

INTERNATIONAL MONETARY FUND

**Integrating Stability Assessments Under the Financial Sector Assessment Program
into Article IV Surveillance**

Prepared by the Monetary and Capital Markets, Legal, and Strategy, Policy, and Review
Departments

Approved by José Viñals, Reza Moghadam, and Sean Hagan

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GLOSSARY

BIS	Bank of International Settlements
CAMELS	Capital adequacy, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FSB	Financial Stability Board
FSLC	Financial Sector Liaison Committee
GFSR	Global Financial Stability Report
IEO	Independent Evaluation Office
NBER	National Bureau of Economic Research
ROSC	Report on Observance of Standards and Codes
SIMIs	Systemically important institutions, markets, and instruments
WEO	World Economic Outlook

EXECUTIVE SUMMARY

- 1. Integration of financial sector issues into bilateral surveillance has been a long-standing challenge.** Financial stability is a key component of the domestic and external stability of members and is important for the promotion of the “stable system of exchange rates” envisaged under Article IV. But although financial sector issues and policies are at the core of the Fund’s surveillance mandate, their effective integration has been a challenge. One of the main reasons is that the FSAP—the key tool for assessing members’ financial vulnerabilities and financial sector policies—is not formally a surveillance instrument but a voluntary program. Moreover, it is conducted jointly with the World Bank in developing and emerging market countries, with a broad coverage that often goes beyond macro-relevant financial stability issues. As a result, the Fund cannot allocate FSAP resources where they may be most needed for surveillance, and the gaps between FSAP updates are long. The growing awareness of the importance of financial sector stability issues for surveillance, and—especially—the recent financial crisis have highlighted these shortcomings.
- 2. To address this challenge, it is proposed to adopt a more risk-based approach to financial sector surveillance by making FSAP stability assessments part of Article IV surveillance for members with systemically important financial sectors.** The last Board review of the FSAP made a number of changes to the program aimed at improving the integration of financial sector issues into surveillance, chiefly by introducing greater flexibility to the FSAP and strengthening its focus on financial stability issues. But in the context of the broader debate on modernizing the Fund’s surveillance mandate and modalities, a majority of directors agreed in principle to consider going a step further: making stability assessments under the FSAP a mandatory part of Article IV surveillance for members with systemically important financial sectors.
- 3. This step would not create new legal obligations for members.** Although the FSAP is currently a form of technical assistance performed by the Fund at the request of members, the issues covered under financial stability assessments conducted under the FSAP may, as a legal matter, be discussed in the context of bilateral surveillance on a mandatory basis.
- 4. Establishing a set of relevant and transparent criteria for identifying jurisdictions with systemically important financial sectors is a key component of the proposal.** It ensures that members would be treated uniformly in the context of this move toward a risk-based approach to financial sector surveillance. The criteria for defining systemic importance combine two key features of a jurisdiction’s financial sector: its size and its interconnectedness with financial sectors in other countries. These criteria are not designed to reflect a country’s broader systemic importance, political or economic, and would need to be periodically reevaluated as financial sectors develop and their size and interconnectedness change. But they help identify a number of jurisdictions with the most systemically important financial sectors today that would be required to have financial stability assessments as part of their Article IV consultations.

5. **The issues covered in these mandatory financial stability assessments would be the core elements of stability assessments defined in the 2009 review of the FSAP**, namely (i) the source, probability, and potential impact of the main risks to macro-financial stability in the near term; (ii) the jurisdiction’s financial stability policy framework; and (iii) the authorities’ capacity to manage and resolve a financial crisis should the risks materialize. Even in countries with systemically important financial sectors, formal assessments of compliance with financial sector standards and codes (and associated ROSCs) and other components of the FSAP, e.g. developmental assessments, would continue to be voluntary.
6. **Mandatory financial stability assessments would be targeted at a frequency of every three years.*** This frequency compares with a six- to seven-year average gap between voluntary FSAP assessments today, and is supported by a review of the empirical literature on systemic financial sector crises and on early warning models for distress of individual financial institutions. As is the case with Article IV consultations, this periodicity would, for the time being, be an “expectation” and applied with flexibility.
7. **Operational changes would help integrate more closely the proposed mandatory assessments into Article IV consultations.** These could include increasing the overlap between the financial stability assessment and Article IV teams and strengthening area departments’ follow up on these assessments through the Article IV process in the period between such assessments.
8. **Making financial stability assessments part of Article IV surveillance would not materially affect the status of the FSAP as a joint program with the World Bank.** The World Bank’s developmental assessments in developing and emerging market countries, including those with systemically important financial sectors, are important and would continue to take place on a voluntary basis, as at present. Joint missions could still be fielded in these countries, where appropriate. And the Financial Sector Liaison Committee would continue to play a coordinating role for the financial sector work of the two institutions.
9. **An increase in resources would be needed to maintain the capacity to satisfy requests from countries requesting FSAPs on a voluntary basis.** The estimated resource cost of regular mandatory financial stability assessments in countries with systemically important financial sectors every three years is based on the working assumption that the Fund will maintain its present capacity to deliver FSAPs for the rest of the membership. On this assumption, the overall resource envelope for the program would have to be increased by about US\$2.8 million from the baseline. In the absence of these additional resources, mandatory financial stability assessments would have to take place at the expense of the countries requesting FSAP assessments on a voluntary basis.

* The Executive Board did not agree with the proposed frequency for the assessments, and instead endorsed targeting a frequency of every five years. See [Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance—Revised Proposed Decision](#).

I. THE CASE FOR MAKING FINANCIAL STABILITY ASSESSMENTS UNDER THE FSAP A MANDATORY PART OF ARTICLE IV SURVEILLANCE¹

10. **Financial stability is a key component of members’ domestic and external stability and is important for the promotion of the “stable system of exchange rates” envisaged under Article IV.** Financial instability can jeopardize growth and price stability. It can also translate into external instability both directly, through a loss of confidence in a country’s currency or other financial assets, and indirectly through its impact on the domestic economy. The consequences and spillovers to the rest of the world can be especially severe in countries with large and globally interconnected financial markets and institutions. These lessons were emphatically underscored by the recent crisis.

11. **Financial sector issues and policies are at the core of the Fund’s surveillance mandate** (see Section II.A).² The [2007 Surveillance Decision](#) clarified that financial sector policies will always be a subject of the Fund’s bilateral surveillance³ and, against the background of the recent global crisis, the October 2008 [Statement of Surveillance Priorities](#) for 2008–11 gave prominence to financial sector issues.⁴

12. **In practice, however, the integration of financial sector issues into bilateral surveillance has been a challenge.** In large part, this is because the FSAP—the premier tool for assessing members’ financial vulnerabilities and financial sector policies—is not formally a surveillance instrument. The FSAP was established in the aftermath of the Asian crisis of the late 1990s as one of several initiatives to strengthen the international financial architecture. However: (i) it was established as a technical assistance instrument (country participation is voluntary and assessments are conducted separately from Article IV consultations); (ii) FSAPs in developing and emerging market countries are carried out jointly with the World Bank, which has no surveillance mandate and a separate set of institutional priorities; and (iii) the scope of assessments is required to be very broad, including issues such as long-term financial sector development needs and access to financial services. These choices reflected the preoccupations of that time: voluntary participation was seen as important for ensuring broad acceptance of the new program; and joint operation with the Bank as a way to exploit synergies in developing countries and, more importantly, to leverage the limited specialized financial sector expertise the Fund possessed in the late 1990s. They nonetheless entrenched the FSAP as a program distinct from the Article IV consultation process, and created a gap between the FSAP and surveillance.

