investment instruments to serve a wider marketplace, close gaps in infrastructure that limit market liquidity, development, and accessibility, promote market discipline, and adapt the oversight framework to the needs of an integrated and complex financial system. The teams typically found that areas of concern interact and reinforce each other, and therefore reforms should address them simultaneously.

Streamlining documentation

31. **FSAP documentation and review have been further streamlined.** The last review proposed to simplify FSAP documentation, reduce unnecessary duplication among the documents prepared, and clarify the joint core of the work and the additional analyses needed for the different purposes of the Bank and Fund. The key joint document is now the aide-mémoire, prepared in the field as a working document and presented to the authorities in draft at the end of the main mission. It is reviewed within about a month of the team's return from the field in a Bank-Fund meeting, merging the two institutions' reviews and streamlining the process.[15] The FSSA and the FSA remain the documents in which FSAP findings are presented to the Fund and the Bank Board, respectively.[16]

32. **Efforts to further shorten the documents will be constrained by the need to provide sufficient support for recommendations.** High-level summaries of main recommendations are now contained in the aide-mémoire, the FSA, and the FSSA. These key documents are generally shorter (FSSAs, in particular, are 20 percent shorter on average than

[15] The lag time between the final mission and the delivery of the main document has been reduced to between two and four months in most instances, down from seven months prior to the 2003 review. The turnaround time for the delivery of the other parts of the report (Technical Notes and Detailed Assessments of Standards and Codes) is also down, from seven months to six. Further reductions in turnaround are difficult to achieve, given the need to provide sufficient time for authorities to provide their reactions.

[16] FSSAs are typically part of the Article IV consultation, but—as Directors agreed in the last review—in cases where the Article IV consultation is delayed or the country is on the 24-month cycle, the FSSAs can be discussed as part of a program review. Of the 16 FSSAs discussed by the Fund Board in 2004, four were part of a program review.

they were before the last review). To address country authorities' continuing need for specific advice (Appendix II), more detailed recommendations are provided to the authorities in an appendix to the aide-mémoire or in the Detailed Assessments and Technical Notes.

D. Financial Sector Assessment Handbook and Seminars

33. **The Financial Sector Assessment Handbook is a joint Bank-Fund project, designed to provide country authorities and staff teams with ready access to the tools used in financial sector assessments.** Therefore, it will:

- serve as an authoritative source on the objectives, procedures, and methodology for financial sector assessments, directing country authorities to relevant sources of information on financial stability and development;
- provide broad guidance to FSAP teams on core issues, techniques, and key references on individual components and core topics of FSAP assessments;
- serve as a comprehensive reference book for training on issues and techniques of financial sector assessments; and
- promote improved transparency and understanding of FSAP objectives and methods by national authorities and further strengthen support for participation in the program.

34. **The draft Handbook is expected to be issued in mid-2005.** The Handbook will be comprehensive in the coverage of topics, while providing in-depth coverage and analysis on a selected set of issues. Wherever appropriate, cross-references to other sources, including websites, will be provided.

35. **Building on the draft Handbook, financial sector assessment seminars are being developed by the World Bank Institute, in cooperation with FSE and MFD.** The goal of the seminars is to familiarize senior and mid-level country officials with key issues pertaining to financial sector stability and development. Participants will be exposed to the specific methodologies, tools, techniques and data requirements for systematic assessments of financial stability and development. They will have a chance to improve their skills in assessing the analytical foundations of financial reforms and to evaluate different financial sector policies to mitigate vulnerabilities and stimulate financial development.

36. **A pilot 5-day seminar was held in Washington, D. C. in June 2004.** It drew 64 participants, consisting of officials from central banks and finance ministries from over 30 countries. In post-seminar feedback, about 90 percent of the participants rated the seminar as "highly useful" for their ongoing work; about 20 percent suggested that the seminar incorporate more case studies and hands-on activities, especially for stress testing and for analysis of financial sector indicators. Going forward, staff plan to offer seminars in regional training centers, with emphasis on regional issues.

E. Resource Use

37. **Comparing the resource contributions of the Fund and Bank is difficult given differences in accounting systems. However, it appears that the balance of resources used in the program has been more equally distributed between the two institutions since the last review.** [17] At that time, the cost of the FSAP was split approximately 40/60 between the Bank and Fund, reflecting the sole responsibility of the Fund for assessments in high-income economies and higher post-mission costs relating to preparation and review of FSSAs.

38. **As a result of measures implemented since the last review, the cost of the FSAP for the Fund has declined.** Since the 2003 review, measures to better control the scoping process have been implemented (Section II.C). The Fund has curtailed the resources used on the assessments and financed fewer experts for standards assessments. As a result, the average Fund cost per assessment was reduced by about 30 percent, despite growing cost associated with the requirement to assess AML/CFT in virtually all FSAPs.

39. **The Bank's relative contribution to the program has increased**. The gradual evolution of the program from resource-intensive initial assessments to updates, smaller country size, and streamlined procedures since the last review allowed the Bank to increase its attention to development issues within an unchanged overall resource envelope for the program. This rebalancing is consistent with the proposals in the last review to increase focus on medium-term and structural issues, and to increase the role of the Bank in low-income countries with small financial systems, while maintaining the Fund's involvement in all assessments.

40. **Updates have been less costly than the original assessments as expected.** However, the number of updates so far has been limited and their scope has varied widely from a complete reassessment to coverage of selected or previously omitted topics, making assessment of their average costs difficult.

III. ANALYTICAL TOOLS

41. **The analytical toolkit of the FSAP has remained broadly unchanged since the 2003 review, although the techniques keep evolving and more developmental tools are envisioned.** The FSAP builds on the following main elements: systematic analysis of FSIs; stress testing; assessments of standards and codes; and an assessment of the broader financial policy and institutional framework as well as of development needs. In order to better understand a financial system's users and their needs, demand side reviews of access to and use of financial services have been adopted.

[17] More details on the Fund's costs associated with the program are provided in the background document for the Fund's Board.

42. **The toolkit for stability analysis in FSAPs appears to complement the financial stability analysis carried out by country authorities.** In recent years, country authorities have been increasing their focus on financial sector stability, as illustrated by a growing number of financial stability reports (FSRs) published by central banks.[18] A survey of FSRs from 25 high- and medium-income countries indicates that the central banks benefit from access to detailed data and from in-house expertise on domestic financial sector institutions and macroeconomic developments. This puts central banks in a privileged position to establish a country-specific, often model-based, approach to financial sector surveillance. FSAP teams build on this country-specific knowledge of the authorities, and carry out independent assessments. They often have an advantage in covering issues that involve several institutions and agencies, such as systemic liquidity or crisis management framework.

43. **The analysis of financial soundness indicators was bolstered by the introduction of the FSI Compilation Guide.** The Guide was posted on the Fund's website in July 2004 (www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm). It should improve the usefulness and comparability of FSIs by clarifying the definition of each FSI and how it should be compiled. Staff's analytical work on FSIs continues to focus on strengthening the framework for assessing risks to financial stability, in particular on empirical studies linking FSIs to macroeconomic developments, and on extending the FSIs to the nonbank financial sector.[19] A Coordinated Compilation Exercise (CCE) for FSIs, endorsed by the IMF Executive Board, is currently underway. This exercise should help develop countries' capacity to compile FSIs, promote cross-country comparability, coordinate national authorities' compilation efforts, and disseminate the FSIs. The CCE envisages that the end-2005 FSI data and metadata of the 62 countries participating in the exercise would be published by end-2006.