¹ The papers cited in this report are publicly available, including at www.imf.org.

² See [Article IV of the Fund’s Articles of Agreement—An Overview of the Legal Framework](#) (June 2006) and [The Fund’s Mandate—The Legal Framework](#) (February 2010).

³ See [Bilateral Surveillance over Members’ Policies—2007 Decision](#) (Decision No. 13919-(07/51), adopted June 15, 2007, hereinafter the “2007 Surveillance Decision”).

⁴ The economic priorities of the Statement of Surveillance Priorities were revised in September 2009, and continue to give prominence to financial sector issues.

13. **The limitations of the FSAP as a surveillance tool have become more conspicuous over time.** The production by Fund staff alone of a *Financial System Stability Assessment* (FSSA) following an FSAP, focusing exclusively on macro-relevant financial stability issues and considered by the Board in conjunction with an Article IV consultation report, was seen as a way to bridge the gap between the FSAP and surveillance. But as awareness of the importance of financial sector issues for surveillance grew, successive reviews of the FSAP, as well as broader evaluations of the Fund’s financial sector work,⁵ highlighted the two major pitfalls of the original design of the program:

- The broad scope of joint Bank-Fund assessments, often going well beyond macro-critical issues, implies large teams, and high costs (for both country authorities and the two institutions). Moreover, the long gaps between updates have been identified as a major handicap for the timely analysis of financial sector vulnerabilities and macro-financial linkages.⁶
- The voluntary nature of the program constrains the scope for prioritization, hampers the allocation of scarce resources where they are most needed, and might create “selection bias” among the countries assessed. (Though not, in itself, a proof of the selection bias argument, the fact that the country of origin of the most recent financial crisis had not, until recently, volunteered for an FSAP lends credibility to this concern.) An important side effect of the voluntary nature of the program is that assessments in similar countries are often done several years apart (or in some cases not done at all), which makes it challenging to extract cross-country lessons for surveillance from FSAPs.

14. **As part of the wider strategy to improve the integration of financial sector issues into surveillance, the last Board review of the FSAP introduced a number of changes to the program that go some way toward addressing the first of these limitations.** The definition of the core elements of a stability assessment;⁷ the delineation of the institutional responsibilities of the Bank (development) and the Fund (macro-relevant stability issues); and the option of modular FSAP assessments focused on either one or the other were meant to make the FSAP more flexible, strengthen institutional accountability, and lead to more focused and—resources permitting—more frequent assessments of macro-critical financial stability issues. At the same time, a number of steps were taken to improve the quality,

⁵ Including the Independent Evaluation Office (IEO) [Report on the Evaluation of the Financial Sector Assessment Program](#), 2006; the report on [Integrating Financial Sector Issues and FSAP Assessments into Surveillance](#) (2009); and last year’s Board review of the FSAP [The Financial Sector Assessment Program After Ten Years—Experience and Reforms for the Next Decade](#) (September 2009).

⁶ “Performance of the FSAP in the Current Financial Crisis,” [The Financial Sector Assessment Program After Ten Years—Background Material](#) (Suppl. 1), Chapter 1.

⁷ See [The Financial Sector Assessment Program After Ten Years—Experience and Reforms for the Next Decade](#) (September 2009), Box 3.

candor, and transparency of stability assessments, including a new generation of quantitative tools, greater emphasis on macroprudential risks and cross-border linkages, and the introduction of the Risk Assessment Matrix.⁸

15. **The next logical step is to make financial stability assessments a mandatory part of Article IV surveillance for members with systemically important financial sectors.** In the context of the broader debate on modernizing the Fund’s surveillance mandate and modalities,⁹ a majority within the Fund’s Executive Board agreed in principle to consider making stability assessments under the FSAP a mandatory part of bilateral surveillance for such members (Public Information Notice (PIN) No. 10/52, April 22, 2010). This step would integrate the macro-critical components of the FSAP into bilateral surveillance in a more risk-based manner by focusing higher-frequency financial stability assessments on members with systemically important financial sectors, while maintaining access to FSAP assessments for all other members at the current frequency. It would also retain the other voluntary components of the program, as well as its joint nature with the World Bank. More fundamentally, it would reaffirm the centrality of financial sector issues in Fund surveillance.

16. **This step would complement ongoing efforts to improve the integration of multilateral and bilateral surveillance.** The proposed mandatory financial stability assessments for members with systemically important financial sectors are firmly embedded into the Fund’s bilateral surveillance mandate and would be part of the bilateral surveillance modalities. Nevertheless, given the importance of financial sector cross-border linkages, better surveillance of jurisdictions with systemically important financial sectors, including their interconnections and potential effect on other members, would enhance the effectiveness of existing multilateral surveillance instruments, notably the WEO and the GFSR, as well as complement ongoing or envisaged tools to bridge the gap between multilateral and bilateral surveillance, such as spillover reports.

II. LEGAL AND OPERATIONAL ASPECTS

A. The Legal Basis for Mandatory Financial Stability Assessments

17. **It is legally possible for the Fund to conduct mandatory financial stability assessments, as proposed below, in the context of bilateral surveillance under Article IV.**¹⁰ Surveillance is mandatory for the Fund and its members. The purpose of bilateral surveillance is for the Fund to assess the compliance of each member with the obligations of Article IV, Section 1, respecting the conduct of its exchange rate policies and

⁸ See [Financial Sector and Bilateral Surveillance—Toward Further Integration](#) (September 2009) and [The Financial Sector Assessment Program After Ten Years—Experience and Reforms for the Next Decade](#) (September 2009).

⁹ See [Modernizing the Surveillance Mandate and Modalities](#) (March 2010).

¹⁰ See [The Fund’s Mandate—the Legal Framework](#) (February 2010), page 7.

its domestic economic and financial policies.¹¹ Under Article IV, Section 1, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (i.e., “systemic stability”). The *2007 Surveillance Decision* recognizes that systemic stability is most effectively achieved by each member adopting policies that promote its own “external stability”—that is, a balance of payments position that does not and is not likely to give rise to disruptive exchange rate movements. Moreover, the *2007 Surveillance Decision* recognizes that each member, in the conduct of its domestic economic and financial policies, promotes its own external stability by promoting its own domestic stability—that is, by complying with its domestic policy obligations under Article IV, Sections 1 (i) and (ii).¹² The *2007 Surveillance Decision* requires the Fund in its bilateral surveillance to assess whether the member’s domestic policies are directed toward the promotion of domestic stability. A member’s policies respecting the financial sector are central to domestic stability and fall within the scope of the member’s domestic policy obligations under Article IV, Section 1. In this regard, the *2007 Surveillance Decision* specifically requires the Fund’s bilateral surveillance, in all cases, to include an analysis of the member’s “financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects).”¹³

18. Since the conduct of financial stability assessments is directly relevant to the Fund’s assessment of a member’s compliance with its existing obligations under Article IV, incorporating these assessments into surveillance would not create new legal obligations for members. Rather, it would involve the application of a member’s existing obligation to consult with the Fund regarding the performance of its obligations under Article IV. For the purposes of bilateral surveillance, the Fund may “request” (i.e., require) a member to discuss any issue that falls within the scope of its obligations under Article IV,

¹¹ The legal basis for surveillance is Article IV, Section 3. Article IV, Section 3 (a) provides that the Fund “shall oversee the international monetary system in order to ensure its effective operation and shall oversee the compliance of each member with its obligations under” Article IV, Section 1. Moreover, given the importance of exchange rate policies for the Fund’s mandate, Article IV, Section 3 (b) requires the Fund to exercise “firm surveillance” over the exchange rate policies of members.