44. **The Bank is compiling additional indicators to help measure the functioning of financial markets (efficiency, quality, reach, and breadth), their level of development and accessibility, and the institutional environment (laws and regulations).** Both quantitative and qualitative indicators will be defined and new collection instruments will be designed to reach subsectors not traditionally covered. This effort will attempt to improve use of existing sources of data, sponsor new work and leverage the efforts of other institutions. The indicators should also provide benchmarks against which to measure outcomes of financial sector lending and advisory operations by the Bank and other agencies.

45. **Stress tests have become more sophisticated.** Compared to FSAPs covered in the 2003 review, a higher proportion of stress tests in the recent FSAPs included scenario analysis rather than single-factor sensitivity analysis, allowed for contagion among banks, and covered the nonbank financial sector (Table 3).[20] Also, the authorities tend to play an

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[18] Virtually all countries publishing stand-alone FSRs have already participated in the FSAP.

[19] Financial Soundness Indicators, IMF, May 14, 2003.

[20] For a survey of stress testing in the FSAP before 2003, see the background paper for the 2003 FSAP review, "Analytical Tools of the FSAP" (SM/03/77, February 25, 2003).

increasing role in stress tests, especially in high-income economies, by helping in the macroeconomic modeling effort, and in some cases by carrying out the actual institution-by-institution calculations or facilitating such calculations by individual financial institutions. In some cases, this has been prompted by confidentiality constraints on the side of the authorities. The missions generally verified the aggregate results using top-down calculations based on publicly available data. Staff's analytical work on stress testing focused on specifying more clearly the links of stress tests to FSIs and other components of the financial stability framework,[21] and also on developing practical stress testing systems to be used in TA and training.

Table 3. Selected Features of Stress Tests in FSAPs
(Percent of FSAP assessments initiated in the period)

	2000–2002	2003–04
Scenario analysis	64	94
Contagion analysis	11	35
Insurance sector covered	25	35

46. **Despite more selective use, the assessments of observance of standards and codes remain an integral component of FSAPs.** As of end-January 2005, 362 assessments of standards and codes have been conducted under the FSAP. Several recent FSSAs included a box summarizing the findings from the standards and codes, and such summaries will become a regular part of the FSSA. Staff research suggests positive links between observance of standards and financial sector performance.[22]

47. **Ongoing work aims at enhancing the treatment of development issues in FSAPs,** particularly those related to improving long-run potential for economic growth by recognizing the interdependence between macroeconomic stabilization and structural reform.[23] Developmental issues examined in the FSAP include:

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[21] See, for example, "Financial Soundness Indicators - Background Paper", IMF, May 14, 2003, and Jones, Matthew, Paul Hilbers, Graham Slack, 2004, "Stress Testing Financial Systems: What to Do When the Governor Calls," *IMF Working Paper* No. 04/127.

[22] See, for example, Podpiera, Richard, 2004, "Does Compliance with Basel Core Principles Bring Any Measurable Benefits?" *IMF Working Paper* No. 04/204, and Caprio, Gerard, et. al., 2004, "Banking Supervision and Regulation: What Works Best?," *Journal of International Finance*.

[23] See, for example, Caprio, Gerard and Patrick Honohan, *Finance for Growth*, World Bank, 2001; Honohan, Patrick, "Financial Sector Policy and the Poor, World Bank Working Paper No. 43, 2004. A workshop was held in March 2004 for FSAP leaders, with sessions on topics such as links and tensions between the prudential and developmental sides of the FSAP, corporate sector assessments undertaken within the FSAP, and financial sector and corporate sector legislation as assessed within the FSAP.

- reasons for high interest rate spreads and what they uncover about impediments to competition within the banking sector;
- design of policies to encourage the development of term finance without creating the distortions often associated with such efforts;
- scope for the exchange of information on bank customers, such as through companies and credit registries, to more accurately handle credit risks;
- the role of creditor rights and corporate insolvency regimes as part of a resolution framework for distressed institutions;
- housing policy, property registration and titling, foreclosure, standardization of mortgage contracts as relevant to the development of housing finance;
- policies advancing transparency of interest rates and service charges;
- the potential for diversifying and deepening the financial system and mobilizing long-term savings though insurance, pension funds and other contractual savings vehicles; and
- the role of microfinance, cooperative, and community bank sectors in determining the degree of access to financial services by all parts of a population and to encourage conditions that would make such institutions sustainable.

The ability of the financial sector to support and sustain economic growth, to reduce poverty, and to provide opportunity to all members of society is the cornerstone of the Bank's analytical work in this sector. As more countries with underdeveloped financial sectors participate in the program, various instruments including surveys and indicators mentioned above are being drawn from that work or designed to permit developmental considerations to come to the fore in an assessment. Work on this subject is coordinated with the Bank's Development Research Group, Fund staff, and external researchers.

IV. Issues and Lessons from Assessments and Updates

A. Selected Common Issues and Recommendations

48. **An analysis of FSAP reports suggests a number of common issues and findings in similar countries.** All these findings combine important stability and developmental elements, even though for presentational purposes, they have been grouped into findings on stability, supervisory capacity and governance, and development. Some issues may need to be addressed on a regional basis, and will need to be taken up in the context of multilateral surveillance and related research.

Stability findings

49. **Rapid credit growth in countries with weak institutional and regulatory environments raises the issue of adequacy of credit risk management systems.** Rapid increases in private sector credit have been observed especially, but not solely, in the emerging market countries of Central and Eastern Europe. In many of these countries, credit

is growing from a very low base. Therefore, its growth can indicate financial deepening or re-intermediation as confidence grows, the legal and governance systems become more robust, and interest rates decline toward high-income country levels. However, if the rapid credit growth is coupled with weaknesses in supervision, banks' risk management systems, or weak creditor and property rights, it can pose a risk of deterioration in credit quality and, at the extreme, a systemic vulnerability. It can also be linked to an asset-price bubble.

50. **Endogenous dollarization presents new and challenging issues for many countries.** The issues in financial dollarization (US dollar or euro-denominated local financial intermediation) are complex and involve a number of trade-offs. It can have favorable effects on the soundness of the financial system, for example by lowering volatility in interest rates. But, it also has risks and drawbacks, limiting the scope for monetary management and lender of last resort substantially, and constraining the financial system's capacity to withstand systemic shocks. It can signal weaknesses in financial conditions, including a lack of confidence in the local currency and currency mismatches within the banking system that are exacerbated by debtors' unhedged foreign currency exposure.[24] Finally, evidence suggests that dollarization may also limit the number of borrowers to whom banks prudentially can lend.

Supervisory capacity and governance findings

51. **Corporate governance of both state-owned and private financial institutions has emerged as an important issue in FSAPs.** Governance in publicly-owned financial institutions is one of the most frequent FSAP issues in medium- and low-income countries. A majority of assessments found that those institutions suffer from governance shortcomings, which weaken the financial system, make it less competitive, and often compromise its supervision. In some cases, missions recommended urgent steps to deal with those problems. They often suggested privatization over time.