¹² These domestic policy obligations form part of the general “chapeau” obligation to collaborate with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates. They require each member to (i) “endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;” and (ii) “seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.” These obligations are “soft” in nature and are cast in terms of best efforts. Under Article IV, a member is required to change its domestic policies only if the member is domestically unstable: if the member is in a state of domestic stability, the member cannot be required to change these policies even if they have negative externalities. For a more detailed discussion of the scope of members’ domestic policy obligations under Article IV, Section 1, see [The Fund’s Mandate—The Legal Framework](#) (February, 2010), p. 8; [Modernizing the Surveillance Mandate and Modalities](#) (March 2010), p. 12.

¹³ [2007 Surveillance Decision](#), paragraph 5.

Section 1, and as discussed above, members' financial sector policies clearly fall within the scope of these obligations. Members are required to hold discussions with Fund staff, and to provide the Fund with such information as the Fund may require for this purpose.¹⁴ As a related matter, Article VIII, Section 5 requires members, subject to certain limitations, to provide the Fund with such information as the Fund deems necessary for surveillance.

19. **Under the Fund's existing legal framework, it is open to the Fund to require members with systemically important financial sectors to engage in regular mandatory financial stability assessments under Article IV while not requiring such assessments of other members.** The principle of uniformity of treatment does not require that members be treated identically. Rather, it requires that any differentiation in the treatment of members by the Fund be based on the application of criteria that are relevant to the provisions of the Articles being implemented. Since, as noted above, the purpose of bilateral surveillance is to assess the extent to which members' policies are promoting systemic stability, it is appropriate for the Fund, when examining the financial sector policies of members, to scrutinize more closely the policies of those members whose financial sectors are most likely to affect systemic stability. Indeed the Fund already uses "systemic importance" as a criterion in its policy framework for surveillance in determining consultation cycles for members.¹⁵ While it may be argued that the stability of the financial sector, in particular, is so central to a member's domestic stability that all members should be required to engage in financial stability assessments under Article IV, the establishment of a framework that would only require such assessments of members with systemically important financial sectors may be justified by the greater likelihood that problems in the financial sectors of these members would lead to domestic and external instability of a type that would give rise to particularly disruptive exchange rate movements and adverse consequences for systemic stability.

20. **In requiring a specific group of members to periodically engage in financial stability assessments on a mandatory basis, the Fund would need to put in place a decision of general applicability that would establish the criteria upon which such members would be chosen, and the modalities through which such assessments would be conducted.** This approach would ensure that the assessments are conducted in a manner that respects the principle of uniformity of treatment. The specific operational aspects are discussed in the following section and a draft decision is proposed at the end of the paper.

¹⁴ Article IV, Section 3 (b) requires members, at the "request" of the Fund, to consult with the Fund on their exchange rate policies. The corresponding obligation of members to consult with the Fund on their domestic economic and financial policies is implicit in the "chapeau" obligation under Article IV, Section 1 to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." See *The Fund's Mandate – the Legal Framework* (2010), p. 6, footnote 9.

¹⁵ See *2009 Bilateral Surveillance Guidance Note*, paragraph 54.

B. Operational Aspects

Definition of Systemically Important Financial Sectors

21. **There is no clear, universally accepted definition of “systemic importance.”**

Systemic importance is not a binary concept but can be measured along a continuum, using different criteria. Systemic importance is also contingent on the state of global or domestic markets, thus reflecting to a certain degree the subjective views of market participants. Distinguishing between different countries on the basis of whether or not their financial sectors are “systemically important” is thus fraught with difficulty.

22. **Nevertheless, establishing a set of relevant and transparent criteria for identifying systemically important financial sectors is a critical component of the proposal to integrate financial stability assessments into Article IV surveillance.** It is key for the uniform treatment of all members in the context of a more risk-based approach to financial sector surveillance. Nevertheless, since financial sectors and their interconnectedness evolve over time, the determination of countries with systemically important financial sectors on the basis of these criteria would have to be reviewed periodically.

23. **The point of departure for defining systemic importance for this exercise is the conceptual framework developed by the IMF, BIS, and FSB.**¹⁶ This framework—originally developed for evaluating the systemic importance of financial institutions, markets, and instruments (SIMIs)—approaches systemic importance from both a domestic and a global point of view. It identifies the following three key concepts: (i) *size*, i.e., the volume of financial services provided by an individual financial institution or market; (ii) *interconnectedness*, i.e., the extent of linkages with other financial institutions or markets; and (iii) *substitutability*, i.e., the extent to which other institutions or markets can provide the same services in the event of the failure of part of the system.

24. **Systemic importance of a financial sector is defined below with the focus on its size and interconnectedness.** The volume of financial services provided by a financial sector is the main component of systemic importance. Size is measured across several dimensions, to capture the importance of a particular financial sector in the specific jurisdiction (expressed in terms of the jurisdiction’s output) and in the global financial system (expressed in absolute terms and scaled by the jurisdiction’s GDP relative to world GDP). Cross-border interconnectedness is an important complementary measure: it captures the systemic risk that can arise through direct and indirect interlinkages among financial sectors in the global financial system, i.e., the risk that individual failure or malfunction may have severe repercussions on other countries or on systemic stability. As regards the notion

¹⁶ IMF/BIS/FSB, (2009) [*Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*](#).

of substitutability, while it is important at the level of individual institutions and markets, it is not included in the criteria. As acknowledged in IMF/BIS/FSB (2009), the concept of substitutability is difficult to measure, because it is hard to capture the degree of uniqueness of an individual institution or a specific market in the provision of a financial service. More importantly, substitutability may not be a relevant concept for entire financial sectors.

25. **It is important to bear in mind the limitations of this definition of systemic importance :**

- **It is not a proxy for a jurisdiction’s systemic importance writ large.** The analytical approach used in this paper is focused on the financial sector. It does not purport to measure all aspects of a country’s relative importance in the world economy, such as the size of the domestic market, growth potential, trade linkages, etc. As a result, some large, systemically important economies may be ranked lower than smaller countries that have relatively big and/or highly interconnected financial sectors.
- **It does not capture market perceptions.** This approach is entirely data based. Market perception of a financial sector’s systemic importance, though a key component of systemic risk, can be volatile; is influenced by economic and political factors that go beyond the size and interconnectedness of the particular financial sector; and is hard to measure objectively. It is therefore not incorporated into this approach.
- **The extent of vulnerabilities is not a factor.** The methodology is focused on systemic importance as measured by size and interconnectedness, not vulnerabilities. This is because the benefits of regular financial stability assessments would be maximized—both for the individual members and for the global financial system—if these assessments were focused on the jurisdictions with the most systemically important financial sectors, not on the most vulnerable. To be sure, members faced with macrofinancial vulnerabilities, regardless of their size or interconnections, would also benefit from an in-depth look at their financial sectors and may need additional Fund support. But there are other instruments, including Article IV surveillance, voluntary FSAPs, and technical assistance, which would continue to provide this analysis.
- **Like all quantitative analyses, it is limited by the quality of data.** In particular, it may not reflect accurately the importance of nonbank and unregulated segments of the financial sector, given the difficulties countries often experience in collecting such data, nor can it fully take into account differences in the quality of data collection and reporting across countries.

26. **The methodology for identifying jurisdictions with systemically important financial sectors, explained in greater detail in the accompanying Background Paper, is a three-stage process that uses available financial data for the entire Fund membership.** The need to apply the criteria uniformly across the entire membership limits the data that can be used. Data for the analysis are mainly drawn from the BIS, the IMF's *World Economic Outlook*, the IMF's *International Financial Statistics*, the IMF's *Coordinated Portfolio Investment Survey*, and the United Nations Conference on Trade and Development's datasets on foreign direct investment. The sample covers 191 jurisdictions (187 Fund members plus four territories that are subject to Article IV surveillance) for the year 2008.

- **In the first stage, separate ordinal rankings of jurisdictions are developed for size and interconnectedness.**
 - **The size of a jurisdiction's financial sector is measured by the volume of financial services.** The size ranking is a median of four rankings, three of which are measures of the "absolute" size of the sector (currency and deposits as a proxy for the banking-system balance sheet; volume on nonbank financial services; and the jurisdiction's international investment position, all measured in U.S. dollars), and the fourth is a measure of the "relative" size of the financial sector (financial depth, measured as a share to the jurisdiction's output). The first three capture the importance of a jurisdiction's financial sector in the global financial system and the fourth measures the relative weight of the financial sector within a given jurisdiction. At the same time, since distress in an individual financial sector can propagate to the rest of the world both directly through financial connections and indirectly through real economy linkages, these measures of size are weighted by the relative size of each jurisdiction's total output to global economic output.
 - **Interconnectedness is determined on the basis of bank-based network analysis.** The basic idea (see Background Paper) is to infer from the pattern of cross-border linkages to what extent the banking sector of a particular jurisdiction is an important center in the international banking network.¹⁷ Data availability has limited the measures of interconnectedness to the banking sector only, so the network is defined as a set of bilateral claims of different banking systems on each other. The importance (or "centrality") of a banking sector in the network is measured in terms of the number and structure of claims on other banking sectors.
- **In the second stage, the rankings of size and interconnectedness are combined into a single weighted composite index of systemic importance.** To derive the single index, the relative weights for size and interconnectedness are set at 0.7 and

¹⁷ The network analysis is based on von Peter (2007), *International Banking Centres: A Network Analysis*, BIS Quarterly Review, and Kubelec and Sá (2010), *The Geographical Composition of National External Balance Sheets: 1980–2005*, Bank of England Working Paper No. 384.

0.3, respectively. As size is a more fundamental measure of systemic importance, it is given a relatively higher weight in the composite index than interconnectedness. As a robustness check, alternative composite rankings are calculated for a range of different weight combinations, and different ways of combining the indices of size and interconnectedness (using averages instead of medians), and different types of bilateral financial assets and liabilities (such as equity, debt, and FDI) are tested.

- **In the third stage, cluster analysis is used to identify groups of jurisdictions with financial sectors that have consistently the highest degree of systemic importance.** The underlying idea is to “let the data speak for themselves” in identifying groups of financial sectors whose rankings are relatively stable across different weight combinations. To capture this idea, the standard deviation of ordinal rankings across different combinations of weights is calculated for each financial sector as a proxy for the robustness of the ranking. Clusters of jurisdictions are then calculated by iteratively minimizing the within-cluster sum of squared standard deviations from cluster means over several possible clusters of jurisdictions. The final list includes the clusters with the jurisdictions that are not just the highest ranked, but also have the most robust rankings across different weighting schemes and represent a substantial share of the global financial system. This methodology eschews as much as possible a priori judgments on the size and makeup of the list (the number of jurisdictions to be included is not predetermined, and it is not possible to “cherry pick” individual jurisdictions), and allows the data to indicate its final composition.

27. **The results identify 25 jurisdictions with the most systemically important financial sectors** (Table 1). They cover almost 90 percent of the global financial system and represent almost 80 percent of global economic output. The group contains 15 of the G-20 countries and advanced economies are heavily represented. The United Kingdom’s financial sector has the highest composite rank. The United States’ financial sector is ranked third despite being ranked first in size because of its relatively lower level of cross-border connections. Several euro area economies are also highly ranked because of the high degree of interconnectedness of their financial sectors. Although these connections are largely within the euro area, for the purposes of this exercise they have been treated as all other cross-border flows because *first*, they may give rise to cross-border systemic risk affecting the domestic stability of the individual countries, as well as the external stability of the euro area as a whole; *second*, the authorities in these countries still have considerable independence in their domestic financial sector policies; and *third*, comprehensive cross-border resolution mechanisms are yet to be established. Moreover, Article IV consultations (and FSAPs) with these members are still conducted separately. Given the degree of financial integration of the euro area countries and the gradual move toward a more integrated system of regulation and supervision in the European Union, this treatment of cross-border exposures of these countries could be reconsidered in the future.

Table 1. Ranking of Jurisdictions with Systemically Important Financial Sectors

Jurisdiction	Overall Rank ¹	Size Rank	Interconnectedness Rank
United Kingdom	1	3	1
Germany	2	4	2
United States	3	1	10
France	4	6	3
Japan	5	2	14
Italy	6	8	8
Netherlands	7	9	6
Spain	8	7	11
Canada	9	9	14
Switzerland	10	15	4
China	11	4	34
Belgium	12	19	5
Australia	13	14	17
India	14	11	29
Ireland	15	20	9
Hong Kong SAR ²	16	17	18
Brazil	17	12	32
Russian Federation	18	13	31
Korea	19	18	22
Austria	20	22	13
Luxembourg	21	26	7
Sweden	22	23	16
Singapore	23	26	12
Turkey	24	21	25
Mexico	25	16	49

Source: Staff estimates.

¹ Weighted average of the size and interconnectedness rankings using 70/30 weights respectively.

² Stability assessments for Hong Kong Special Administrative Region would form part of Article IV consultations with the People's Republic of China.

28. **This list of jurisdictions may change over time.** Systemic importance is a dynamic concept. As countries and financial sectors develop, this list will likely change. When data on size and interconnectedness are updated, the same three-stage methodology may result in a different list, both in terms of size and country composition. In addition, as new data sources become available (for instance, to allow extending the network analysis beyond the banking sector data) and as network analysis methodologies gain in sophistication, the methodology itself may need to be revisited in the future.