52. **FSAPs have also identified issues of corporate governance in private financial institutions.** Sound corporate governance is all the more relevant in the context of increased reliance on risk-based supervision and market discipline within the framework of the revised Capital Accord (Basel II). Identified moral hazard issues associated with deposit insurance, weak mechanisms for bank resolution, as well as regulatory forbearance give added importance to governance issues. Partly in response to FSAP findings, the Bank has developed new templates to address issues of governance of banks.

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[24] See Gulde, Anne-Marie, David Hoelscher, Alain Ize, David Marston, and Gianni de Nicoló, "Financial Stability in Dollarized Economies," *IMF Occasional Paper* No. 230, 2004; Honohan, Patrick, Alain Ize, and Gianni De Nicolo, "Dollarization of the Banking System: Good or Bad?," *World Bank Working Paper* No. 3116, 2004; de la Torre and Sergio Schmukler, "Coping with Risk through Mismatches: Domestic and International Financial Contracts for Emerging Economies," *World Bank Working Papers* No. 3213, 2004. On dollarization and standards, see *Financial Sector Regulation—Issues and Gaps*, SM/04/268, August 5, 2004.

53. **While the revised Capital Accord (Basel II) has stimulated substantial interest in upgrading banking supervision and banks' risk management, in many countries basic infrastructure and capacity building are more urgent.** Some countries have indicated their interest in assessments and assistance relating to the transition to Basel II. Staff believe a baseline compliance with the BCP, which incorporates Basel I as the capital adequacy standard, is necessary before moving to the new accord. At present, many countries lack the information infrastructure, notably internal ratings or the ratings of external credit assessment institutions needed to implement several of Basel II approaches to minimum capital. Pillar III of Basel II calls for enhancing transparency in banks' public reporting and sets out the public disclosures that banks must make to lend greater insight into the adequacy of their capitalization. Such transparency is desirable for countries at all levels of development. FSAPs refrain from pushing countries toward implementation of Basel II, or toward specific country options under the Basel II framework. Compliance with BCP and other supervisory standards are judged in the context of the country's capacity and sound international practice.[25]

54. **The increase in the number of financial conglomerates has complicated the task of supervisors even if supervision is conducted on a consolidated basis.** Where risk-based supervision has not replaced compliance-based supervision, supervisors are particularly handicapped. Weaknesses in accounting and disclosure can be compounded by ownership issues and poor governance. The comprehensive assessment of supervisory capacity in the FSAP can highlight the issue.

55. **In many countries, there are important limits to the effectiveness of the home-host supervisory cooperation.** This is particularly important in financial systems dominated by subsidiaries or branches of foreign financial institutions, where domestic supervision needs to be closely coordinated with foreign supervision. The FSAP has so far addressed this issue by stressing the need for coordination with foreign supervisors, and in several cases also by having discussions with relevant foreign supervisors. More broadly, the FSAP's country-by-country assessments provide an information base for more regionally-oriented follow-up.

56. **Financial sector oversight agencies in some countries have weak governance structures.** A growing number of countries request assistance in reforming their supervisory infrastructure in order to address governance issues such as the institutional structure, decision-making, independence, and accountability.

57. **In many countries, shortcomings in the AML/CFT legal and regulatory framework and its implementation were identified.** The most prevalent deficiency was weaker compliance with standards concerning combating the financing of terrorism. In some countries, updated legislation is needed, and even in countries where the essential legal

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[25] A joint Bank-Fund paper is under preparation. For Fund staff's position, see *IMF Staff Note on Basel II: Guidance for Fund Staff*, April 23, 2004 (www.imf.org/external/np/mfd/2004/eng/042304.htm).

elements of an AML/CFT regime are in place, there are significant gaps. Implementation remains a challenge for many countries, often due to insufficient resources and training.

58. **Weaknesses in frameworks to resolve troubled financial institutions are frequent.** Sometimes, legal confusion regarding the allocation of regulatory powers was evident. Problems could be compounded by the regulatory treatment of collateral and claimants, unclear definitions of insolvency, and disorderly transfers of obligations. Frequently, the framework in place encouraged expectations of government bailouts. Inefficiencies were also noted in insolvency procedures for nonfinancial corporations. Legal and judicial weaknesses were found to prevent the efficient exit or reorganization of corporations. Given the close connection between banks and the corporate sector, recommendations included designing comprehensive strategies to deal with problems that link the banking and the corporate sectors so as to minimize risks and fiscal costs, avoid delays and bailouts of shareholders, and maintain accountability and transparency. In other cases, the creation of specialized courts and the training of judges were recommended. Analysis and recommendations in this area have drawn on the Global Bank Insolvency Initiative, which has been undertaken by the Bank and the Fund, in cooperation with others. The Initiative establishes principles for putting in place legal, regulatory and institutional frameworks that are effective in dealing with bank insolvency.

Development findings

59. **The development component of the FSAP assesses the extent to which financial markets provide services to the full range of customers, specifically, the extent to which markets and services are missing or are insufficiently accessible.** In many countries, the underdevelopment of sectors such as securities markets, insurance and contractual savings restrict the types of financial services offered. On the one hand, the availability of financial services can be complicated by a lack of instruments, inadequate information, and poorly functioning markets, such as interbank, bond, equity and derivatives markets. On the other hand, aspects of structural reform are identified in the development assessment. The role of microfinance institutions is also assessed. Financial sector deficiencies are often traced to problems in the country’s wider economic infrastructure, including the legal, judicial and education systems, as well as the absence of economic scale and scope associated with small financial systems.

60. **Implementation of laws and the functioning of the legal and judicial system with respect to loan recovery and property rights remain inadequate to support a resilient financial sector in a large number of countries.** Institutional dysfunctions undermine creditor rights, the development of a credit culture, and credit contract enforcement. Systems for corporate restructuring or liquidation are inadequate and reforms that would facilitate the use of movable collateral to secure credit have been slow getting started. Company and land registries, and titling and property rights systems were often found to be outmoded. These conditions help explain high liquidity in banks, limited credit access on the part of all economically productive parts of an economy, and high intermediation spreads.

61. **A key development opportunity often identified was the potential for improvements in the information infrastructures to lower lending costs and broaden the pool of creditworthy borrowers.** This is particularly important in those countries that have weak collateral systems and for those potential borrowers who, lacking traditional forms of collateral, could develop "reputational collateral" through good repayment records. The legal basis for collecting and sharing credit information might be missing or severely limited by privacy laws and other factors. Teams recommended establishing credit information systems and the institutions, such as credit bureaus, that allow their effective functioning, as an important way to broaden access to financial services.[26]

62. **Some financial systems lack sufficient competition to encourage the provision of reliable and affordable financial services.** Among the reasons for this are: restrictions on foreign entry and other sources of market contestability, underdeveloped securities markets, connected lending and the general investment climate. The outcome is likely to be that entrepreneurs lack access to a range of sources for funds for capital and investment, and households will have trouble finding affordable mortgages and consumer finance.