29. **The conduct of financial stability assessments with a specified group of members as part of bilateral surveillance would not preclude other forms of multilateral or regional engagement with these members.** Cross-country analyses of financial interconnections or vulnerabilities, special studies (such as the 2007 study on *Financial Integration in the Nordic-Baltic Region*), or other forms of regional policy dialogue in the context of the FSAP could still take place, where appropriate. Reliance on these forms of engagement would take into account the degree of cross-border interconnectedness of the various financial sectors and the extent of regional integration of financial policies and the supervisory architecture.

Thematic Coverage and Data Requirements

30. **The last FSAP review established the core elements of the financial stability assessment, the Fund’s main responsibility in the context of the FSAP (Box 1)¹⁸ ().** These elements provide a coherent framework for financial stability policy and correspond to the minimum required for a well-rounded assessment of financial vulnerabilities, macro-financial linkages, and financial stability policies. These elements would comprise the core of stability assessments conducted in countries with systemically important financial sectors as part of Article IV surveillance.

31. **Formal assessments of compliance with financial sector standards and codes (and associated ROSCs) and other components of the FSAP would continue to be voluntary.**¹⁹ They may be included in the mandatory financial stability assessment, as necessary, on a voluntary basis, as is the case at present. Similarly, additional elements currently covered in voluntary FSAPs, notably assessments of developmental needs, would continue to be conducted upon request and subject to resource constraints (see section below on cooperation with the World Bank).

32. **Financial stability assessments conducted as part of surveillance would require the same access to data typically provided in voluntary FSAPs.** Adequate coverage of the three core elements may require access to information typically not provided to Article IV missions but made regularly available to FSAP teams, such as selected data on individual financial institutions or supervisory data, which are often confidential. Also, arriving at an assessment of the quality of supervision in the country would normally require a careful

¹⁸ See [Financial Sector Assessment Program After Ten Years—Experience and Reforms for the Next Decade](#) (September 2009).

¹⁹ As is the case with the financial stability modules under the FSAP on which the mandatory financial stability assessments are based, there would be no requirement that a full AML/CFT assessment be conducted in the context of a mandatory financial stability assessment (see [Financial Sector Assessment Program After Ten Years—Experience and Reforms for the Next Decade](#) (September 2009), page 32, footnote 14). Issues related to the conduct of AML/CFT assessments will be discussed in the forthcoming Board paper on the Fund’s AML/CFT policy.

Box 1. The Elements of a Mandatory Financial Stability Assessment

A mandatory financial stability assessment would comprise the three core elements of identified in the 2009 Board review of the FSAP.

- ***An evaluation of the source, probability, and potential impact of the main risks to macro-financial stability in the near term.*** This involves analyzing the structure and soundness of the financial system; salient trends in both the financial and nonfinancial sectors; risk transmission channels (such as macro-financial linkages and feedback loops); and features of the overall policy framework that may attenuate or amplify financial stability risks (e.g., exchange rate regime). Both quantitative analysis (Financial Soundness Indicators, stress tests) and qualitative assessments (of the regulatory structure, relationship between supervisors, supervisory approach and governance) would be used to estimate the severity of risks and rank them according to the likelihood of occurrence and their potential impact.
- ***An assessment of the authorities' financial stability policy framework.*** This involves an evaluation of the effectiveness of financial sector supervision against broadly accepted international standards and best practices; the quality of financial stability analysis and reports; the role of and coordination between the various institutions involved in financial stability policy (with special emphasis on the central bank); and the effectiveness of monetary policy.
- ***An assessment of the authorities' capacity to manage and resolve a financial crisis should the risks materialize.*** This involves an overview of the country's liquidity management framework (instruments, collateral policies); financial safety nets (deposit insurance, lender-of-last-resort arrangements); crisis preparedness and crisis resolution frameworks (bank resolution); and the possible spillovers from the financial sector onto the sovereign balance sheet.

examination of a sample of supervisory reports. Article VIII, Section 5 requires members, subject to certain limitations, to provide the Fund with such information as the Fund deems necessary for its activities, including surveillance. However, members are under no obligation to provide the Fund with information in such detail as to disclose the affairs of individuals or corporations. As a result, it would be important to reach understandings with the relevant authorities to obtain access to firm-specific data on a voluntary basis without violating banking secrecy or other laws. As the experience with FSAPs has shown, in the vast majority of jurisdictions this is possible by, e.g., providing the institution-by-institution data in an anonymized form, having the supervisory authorities conduct the stress testing exercise on the basis of specific assumptions and parameters provided by the staff, or providing access to supervisory reports on a confidential basis ("reading room only"). As with Article IV consultation reports, FSSAs would include an assessment of the adequacy of the data for the purposes of the financial stability assessment, and point out explicitly any limitations of the analysis due to lack or poor quality of data.²⁰

²⁰ In the context of Article IV surveillance, members provide the Fund with a great deal of information on a voluntary basis in addition to the information that they are legally required to report under Article VIII,

(continued)

Frequency

33. **The “right” frequency for financial stability assessments has to be a balance of different considerations.** Financial stability assessments should in principle take place as frequently as needed in order to provide timely input to surveillance and minimize the probability of vulnerabilities or threats to financial stability growing undetected. At the same time, since these assessments have resource costs both for the country and for the Fund, their frequency should be determined so as to ensure the most effective use of Fund financial and staff resources.

34. **While it is not easy to determine the optimal frequency of financial stability assessments from first principles, three years seems a reasonable target.*** This judgment is based on a review of early warning frameworks used by supervisors for specific institutions, systemic crisis prediction models, and the history of financial crises, which suggest that three years would be an appropriate frequency for regular in-depth assessments of financial stability. In addition, this frequency would allow sufficient time to the authorities to evaluate and implement the related policy recommendations. For a more detailed discussion of the points summarized below, see the accompanying Background Paper.

35. **Early warning models for identifying financial distress in individual financial institutions have a typical lead time in the range of a few months to three years.** National supervisory authorities use various early warning models, including CAMELS ratings, market-based indicators and others, to identify weak institutions and take preventive action. The experience suggests that an assessment window of no more than three years may be needed for such an exercise to identify vulnerabilities with reasonable accuracy and provide sufficient advance warning for effective action.

36. **The early warning literature on systemic crises suggests a somewhat lower frequency.** The vulnerabilities assessed in systemic crisis models are primarily of a macro-financial nature and, as such, likely to have longer gestation periods. These models typically use annual data of cross-country systemic crises and strive to identify emerging vulnerabilities one to five years prior to the crisis. For instance, the IMF’s empirical model of financial crises used in the Vulnerability Exercise is built on both medium-term indicators over the latest five years and near-term indicators over the past one year (including

Section 5. The Fund has, pursuant to Article VIII, Section 5, adopted a decision that obligates members to report certain types of information for the purposes of surveillance (See [Strengthening the Effectiveness of Article VIII, Section 5](#), Decision No. 13183-(04/10), adopted January 30, 2004, as amended). It is not proposed, for the purposes of mandatory financial stability assessments, to expand this list. Rather, the Fund would normally obtain such additional information as needed on a voluntary basis from members.

* The Executive Board did not agree with the proposed frequency for the assessments, and instead endorsed targeting a frequency of every five years. See [Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance—Revised Proposed Decision](#).

macroeconomic and bank/household/corporate indicators and asset price acceleration measures). Therefore, this strand of literature seems to suggest that a five-year window is an acceptable upper bound for the optimal time horizon for macro-financial stability analysis. It should be noted, however, that the predictive performance of these models is relatively poor, at least compared to early warning models for financial distress of individual institutions using higher frequency data.

37. The literature on the history of financial crises does not provide any guidance for the optimal frequency of financial stability assessments, but suggests the need for more frequent assessments when the system is undergoing structural change or innovation. Over the last several centuries, major financial crises have taken place years or even decades apart. The frequency of crises has increased in recent decades, especially since the 1980s. However, the pattern of crises suggests higher risks and a more rapid accumulation of vulnerabilities during periods of structural change, major innovation, and deregulation.

Integration with Article IV Consultations

38. A mandatory financial stability assessment would be part of the Article IV consultation with the relevant member. While the mandatory financial stability assessment and the Article IV consultation mission would typically take place at different times, as at present, it would be expected that the financial stability assessment would be part of the Article IV process and discussed in an Executive Board discussion of an Article IV report for the member.

39. The operational procedures for the mandatory financial stability assessments would be largely the same as for the voluntary assessments in the context of the FSAP. Documentary outputs of the mandatory financial stability assessments would be the same as in the case of voluntary stability assessments conducted under the FSAP. As with regular FSAPs, the key findings and recommendations of financial stability assessments would be summarized in a *Financial System Stability Assessment* (FSSA) report, which would normally be issued to the Board alongside the Article IV staff report. Moreover, the relevant Article IV report would integrate into the staff assessment the principal findings of the mandatory financial stability assessment. The FSSA would include the Risk Assessment Matrix, introduced in the 2009 review of the program. As with the voluntary FSAP missions, the team would normally draft and leave with the authorities an Aide-Mémoire, a confidential document that forms the basis of the FSSA. The mission could also produce technical notes (to provide further detail on technical issues to the country authorities) and detailed assessment reports on the observance of standards and codes (if assessments of compliance with standards and codes were carried out on a voluntary basis). Publication policies and procedures for the FSSA and other documents produced under the mandatory financial stability assessments would be the same as those for the FSAP currently.

40. **In addition, a number of operational changes would be implemented to integrate more closely the proposed mandatory assessments into Article IV consultations.**

- MCM and Area Departments would endeavor to increase the overlap between financial stability assessment and Article IV teams. This could involve fielding the two missions simultaneously or having the Area Department mission chief lead the financial stability assessment, if appropriate.
- Area Departments would strengthen their follow up of financial stability assessments and embed their findings and recommendations into the Article IV process in the period between such assessments. The inter-departmental review process would play a critical role in ensuring that the increased frequency of these stability assessments is reflected in expanded coverage of financial sector issues in Article IV consultations.

Coordination with the World Bank

41. **The World Bank is providing important input to financial sector assessments in developing and emerging market countries.** In these cases, the Bank's staff's primary contribution is the financial development assessment, and FSAP missions can take place jointly with the Fund. Developmental assessments focus on the medium- to long-term needs for the deepening and strengthening of the financial sector, aiming to address major weaknesses affecting the sector's efficiency, soundness, and contribution to long-term growth and social development. This perspective is an important complement to the financial stability assessment conducted by the Fund, regardless of whether the latter is done at the authorities' request or as part of Article IV surveillance.

42. **Making financial stability assessments part of Article IV surveillance would not materially affect the status of the FSAP as a joint program with the World Bank, provided the necessary resources are made available.** *First*, this change will only affect a small subset of developing and emerging market countries, where the program is conducted jointly with the Bank: of the 25 jurisdictions judged to have systemically important financial sectors on the basis of the selection criteria discussed above (Table 1), only a handful would be developing and emerging market countries. Even if this number were to grow in the future as these financial sectors develop—and the selection criteria evolve—it is likely to represent a fraction of this group of countries. And *second*, even in the relatively few developing and emerging market countries that would be subject to mandatory financial stability assessments, the Bank's role would remain unchanged.

- ***The developmental assessment of the financial sector will continue to be a voluntary component of the FSAP in these countries.*** As at present, the authorities will have the opportunity to request a financial development assessment from the World Bank, regardless of whether the financial stability assessment under the FSAP continues to be voluntary or has become mandatory for some of them. Requests for voluntary assessments will be prioritized on the basis of the criteria already established by the two Boards.

- ***There would be no substantive difference in the delivery modalities of FSAPs.*** Initial FSAP assessments, where financial stability and development aspects are examined simultaneously, would continue to be conducted jointly in countries where the Bank is involved. FSAP updates in countries where the financial stability assessment is mandatory could be conducted jointly if (i) the country had requested a developmental assessment, or (ii) a joint FSAP assessment was overdue.

43. **The Financial Sector Liaison Committee (FSLC) will continue to play a coordinating role.** The FSLC, a joint committee of Bank and Fund senior staff created in 1998, has as its core mandate the facilitation and administration of the FSAP in countries where assessments are conducted jointly.²¹ Its role was elevated by the last Board review of the FSAP to ensure a strong and effective coordination mechanism while minimizing additional bureaucratic procedures. FLSC will continue to ensure continuous information flow between the two institutions and consistency of financial sector advice in developing and emerging market countries, regardless of whether some of these have to undertake financial stability assessments as part of Article IV surveillance.

Resource Requirements

44. **The proposal to make regular financial stability assessments mandatory for members with systemically important financial sectors would add to the already considerable resource demands on the FSAP.** Even without the proposed changes, the program is facing unprecedented demand, primarily reflecting the G-20 and FSB countries' commitment to the process (FSB members, which include all the G-20 countries, have voluntarily pledged to request assessments under the FSAP every five years).²² Initial assessments for Indonesia, China, and the United States will be completed in FY2011, leaving Argentina as the only G-20 member without an FSAP assessment. Increasing the frequency of financial stability assessments that are done as part of surveillance in countries with systemically important financial sectors would require additional resources. Absent these, it would entail a sharp reduction in the Fund's capacity to deliver FSAP assessments to the rest of the membership on a voluntary basis.

45. **The estimated incremental resource cost of mandatory financial stability assessments in members with systemically important financial sectors is based on the assumption that the Fund will maintain its present capacity to deliver FSAPs to the rest of the membership.** This would involve *first*, ensuring adequate resources to meet current G-20/FSB country commitments to undertake FSAPs every five years; and *second*, increasing the envelope to accommodate the higher frequency of mandatory financial

²¹ [The Financial Sector Assessment Program After Ten Years—Experience and Reforms for the Next Decade](#) (September 2009), Appendix V.

²²See "[Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of the Financial Stability Board to G20 Leaders](#)," June 18, 2010.

stability assessments. This calculation takes into account the fact that FSAP assessments in members with systemically important financial sectors are more resource-intensive than others: as Table 2 shows, based on actual data for FY2008–2010, the average cost of an FSAP update in G-20/FSB jurisdictions was more than twice that of other members.

Table 2. FSAP Average Costs, FY2008–2010

	FY08-FY10		
	Total	Initial	Updates
	(Thousands of U.S. dollars)		
Total average annual cost (Fund only)¹	7,036	2,913	4,123
Countries with systemically important financial sectors (incl. G20/FSB)	1,922	1,167	754
<i>of which: G20/FSB</i>	1,828	1,167	660
All other countries ¹	5,115	1,746	3,368
All other countries, excluding OFCs	4,906	1,537	3,368
Average cost of an individual FSAP (Fund only)	335	380	309
Countries with systemically important financial sectors (incl. G20/FSB)	961	1,751	660
<i>of which: G20/FSB</i>	1,097	1,751	660
All other countries ¹	269	249	281
All other countries, excluding OFCs	283	288	281

Source: Staff calculations.