63. **The failure to mobilize long-term savings through contractual savings institutions—also in the context of pension reform—or to efficiently intermediate them often starves economies of term finance.** Many economies are stymied by the lack of liquid and transparent securities markets for efficient placement of the growing pension funds. Some FSAPs have therefore either included pension sector experts or closely liaised with other Fund or Bank missions addressing this topic.

64. **Policy issues around the appropriate form of regulation and the removal of interest rate ceilings or distorting government subsidies arose regularly with respect to microfinance.** The question of how to supervise microfinance institutions effectively, including the decision as to which entities require supervision and at what level, and whether supervision should be carried out by the banking regulator, an alternative specialized agency, or in a devolved manner, requires country-specific solutions.[27] The teams often found distorting government policies and practices likely to hinder the wider development of microfinance, and also noted some confusion of social and prudential objectives. In some countries, the legal framework contained hurdles that could impinge on the growth of the microfinance institutions. Recommendations often sought to provide guidelines on regulating microfinance institutions and discussed, where necessary, the problem created by lending rate ceilings.

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[26] The Bank has significantly increased its TA in this area, and the IFC has actively promoted institution building investments in credit bureaus in various countries.

[27] In these efforts, staff have consulted with CGAP and other entities on good practices of the development and regulation of microfinance.

B. Responses by Country Authorities

65. **Feedback from country authorities suggests that the program helps their efforts at strengthening and developing their financial sectors.** A survey of responses to questionnaires sent after FSAP missions suggests that authorities generally appreciate the comprehensive and system-wide approach to analyzing financial sector issues.[28] In low- and medium-income countries, the FSAP is seen as helping to map the transition to a more diversified and competitive financial sector. In high-income countries, the main perceived benefit of the FSAP is that it provides an independent check-up of the health of the financial system and assessment of the regulatory framework from an international perspective. Stress tests and the peer-review elements of the FSAP have been particularly appreciated. The main criticism from authorities, especially from countries assessed prior to the last review, related to the burden placed on country counterparts for data and other information. Authorities also made a number of suggestions to improve the program going forward, including improvements in the methodology for developmental issues, more research on financial stability issues, studying how standards affect the financial systems, and creating swifter mechanisms for the provision of follow-up, including TA.

66. **Country authorities also indicated a number of steps that they have already undertaken or plan to undertake in the near future to implement FSAP recommendations.** In some cases, these steps were identified by the FSAP, in other cases, the authorities were considering the identified measures earlier, and the FSAP reinforced their decision to introduce such measures.

67. **FSAP updates and other follow-up generally indicate progress since the initial assessment.** The updates conducted so far tend to show improvements in a number of areas; however, the sample of updates is small and likely to be biased towards countries that made larger changes in response to FSAP recommendations. Improvements were also documented in most post-FSAP Article IV consultations, even though the still somewhat uneven treatment of financial sector issues in Article IV reports (Section V.A) makes it difficult to generalize. Such treatment ranges from a short general statement to a full-page box listing specific steps made by authorities in response to FSAP recommendations.[29]

68. **A broader measurement of the impact the FSAP has on a country's financial sector is difficult and not in the purview of this paper.** The impact of the FSAP goes beyond authorities' policies (e.g., it affects other work by the Fund and the Bank, and the international community at large). The IEO's and OED's evaluations of the FSAP are likely to provide a fuller assessment of the impacts of FSAP recommendations.[30]

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[28] Appendix II provides more information on the feedback in the post-FSAP questionnaires.

[29] The recent Article IV report for Hong Kong SAR (SM/05/01, January 4, 2005) is an example of the latter.

[30] The Bank's Quality Assurance Group has completed assessments of 13 FSAP reports, program processes, and outcome as measured through impact on other Bank work

(continued)

V. THE PROGRAM'S LINKS TO OTHER ACTIVITIES OF THE BANK AND THE FUND, STANDARD SETTERS, OTHER AGENCIES, AND COUNTRY AUTHORITIES

A. Surveillance

69. **FSAP assessments and updates provide important inputs to the Fund's surveillance mandate.** The Fund's Article IV consultations and Board discussions of global developments are informed and supported by FSAP findings. As noted by Directors during the last FSAP review, the program cannot be the only tool of financial sector surveillance, given its voluntary nature and resource constraints. It is therefore complemented by other surveillance tools, in particular Article IV work and ongoing financial sector monitoring from headquarters.

70. **The reorganization of MFD was an important step towards integrating the FSAP into ongoing financial sector surveillance.** In 2003, MFD (formerly MAE) was reorganized into four wings, with the Financial System Surveillance Wing being responsible for the FSAP and ongoing financial sector surveillance. The wing consists of three regionally organized divisions and a policy division. Each regional division has dedicated economists responsible for surveillance of individual countries, as well as for coordinating with the corresponding country TA experts.

71. **The coverage of financial sector issues in surveillance has improved in the last two years.** As noted in the last Biennial Review of Fund Surveillance, coverage of financial sector issues varies across countries, being relatively broad for medium-income countries, more selective for high-income countries, and uneven for low-income countries.[31] Nonetheless, attention given to financial sector issues in Article IV reports increased, often following the completion of an FSAP. The number of MFD staff participating in area department missions rose from 17 in FY2003 to 32 in FY2004 and is projected to increase to about 40 in FY2005 (of which about two-thirds for countries that participated in an FSAP and one-third for countries that did not). Also, to better link FSAP work to the Fund's surveillance of international capital markets, staff from the Fund's International Capital Markets Department (ICM) are included in FSAP missions to economies where capital markets are more developed and regionally and globally integrated. Further steps to strengthen financial surveillance are discussed in Section VI.

B. Development Perspective

72. **The FSAP provides important inputs to the Bank's growth and poverty reduction mandate.** Extensive evidence confirms that a deep, inclusive and efficient

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(http://lnts022.worldbank.org/mds/mdoqa/qagreports.nsf). It found the quality of the work to be generally very high; early concerns related to the likely impact of the FSAP findings on Bank work programs.

[31] See *Biennial Review of Fund Surveillance—Overview; Modalities of Surveillance; Content of Surveillance*, August 24, 2004.

financial system that serves all members of society can contribute robustly to sustained economic growth and lower poverty.[32] Yet financial sector development is not merely a consequence of wider economic development. The motivation for bringing the development assessment of the financial system center-stage is guided by the presumption, based on a sizable body of empirical evidence, that an effective financial system is most effectively provided by market-driven financial service providers, with the main role of government as regulator and provider of an effective financial infrastructure.

73. **To generate the productivity growth needed to support growth, a financial system needs to continuously improve its efficiency in the sound allocation of resources and management of risks across the widest possible spectrum of economically active groups.** Moreover, at all levels of development, continued efficient and effective provision of financial services requires adjusting financial policies and financial systems' structure in response to financial innovations and to shifts in the broader macroeconomic and institutional environment. This provides the motivation for integrating an analysis of financial structure and the development assessment of the financial sector with a stability assessment. It also indicates why the FSAP findings have the capacity to significantly enhance the analysis embodied in the CAS, and Poverty Reduction Strategy Papers and other Bank reports.

C. Technical Assistance, Lending, and Analytical and Advisory Services

74. **Efforts are ongoing to make TA follow-up on FSAP findings more systematic.** Managers in the Fund and the Bank use the FSAP recommendations as a key input in planning TA activities in consultation with country authorities.

75. **Substantial resources, especially in developing countries, are devoted to FSAP follow-up through TA.** In the Fund, the volume of FSAP follow-up TA increased from 2–3 person-years in FY2001–02 to 6 and 10 person-years in FY2003 and FY2004, respectively.[33] In the Bank, FSAP follow-up is incorporated in country strategies and involves structuring TA programs as part of lending operations. Out of the 27 CASs updated in FY04, 22 incorporated financial sector issues, and the CASs utilized the findings of the FSAP in all cases where an FSAP was available. The Bank also provides non-lending TA and advisory services to follow up on FSAPs, although these are generally subject to funding made available by the Bank's country management units (CMUs). Follow-up TA in the AML/CFT area is an exception as dedicated funding is available.[34] The need for CMU funding and,

[32] See, Honohan, Patrick, "Financial Sector Policy and the Poor," World Bank Working Paper No. 43, 2004; ibid, "Financial Development, Growth and Poverty: How Close Are the Links?" World Bank Policy Research Working Paper 3203, 2004; Demirgüç-Kunt, Asli and Ross Levine, editors, *Financial Structure and Economic Growth*, MIT Press, 2001.

[33] See *IEO Evaluation of the Technical Assistance Provided by the Fund* (SM/05/41, 01/31/05).

[34] In the Bank, follow-up TA for AML/CFT was $0.72 million in FY04. This does not reflect TA components of loans or costs of Bank capacity building conferences or other advocacy and knowledge management projects.

more generally, differences in scheduling between an FSAP and the preparation of a CAS can complicate the task of systematically following up on FSAPs. Progress has been made, however, as familiarity with the program on the part of country directors and Bank staff has increased.

76. **The Bank's total lending program in the financial sector for FY 2003 to 2005 (planned) is $3.9 billion (25 loans), of which $1.7 billion (17 loans) has been to countries that have participated in the FSAP.**[35] The Bank's regions with the largest lending programs for the financial sector—Europe and Central Asia and Latin American and the Caribbean—make the most use of analytical underpinnings provided by the FSAPs. These regions have also participated most actively in the program. The Middle East and North Africa region, with a small lending program in the financial sector, has also experienced a substantial increase in dialogue with its countries around the reform of their financial sectors.[36]

77. **Follow-up TA is provided by outside donors and other institutions cooperating with the Bank and the Fund.** The Financial Sector Reform and Strengthening (FIRST) Initiative was established to facilitate the systematic follow-up of the recommendations from the FSAP/ROSC initiatives and to assist countries in advance of participation in FSAP/ROSC, as well as to provide support for capacity building in the financial sector more generally.[37] The FIRST Coordination Unit, based in Washington, works actively with Bank and Fund staff to promote and develop TA projects for funding by FIRST, and some funds have been earmarked in the Bank's Financial Sector Vice Presidency to facilitate project preparation. In addition, Bank and Fund staff work with FIRST to catalyze funding to support FSAP follow-up by organizing donor meetings to discuss countries' follow-up priorities. The Bank and the Fund also continue to work with the regional multilateral development banks to coordinate the provision of TA. These institutions are informed about the analysis and recommendations and TA arising from the FSAP so as to minimize duplication of effort.

D. Relationships with Standard Setters and External Experts

78. **FSAPs have helped identify issues or gaps in the standards and codes that require the attention of standard-setting bodies.** Standard setters other than the Fund and

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[35] For FY04 Bank TA and capacity building lending and non-lending, including treasury central bank capacity building TA, came to $59.2 million.

[36] In addition to Bank TA and lending, the World Bank Group more broadly delivers support for institution building through other instruments including IFC institution building investments and related TA activities, and training/capacity building activities.

[37] FIRST is a $53 million initiative jointly undertaken by the Bank, the Fund, and a number of national development agencies (www.firstinitiative.org). As of mid-August 2004, FIRST approved projects amounting to $15.8 million, of which some 20 percent were directly related to the FSAP. Sixty percent of these were referred by Bank and Fund staff.

The Bank normally do not conduct assessments themselves.[38] Therefore, the FSAP assessments are a key source of systematic feedback on issues regarding financial sector standards. The feedback provided by the Fund and the Bank to standard setters has taken several forms, including through dedicated conferences and seminars, participation of staff from those bodies in FSAP discussions, and specialized papers. In particular, a recent Fund Board paper reviewed the implementation of regulatory standards in the banking, insurance, and securities sectors, and provided recommendations to country authorities, standards setters, and international organizations.[39]

79. **Quality control on standard assessments has been strengthened, including by establishing a roster of external reviewers.** In line with the last FSAP review, the Fund's roster of external reviewers in banking, insurance, payment, and securities has reinforced the internal review process by enlarging the pool of independent outside reviewers. Also, staff has cooperated closely with standard-setting agencies to improve consistency in standards assessments through the adherence to methodologies and guidance notes, prepared by Fund/Bank staff and the standard setters.

E. Relationship with FATF AML/CFT Standards and Other Market Integrity Standards

80. **The Fund and Bank Boards have decided that AML/CFT assessments are to be included in all financial sector assessments under the FSAP and OFC programs,**[40] except where countries have already had an AML/CFT assessment, including through FATF or FATF-Style Regional Body (FSRB) mutual evaluations.[41] For FSAP updates, AML/CFT assessments should take place if the country has not previously been assessed using the agreed methodology. Since the last Board review, the coverage of these issues in FSAP reports has increased significantly.[42]

[38] FATF and FSRBs are an exception in that they carry out a program of mutual evaluations to assess compliance with AML/CFT standards.

[39] *Financial Sector Regulation—Issues and Gaps*, SM/04/268, August 5, 2004.

[40] The general aspects of the AML/CFT efforts were reviewed by the Board in 2004 (http://www.imf.org/external/np/sec/pn/2004/pn0433.htm). In the present review, AML/CFT issues are considered only to the extent that they impact the FSAP. For FSAP/OFC update missions, AML/CFT assessments are required if the country has not previously been assessed using the agreed methodology.

[41] Nine of the 21 AML/CFT assessments that have been completed or are close to completion since the last Board report have been conducted by FATF/FSRBs.

[42] A review of the quality and consistency of FATF/FSRB AML/CFT assessments and the effectiveness of coordination with the Fund and the Bank will be presented to the Boards in January 2006.

81. **Four other market integrity standards (accounting, auditing, corporate governance, and insolvency and creditor rights[43]) are frequently assessed by the Bank outside the FSAP,** partly to ease the logistical burden on the authorities.[44] These assessments are reflected in the FSAP, if done prior to an FSAP, as their relevant aspects are taken into account in the assessment of other standards and in the overall FSAP exercise.

VI. Proposals Going Forward

82. **This section sets out staff views on which aspects of the FSAP should remain the same and which should change going forward.** It is based on the experience of the past five years of assessing financial sectors in a wide range of countries, and reflects the developments, authorities' feedback, and lessons discussed in the previous sections.