1/Includes the cost of assessments of offshore financial centers (OFCs), which were incorporated into the FSAP program in 2008.

46. **On this assumption, the overall resource envelope for the program would have to be increased by about US\$2.8 million from the baseline.** The average annual cost of the program for the Fund (including staff resources, travel, and headquarters-based review and support) during FY2008–2010 was just over US\$7 million (Table 3). This covered around 21 FSAPs—some of them joint with the World Bank—most of which, however, were not in systemically important countries. Starting last year, demand for assessments in G-20 countries increased substantially, raising both the number of assessments and their average cost. To meet the demand for assessments every five years from G-20/FSB countries without reducing the number of FSAPs in non-G-20 countries would require an additional US\$1.2 million at steady state (column “baseline” in Table 3). Increasing the frequency of assessments for 25 jurisdictions with systemically important financial sectors to a three-year cycle would imply undertaking eight to nine mandatory financial stability assessments every year.* However, as some of these would take place anyway in the context of voluntary

* The Executive Board did not agree with the proposed frequency for the assessments, and instead endorsed targeting a frequency of every five years. See [Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance—Revised Proposed Decision](#).

FSAPs in baseline scenario, the net increase in resource demands is estimated at about US\$2.8 million compared to baseline, or about US\$4 million relative to the average annual cost of the program during FY2008–2010.

47. **Historical figures may, if anything, underestimate the cost of financial sector surveillance, including mandatory financial stability assessments, going forward.** The renewed emphasis by the G-20 and the FSB on compliance with international financial sector standards and codes may well result in greater demand for standards assessments by members, both in FSAPs undertaken voluntarily and in mandatory financial stability assessments. The historical costs used in these calculations, however, reflect the low number of financial sector ROSCs included in recent FSAPs (on average, less than one ROSC per FSAP).

Table 3. Estimated Resource Impact of Mandatory Financial Stability Assessments

	FY08-FY10 Average ¹	Baseline scenario ²	With mandatory stability assessments ³
Average number of FSAPs	21	23 - 24	27 - 28
Countries with systemically important financial sectors (incl. G20/FSB)	2	4 - 5	8 - 9
<i>of which: G20/FSB</i>	2	4 - 5	5 - 7
All other countries	19	19	19
		(in millions of US\$)	
Fund Costs of FSAPs	7.0	8.2	11.0
Countries with systemically important financial sectors (incl. G20/FSB)	1.9	2.9	5.7
<i>of which: G20/FSB</i>	1.8	2.9	4.0
All other countries ⁴	5.1	5.3	5.3

Source: Staff estimates.

1/ Numbers are rounded.

2/ Assumes G20/FSB countries have FSAP updates every 5 years, and all other countries have updates at the current update frequency of every 6-7 years.

The cost of each additional FSAP update of a country with a systemically important financial sector is set at the average of a G20 FSAP update cost.

3/ Assumes that countries with systemically important financial sectors have stability assessments every 3 years, and all other countries have FSAP updates at the current frequency of every 6-7 years. The cost of each mandatory stability assessment is set at the average of a G20 FSAP update cost.

4/ Projected costs based on the average cost of an FSAP update in countries with non-systemically important financial sectors excluding OFCs.

48. **In the absence of these additional resources, mandatory financial stability assessments would have to take place at the expense of the countries requesting FSAPs on a voluntary basis.** In case the resource envelope for the program remained unchanged at the level of the FY2008–2010 annual average, conducting financial stability assessments in the countries with systemically important financial sectors every three years—which would now be mandatory also for the Fund—would imply reducing the number of voluntary FSAPs

the Fund could deliver by almost half.* While the Bank could be expected to absorb some of the demand in developing countries, the two institutions have different areas of focus and expertise, so the room for substitution would be limited: as a result, the joint operation of voluntary FSAPs with the World Bank in these countries would be affected. And even this option would not be available to advanced economies without systemically important financial sectors, where FSAPs are the responsibility of the Fund alone.

III. KEY FEATURES OF THE PROPOSED DECISION*

49. **A proposed Decision setting out the framework for the conduct of mandatory financial stability assessments is appended.** As noted above, this framework seeks to ensure that members are chosen for mandatory financial stability assessments and that these assessments are conducted in a manner that respects the principle of uniformity of treatment. The Decision seeks to address several important questions, including the following.

- **Who will decide whether a member’s financial sector is systemically important?**
The proposed Decision provides that the Managing Director would, in consultation with the Executive Board, determine whether the financial sector of a member is systemically important on the basis of the criteria set out above. An assessment of the systemic importance of members’ financial systems would be made for this purpose at least every three years.*
- **How frequently will mandatory financial stability assessments be conducted?**
The proposed Decision provides that such assessments would be conducted every three years for so long as the member’s financial sector is determined to be systemically important.* Moreover, the Decision establishes a system of periodicity that would seek to align the conduct of financial stability assessments with the Article IV consultation process with the relevant member. Thus, it clarifies that, after a member’s financial sector has been determined by the Managing Director to be systemically important, (i) the first mandatory financial stability assessment would be expected to be completed (i.e., discussed by the Executive Board) by the deadline for completion of the first Article IV consultation with the member that follows the third

* The Executive Board did not agree with the proposed frequency for the assessments, and instead endorsed targeting a frequency of every five years. See [Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance—Revised Proposed Decision](#).

* The Executive Board did not agree with the proposed frequency for the assessments, and instead endorsed targeting a frequency of every five years. See [Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance—Revised Proposed Decision](#).

anniversary of the Managing Director's determination,²³ and (ii) subsequent assessments would be expected to be completed by the deadline for completion of the first Article IV consultation with the member that follows the third anniversary of the date of completion of the previous financial stability assessment with the member.²⁴ As is the case with deadlines for Article IV consultations, it would be possible to complete a financial stability assessment sooner if deemed appropriate.

- **What would happen if the three-year periodicity were not respected?*** Following the approach currently taken with respect to Article IV consultations, this periodicity would be expressed in terms of an “expectation” rather than an obligation, and the three-year cycle would thus be applied with some flexibility. A member that failed to engage in the conduct of a mandatory financial stability assessment or to provide the information requested by the Fund would be subject to the existing legal framework applicable to members' obligations with respect to Article IV. To the extent that the three-year cycle were not adhered to with respect to a particular member, the Executive Board would be informed of the reasons for the delay.²⁵
- **When will the framework for mandatory financial stability assessments be reviewed?** It would be expected that the Decision would be reviewed in light of experience after the first round of mandatory assessments is completed and, in any event, within four years of the Decision's adoption.*

²³ The determination of the expected date of completion for an Article IV consultation with a member would take into account any grace period that applies under Fund surveillance policy.

²⁴ With respect to financial stability assessments for territories of members, the expected date of the Executive Board discussion would be based on the expected date of the Executive Board discussion of the relevant Article IV report respecting the territory.