83. **The objective of the program will remain to identify vulnerabilities and development needs through a comprehensive analysis of the financial sector** given constraints on resources, time and the voluntary nature of the program. Individual country circumstances and resource constraints will continue to be accounted for in the scoping. The program should include initial assessments and updates as it does presently.

84. **The FSAP should remain a joint Bank-Fund program, given the benefits this entails for the two institutions and for country authorities.** The collaboration between the Bank and the Fund in delivering the program has been an essential element of the initiative from its inception. For the member countries, benefits include greater consistency of policy advice and a more comprehensive and strategic overview of a country's financial sector. These benefits would be difficult to achieve without the joint approach. As a principal vehicle for coordination of the financial sector work programs of the Bank and the Fund, the joint program ensures better resource utilization between the two institutions and promotes discussions of objectives in financial sector surveillance and development that have no other forum.

85. **Voluntary participation (with the expectation that, over time, all countries will participate) also remains central to the program.** The voluntary nature gives the program greater country ownership. At the same time, it creates challenges for the management of the program, as the timing of participation depends largely on the decision of the country authorities. Often one country will participate after a neighboring country has had an assessment. With an increasing number of countries participating in the initial assessments, awareness of the importance of strengthened financial sectors has spread even to countries

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[43] Work is ongoing on harmonizing the Bank's *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, which have been used in a series of experimental ROSCs, and UNCITRAL's *Legislative Guide on Insolvency*, with the aim of developing a unified standard for ROSCs, and supporting reference document.

[44] The exception to this was the corporate governance assessment that was assessed with the FSAP until 2004. More than 100 assessments of the four standards have been carried out by the Bank since November 1999: 38 in corporate governance, 39 in accounting and auditing, and 24 in insolvency and creditor rights.

that have not yet volunteered, with the result that several have stepped up their own improvement efforts.

86. **The staff proposes to keep publication of FSSAs and FSAs voluntary, but to add the presumption that the authorities will, in fact, agree to publish these documents.** In the Fund, this will align the publication policies for FSSAs with those for Article IV staff reports and background papers.[45] Materially, the difference is unlikely to be substantive, as the publication rate for FSSAs has been about the same as for those other documents.

87. **Research on developmental and stability issues will be an ongoing endeavor.** The developmental issues currently under investigation include: the legal and institutional underpinnings required to improve the provision of financial services to SMEs; the role of microfinance institutions and direct access of poor households to financial services, including from specialized microfinance firms, in reducing poverty; policies and approaches that are conducive to the "scaling up" of microfinance and its integration in the mainstream financial system; the role of competition policy in enhancing the reach and lowering the cost of particular financial services, including privately funded pensions; and what types of financial services and financial infrastructure can be most effectively outsourced to foreign capital markets, including in the securities and pension areas. On stability issues, research is focused on developing better methodologies for quantifying macro-financial linkages and aggregate stress-testing, incorporating forward looking market-based indicators in vulnerability assessment, policy responses to credit growth and asset price bubbles, and improving risk management systems.

88. **In countries with limited institutional capacity, the program could more fully exploit its potential** in providing an in-depth assessment of structural features of the financial system and of ensuring that the findings of the assessment are communicated to the authorities in a manner that helps them to respond effectively by strengthening their policy and institutional capacity. The FSAP should be flexible enough to accommodate required in-depth assessments as well as provide time and resources to creating an action plan to follow-up on FSAP recommendations.

A. Future Shape of the Program

89. **Updates will be an increasingly important part of the program.**[46] The share of updates (in terms of the number of missions) has already increased from 5 percent in 2001–

[45] See *The Fund's Transparency Policy– Issues and Next Steps* (SM/03/200, Rev. 1, October 1, 2003) and *The Fund's Transparency Policy—Issues and Next Steps—Amendments to the Transparency Policy Decision* (SM/04/39, February 12, 2004). Move to voluntary but presumed publication of FSSAs will entail a modification of the current publication policies of the Fund.

[46] Experience with the FSAP updates conducted so far suggests that distinguishing between reassessments or comprehensive updates, and focused updates, as done in the previous FSAP review documents, has led to more not less ambiguity over the scope of such an exercise. A single term, update, will therefore be used going forward. The scope of an update will vary nonetheless.

02 to 25 percent in 2003–04, and this increase will continue. However, more active promotion of the updates is needed to increase awareness, through outreach programs and active encouragement by both Boards, management, and staff. As a step towards creating greater awareness, Fund staff proposes instituting annual reporting to the Fund Board on country participation in initial assessments and updates.[47]

90. **Given the pace of financial sector development, and the need to keep the staff's institutional knowledge current enough for effective financial sector work, an average frequency of FSAP updates of about five years seems reasonable.** In any particular country, frequency will depend on financial sector developments, the country's willingness to participate, and resource availability for the program. Subject to the authorities' agreement to participate, the interval between assessments should be shorter in systemically important countries, countries with serious vulnerabilities, and countries where there have been significant macroeconomic shocks to the financial system or major reforms since the last assessment. An earlier update may also be appropriate in cases where important financial sector issues were not covered in the original FSAP but are deemed to warrant an in-depth analysis.[48] Eligibility for an update will be subject to the same selection criteria as currently used for the initial assessment. The recommendations of the IEO and OED reviews of the FSAP may have implications for the desired frequency of updates.

91. **Over time, once the initial round of assessments is completed, a resource envelope similar to the current one seems sufficient to achieve the frequency of updates proposed above.**[49] Within any given year, the exact number of initial assessments and updates, as well as follow-up work though Article IV or other missions, would depend on the mix of countries and issues to be addressed within the existing resource envelope. As updates begin to account for the bulk of the FSAP work, the Fund/Bank resource mix may vary more, broadly reflecting the relative significance of stability and development issues.

92. **Based on experience gained in conducting updates, the following paragraphs define the scope for and modalities of an update more clearly than was possible at the time of the last review.** The experience is derived from 10 updates that are either completed or under way.

93. **The goal of the updates is to help countries at different stages of development maintain reforms or otherwise strengthen their financial sectors to minimize vulnerabilities and better contribute to the intermediation that supports growth and poverty reduction.** Updates are also important from the viewpoint of surveillance, even

[47] Such reporting could be similar to the Fund's *Quarterly Report on the Assessments of Standards and Codes* (http://www.imf.org/cgi-shl/create_x.pl?asc).

[48] For the updates started and planned to start between mid-2004 and mid-2005, the interval between the initial assessment and the update is 4.4 years on average.

[49] For more details relating to the Fund, see the Fund's background document on Fund costs of the FSAP.

though given their low frequency and voluntary nature, they need to be complemented by work in Article IV consultations and ongoing surveillance at headquarters. Updates allow for more in-depth analysis of the financial sector than possible in Article IV consultations.