²⁵ The Executive Board will, in the coming months, consider a paper on the obligation of members to consult with the Fund under Article IV and, in particular, the advisability of making members' adherence to Article IV consultations cycles obligatory at least in some circumstances. Pending that discussion, it is proposed that the periodicity of mandatory financial stability assessments be expressed in terms of “expectations” in a manner that is similar to the approach taken with respect to Article IV consultations more generally.

PROPOSED DECISION*

*The Executive Board did not adopt this proposed decision, but endorsed a revised proposed decision (see Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance—Revised Proposed Decision). The Decision adopted by the Executive Board provides for targeting financial stability assessments at a frequency of every five years. Moreover, it provides that both the Decision and the list of systemically important members will be reviewed within five years of adoption of the Decision and at similar intervals thereafter. At the same time, the Decision may be reviewed at any time to take into account major advances in availability of data and in the development of methodologies for assessing the systemic importance of financial sectors. The Decision no longer includes provision on the reporting of information under Article VIII, Section 5 set out in paragraph 10. The Decision also stipulates that a financial stability assessment will be conducted and the FSSA resulting from assessment will be discussed by the Executive Board by no later than the first deadline for completion of Article IV consultation with the member or a territory of a member that follows the fifth anniversary of such determination.

The following Decision, which may be adopted by a majority of votes cast, is proposed for adoption by the Executive Board.

This Decision sets out the scope and modalities of bilateral surveillance over the financial sector policies of members with systemically important financial sectors in accordance with Article IV, Sections 3 (a) and (b) of the Fund's Articles and the Fund's Decision on Bilateral Surveillance over Members' Policies – 2007 Decision (Decision No. 13919-(07/51), adopted June 15, 2007 (the "2007 Surveillance Decision").

Introduction

1. Article IV, Section 1 of the Fund's Articles requires each member to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates" ("systemic stability"). Recognizing the important impact that a member's domestic economic and financial policies can have on systemic stability, Article IV, Sections 1(i) and (ii) establish obligations for members respecting the conduct of these policies, including their financial sector policies.

2. In accordance with the framework set out in Article IV, the *2007 Surveillance Decision* provides that systemic stability is most effectively achieved by each member adopting policies that promote its own “external stability” – that is, a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. In the conduct of their domestic economic and financial policies, members are considered to be promoting external stability when they are promoting their own domestic stability – that is, when they comply with the obligations of Article IV, Sections 1 (i) and (ii) of the Fund’s Articles. For this purpose, the *2007 Surveillance Decision* requires the Fund’s bilateral surveillance to assess, in particular, whether a member’s domestic policies are directed towards domestic stability. It provides that “financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects)” will always be the subject of the Fund’s bilateral surveillance with respect to each member.
3. While an examination of members’ financial sector policies is important in all cases of bilateral surveillance, the Fund decides that, taking into account the framework described above and the overall purpose of surveillance, heightened scrutiny should be given in bilateral surveillance to the financial sector policies of those members whose financial sectors are systemically important, given the risk that domestic and external instability in such countries will lead to particularly disruptive exchange rate movements and undermine systemic stability. As financial stability assessments are a key tool for assessing members’ financial vulnerabilities and financial sector policies, it is appropriate that financial stability assessments be conducted with such members as provided for in this Decision.
4. This Decision does not impose new obligations on members or, in particular, modify the scope of their obligations under Article IV, Section 1. The Fund, in its bilateral

surveillance, will continue to assess whether a member's domestic economic and financial policies are directed toward the promotion of domestic stability.

Scope and modalities of financial stability assessments

5. **Determination of systemic importance.** The Managing Director, in consultation with the Executive Board, will identify those members that have systemically important financial sectors. This determination will be made at least every three years, will be based on an assessment of the size and interconnectedness of members' financial sectors as contemplated in paragraphs 23 to 26 in SM/10/235.

6. **Financial stability assessments.** Where the financial sector of a member is determined to be systematically important pursuant to paragraph 5 of this Decision, the member shall engage in a financial stability assessment in the context of bilateral surveillance under Article IV of the Fund's Articles in accordance with the terms of this Decision. For this purpose, the member shall consult with the Fund and the authorities of the member shall make themselves available for discussions with Fund staff of the issues that fall within paragraph 7 of this Decision.

7. **Scope of financial stability assessments.** The financial stability assessments undertaken under this Decision will consist of the following elements:

- a. **An evaluation of the source, probability, and potential impact of the main risks to macro-financial stability in the near-term for the relevant financial sector.** Such an evaluation will involve: an analysis of the structure and soundness of the financial system; trends in both the financial and non-financial sectors; risk transmission channels; and features of the overall policy framework that may

attenuate or amplify financial stability risks (such as the exchange rate regime).

Both quantitative analysis (such as balance sheet indicators and stress tests) and qualitative assessments will be used to evaluate the risks to macro-financial stability.

- b. **An assessment of the authorities' financial stability policy framework.** Such an assessment will involve: an evaluation of the effectiveness of financial sector supervision; the quality of financial stability analysis and reports; the role of and coordination between the various institutions involved in financial stability policy; and the effectiveness of monetary policy.
- c. **An assessment of the authorities' capacity to manage and resolve a financial crisis should the risks materialize.** Such an assessment will involve an overview of the country's liquidity management framework; financial safety nets (such as deposit insurance and lender-of-last-resort arrangements); crisis preparedness and crisis resolution frameworks; and the possible spillovers from the financial sector onto the sovereign balance sheet.

8. **Modalities of assessments.** The key findings and recommendations of a financial stability assessment under this Decision will be summarized in a Financial System Stability Assessment Report (FSSA) that will normally be discussed by the Executive Board at the same time as the relevant Article IV consultation report.

9. **Frequency.** Where the financial sector of a member is determined to be systemically important pursuant to this Decision, it will be expected that a financial stability assessment will be conducted and the FSSA resulting from such an assessment will be discussed by the

Executive Board by no later than the third anniversary of the expected date of completion of the first Article IV consultation with the member that follows such a determination or, in the case of the financial sector of a territory of a member, the third anniversary of the expected date of completion of the first Article IV consultation discussion with respect to that territory by the Executive Board that follows such a determination. It is expected that subsequent FSSAs for a member with a systemically important financial sector will be discussed by the Executive Board by no later than the expected date of completion of the first Article IV consultation with that member that follows the third anniversary of the date of completion of the previous Executive Board discussion of the FSSA respecting that member or, in the case of the financial sector of a territory of a member, the expected date of completion of the first Article IV consultation discussion with respect to that territory by the Executive Board that follows the third anniversary of the date of completion of the previous Executive Board discussion of the FSSA respecting the financial sector of that territory.

10. **Provision of information.** Under Article VIII, Section 5, the Fund may, subject to certain limitations, require members to provide the Fund with information it deems necessary for the conduct of a financial stability assessment. While members are under no obligation to provide information in such detail that the affairs of individuals or corporations are disclosed, the Fund may obtain such information by agreement with members, with due regard to the confidentiality of such data.

Miscellaneous

11. **Review.** The Fund will review this Decision no later than four years following the date of its adoption. In particular, as “systemic importance” is a dynamic concept, the Fund

will review and revise, as necessary, the criteria for determining members with systemically important financial sectors.