94. **All updates will contain a minimum, core element.** As a minimum, updates will comprise a stock-taking exercise, assessing financial sector developments and progress in implementing FSAP recommendations. Where progress has been slow or recommendations not carried out, it will ascertain reasons for the lack of progress. The update will contain the financial stability analysis, factual updates of standards and codes included in the initial FSAP assessment, and a reassessment of key development and structural issues raised in the initial assessment.[50]

95. **To provide flexibility and to increase the usefulness of the program to the authorities, an FSAP update may contain two additional elements.** Subject to available resources, the following elements will be included if requested by the authorities and if considered relevant by the staff for a better understanding of financial stability or development:

- ***A substantive update of previously assessed standards*** will be an option.[51] The standards and codes to be substantively updated (meaning in-depth reassessment including of the underlying grading) will be determined by the staff, based on the authorities' request, taking into account the time lapsed, the changes since the previous assessment, and the level of development. Even if a substantive update is not done for a standard, a factual update would inform on compliance.

- ***Issues not covered in the previous assessment*** (including standards not previously assessed) could be addressed in an update, if these issues were not otherwise covered by other avenues of Bank and Fund work. For example, strengthening of the regimes for bank governance and insolvency; information and legal infrastructures; access issues; an in-depth assessment of corporate vulnerabilities and financing needs; housing finance; e-finance and e-security; exposures to derivatives; or capital market development could well be appropriate in some countries.

96. **In other aspects, the updates will follow existing program practices.** In particular, FSAP updates will be staffed jointly (with the exception of high-income country missions), with experts from cooperating institutions as warranted by the issues. An update will normally involve one joint mission. FSAP updates to high-income countries will be staffed by the Fund, as is already the case for initial assessments. The output will be similar to an

[50] Factual updates report on key developments relevant for the standards and codes. In contrast to substantive updates, they do not include reassessing the underlying grading.

[51] If an AML/CFT assessment was not performed in the initial assessment, AML/CFT issues would be assessed as part of the update, although the scope and modalities of the assessment will depend to some extent on the specific circumstances of each country.

initial FSAP with an aide-mémoire discussed with the country at the end of the joint mission and technical notes and detailed assessments prepared as appropriate. In addition, the FSSA and FSA will be updated.

97. **The structure of the assessment in low-income countries for both initial assessments and updates requires an adjustment,** particularly to include an extended lead time in the engagement to allow in-depth fact-finding before the main assessment or update mission in order to shift decisively towards development issues. Amassing the information needed for the analysis of the more developmental issues will require flexibility in the time allotted to teams and the enhancement of toolkits to help guide this work. Fact-finding that requires time, such as the collection of survey data, can not always be done in the context of a one- or two-mission assessment. Given the developmental focus of this work, it will generally be carried out by Bank staff. The longer-term engagement of this phase of FSAP assessment, including updates, need not affect the speed with which the main assessment report (including the stability issues) is prepared. In countries with limited administrative resources, every effort will be made to lighten the overall administrative burden and to adapt the product to that country's needs.

B. Follow-up and Relationships to Other Financial Sector Work

98. In the Fund, follow-up activities to the FSAP will continue to consist of financial sector surveillance and technical assistance.[52] In the Bank, follow-up will continue to involve devoting resources to projects designed to support the institution and capacity building required to implement FSAP findings. Such projects are specific to the needs of individual countries and, therefore, the effort to better integrate FSAP findings into Country Assistance Strategies (CAS) and Poverty Reduction Strategies (PRSP) will continue. In both institutions, financial sector research will continue to follow-up on cross-country developmental and stability issues; in addition, region-wide issues will be addressed through regional financial sector projects. Finally, given the scale of the work needed, follow-up TA will also be provided by donors, including FIRST.

Financial Sector Surveillance

99. **FSAP initial assessments and updates will remain a key input into surveillance of the financial sector.** The initial assessments, which are based on a comprehensive and in-depth analysis, can provide a benchmark for surveillance for several years. FSAP updates, as defined in this paper, will provide a regular expert update on the status of the financial sector in the country.

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[52] The FSAP was not designed to have a formal link to the Fund's lending activities, and such a link is not envisaged going forward. Even though Fund-supported programs in some cases included measures recommended by the FSAP, the inclusion of these measures was based on their own merit for the program rather than on their mention in the FSAP. The share of countries with a Fund program among those covered by the FSAP is about the same as in the membership as a whole.

100. **Other modes of MFD support, particularly participation in Article IV missions, will continue to strengthen coverage of financial sector issues in Fund surveillance.** The voluntary nature of the FSAP and the lower frequency of updates may in some cases limit the FSAP's ability to contribute to timely and in-depth financial sector surveillance. However, financial sector surveillance belongs to the IMF's core mandate and falls under the Article IV umbrella. Some aspects of financial sector assessment carried out under the FSAP on a voluntary basis can be performed in the context of Article IV consultations. Nonetheless, there are limits to which regular Article IV missions can make broad, in-depth assessments of financial sector issues, even with increased assistance from relevant functional departments.

101. **MFD is working with area departments to enhance the Fund's capacity to carry out ongoing financial sector surveillance.** [53] In late 2004, Fund staff began a pilot project for improving Article IV financial sector surveillance. The pilot will cover countries in each of the area departments. MFD will participate in Article IV missions for some countries, while in most others, it will provide guidance on how to address financial sector issues. The experiences with these modes of cooperation will be evaluated later in 2005. Also, MFD's off-site surveillance is being strengthened with a view to making its results available to country desks on a routine basis to help them in preparing their financial sector work. MFD has started using its internal FSI database to analyze FSIs on a regional basis and will use it to provide better support for area departments.[54]

Support for Development and Structural Reform

102. **The FSAP analysis and the dialogue it promotes about financial sector issues will continue to provide countries, the Bank, and the Fund with a forum for further development and structural reform.** Although different regions within the Bank take different steps following an FSAP, most use the findings to deepen or rekindle interest in financial sector strengthening with its clients. The expectation is that this will lead, among other things, to further improvements in bank failure resolution frameworks and payments systems; liberalization of sectors such as insurance that are sometimes held by monopolies; reform of nonbank financial intermediaries such as postal, development and housing banks; and the preparation of new regulatory frameworks for microfinance. FSAP findings, when put together with the Investment Climate Assessments, will provide a better understanding of the business environment and further enrich the policy dialogue with the authorities.

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[53] The International Monetary and Financial Committee have called for enhancing financial sector surveillance in Article IV consultations (IMF Press Release No. 04/210, 10/2/2004). In the 2004 Biennial Surveillance Review, Fund Directors pressed staff to make use of all available options to bring necessary expertise to bear on analysis of financial sector issues, including, for example, encouraging participation in the FSAP, separate MFD or ICM missions (with the authorities' consent), MFD and ICM participation in Article IV missions, and training of area department staff by MFD and ICM (see *The Chairman's Summing Up— Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision*, SUR/04/80, 08/02/2004).

[54] The database combines data obtained from FSAPs and area department missions with those from large private databases; however, the use of private databases for country comparisons is limited by lack of standardization. These shortcomings are expected to be overcome with the ongoing CCE.

103. **Staff will continue its efforts to provide TA follow up for FSAPs and enhance coordination.** Experience suggests the need for flexibility in the way this is accomplished, particularly to improve country ownership. Specifically, in cases where implementation of FSAP recommendations would benefit from TA, staff will approach national authorities and propose various options to move forward. For instance, these could include follow up meetings convened by the authorities with staff assistance, to which other donors—notably FIRST—could be invited also.

Regional Financial Sector Work

104. **Given the increasing multilateral and cross-border linkages, regional financial exercises may be warranted for several regions.** In instances where foreign institutions play an important role in local financial markets, country-by-country assessments may not capture the full extent of spillovers inherent in financially integrated regions. Also, countries can gain from deepening such linkages (while addressing related vulnerabilities), since enhanced trading of financial products could help overcome structural weaknesses and shallow financial systems. In addition to the Financial Sector Regional Project for Central America mentioned earlier, a Nordic–Baltic regional financial sector project has been requested by the authorities, and discussions are ongoing on FSAPs in the two African monetary unions. Staff is exploring other potential cases for regional analysis. Such regional projects would elaborate on FSAP-related issues in a regional perspective. The regional projects would be carried out subject to the overall budget envelope for the FSAP. Additionally, in the Fund, an interdepartmental project on financial market integration is being prepared for the next selected issues paper on euro area policies. In the Bank, extensive work on regional issues has been conducted in the areas of bond market development (West Africa), payments systems (Latin America), and AML/CFT (Central Asia).

C. Next Review

105. **The staff proposes that the next Board review of the FSAP should take place in three years**, allowing for the implementation of recommendations from the upcoming reviews of the FSAP by the IEO and the OED.

VII. Issues for Discussion

106. **Do the proposed approaches in Section VI seem appropriate to strengthen the program?** Specifically, Directors might wish to comment on the following issues:

Issues for the Bank and the Fund

- Are Directors satisfied with the coverage of countries by region and by level of development so far? Do Directors have suggestions on how to encourage wider participation in both initial assessments and updates?

- Do Directors agree that the scope of an update should be flexible and defined along the lines suggested in paragraphs 94–96?

- Do Directors agree that in low-income countries, the adjustment of the FSAP envisaged in the last review should be deepened, as proposed in paragraph 97?

Issues for the Fund

- Do Directors think that the pace and coverage of initial assessments and updates is sufficient to help identify financial sector vulnerabilities and development needs on a timely basis? Do Directors agree with the proposal to institute annual reporting to the Board on country participation in the program (paragraph 89)?

- Do Directors concur with the proposal that publication of FSSAs will now be voluntary but presumed (paragraph 86)?

- Are Directors satisfied with the ongoing efforts through the FSAP and other modes of financial sector surveillance, as identified in paragraphs 99–101?

Issues for the Bank

- Do Directors wish to discuss a representative sample of FSAs, possibly in the context of a semi-annual technical briefing on the FSAP program?

- Do Directors concur with the proposal to add a presumption that the authorities will elect to publish the FSAs (paragraph 86)?

- Do Directors agree with the practice of public disclosure of Technical Notes and Detailed Assessments (paragraph 22)?

COUNTRIES THAT HAVE NOT PARTICIPATED OR AGREED TO PARTICIPATE IN THE FSAP
(As of February 1, 2005)

Afghanistan, Islamic State of
Angola
Bahamas 1/
Belize 1/
Benin
Bhutan
Brunei Darussalam
Burkina Faso
Burundi
Cambodia
Cape Verde
Central African Republic
Chad
China, The People's Republic of
Comoros
Congo, Democratic Republic of the
Congo, Republic of
Cyprus 1/
Djibouti
Equatorial Guinea
Eritrea
Ethiopia
Gambia
Guinea
Guinea-Bissau
Guyana
Haiti
Indonesia
Iraq
Kiribati
Lao People's Democratic Republic
Lesotho
Liberia
Libya
Malawi
Malaysia
Maldives
Mali
Marshall Islands 1/
Micronesia
Mongolia
Myanmar
Namibia
Nepal
Niger
Palau 1/
Panama 1/
Papua New Guinea
Samoa 1/
São Tomé and Príncipe
Seychelles 1/
Sierra Leone
Solomon Islands
Somalia
Suriname
Swaziland
Syria
Tajikistan
Timor Leste
Togo
Tonga
Turkmenistan
Turkey
United States
Uzbekistan
Vanuatu 1/
Vietnam
Zimbabwe

1/ The country has undertaken an OFC module 2 assessment by the IMF, which generally involves assessments of compliance with international standards in the banking sector, and, if significant, in the insurance and securities sectors. It also evaluates the effectiveness of the AML/CFT regime. Compared to assessments under the FSAP, it does not include an assessment of risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks.

POST- FSAP FEEDBACK RESPONSES

107. **A survey of feedback received in the post-FSAP questionnaires was conducted to summarize the authorities' reactions to the assessment.** A questionnaire asking about their experience with the assessment is attached to the final FSAP documents when they are returned to the authorities. This survey is based on 28 questionnaire responses, including 18 received before the 2003 review and 10 received since then. The survey includes 26 initial assessments and 2 updates.

108. **Virtually all responding country authorities described their overall impression of the FSAP as good or very good,** and—notwithstanding concerns of some, in particular about the workload involved in the exercise—they noted that the participation has been valuable or very valuable.

109. **The main reason for the country's interest in participating was to obtain an independent expert evaluation of the financial sector and its regulatory framework.** This was noted in 70 percent of responses overall, and in all of the high-income countries. Other reasons also noted were to enhance the credibility of the system (40 percent) and the fact that other countries participated or could participate as a result of a country's participation (30 percent). Thirty-five percent of countries (60 percent of medium- or low-income countries) saw the FSAP as a vehicle for identifying measures for reform or obtaining technical assistance, and learning new tools such as stress testing.

110. **The purpose of the program was clearly communicated,** according to 96 percent of the responding countries. In 50 percent of the countries, this was achieved through pre-FSAP contacts with the mission chief or other staff. Virtually all (93 percent) of the country authorities thought that the coverage of topics in the program was adequate and comprehensive, even though 15 percent noted some specific topics deserving further attention.

111. **A majority of the country authorities (64 percent) noted the considerable work involved in participating in the program.** Most of these countries mentioned that providing the data requested by the mission was the most burdensome aspect of the exercise. Several suggested longer lead times for providing the necessary data and in some cases translation of the necessary documents. Notably, the FSAP updates for which a feedback is available did not include concerns about the workload involved.

112. **Virtually all the country authorities noted their satisfaction with the quality of the report.** Some countries suggested that more information be provided on certain topics or in follow-up work. Fifty percent of country authorities saw as the greatest benefits of the program the discussions with the experts and other team members. Some (20 percent) considered the discussions even more important than the report itself.

113. **All country authorities noted that they are likely to utilize the team's findings in the near and medium-term.** Fifty percent of country authorities noted that they already

started implementing some of the recommendations of the FSAP. Thirty-five percent of respondents thought that the FSAP will be very useful in discussing financial sector reforms with other stakeholders. Twenty percent noted that the FSAP prompted them to develop their own stress testing models.

114. **The authorities also made a number of suggestions going forward.** In particular, responses from countries assessed before the 2003 review focused on suggestions to sharpen the scope of the assessment, increase selectivity about issues and standards assessed, and deploy other tools in financial sector surveillance and follow-up. Responses both before and after the last review asked for improvements in the methodology for developmental issues, more research on financial stability issues, studying how standards affect the financial systems, addressing gaps in existing standards and methodologies, and creating swifter mechanisms for the provision of follow-up TA.