

Chapter 1

Financial Sector Assessments: Overall Framework and Executive Summary

1.1. Introduction

The design of policies to foster financial system stability and development has become a key area of focus among policy makers globally. This policy focus reflects the growing evidence that financial sector development can spur economic growth whereas financial instability can significantly harm growth and cause major disruptions, as was seen in the financial crises of the 1980s and 1990s (World Bank 2001). This focus also reflects the recognition that close two-way linkages between financial sector soundness and performance, on the one hand, and macroeconomic and real sector developments, on the other hand, need to be considered when designing macroeconomic and financial policies. Moreover, although the development and international integration of financial systems can strengthen access to foreign capital and can promote economic growth, there is a risk of cross-border spillovers of financial system disturbances. Effective surveillance of national financial systems, along with a harmonization and international convergence of key components of financial policies, will help minimize those types of risks and will promote orderly development of the financial system. Thus, financial stability considerations and financial sector development policies are intrinsically interlinked.

Recognizing the need for stronger policies to foster financial stability and development, several entities around the world, including national authorities, multilateral development agencies, regional development institutions, and various standard-setting bodies are focusing on further developing the tools and methodologies of financial sector analysis and assessments. The purposes of those tools have been to monitor financial system soundness and developments, to analyze the linkages between the financial sector and the macro-economy, to assess the effectiveness of various aspects of monetary and financial policies, and to pro-

Box 1.1 Financial Sector Assessment Program (FSAP)—A Chronology

The program was developed by the World Bank and the International Monetary Fund to help strengthen financial systems in the context of IMF's bilateral surveillance and World Bank's Financial Sector development work. In consultation with the Bank's regions and the Fund's area departments, the World Bank–Fund Financial Sector Liaison Committee (FSLC)^a coordinated the initial development of the program and later has helped manage the program. The FSLC has held several outreach meetings on FSAP with concerned country authorities and sought regular feedback on the program from participating countries to adapt the program to country needs and to use the feedback as input into various Board reviews of the programs.

Pilot program launch on May 1999. The managements of the Bank and the Fund inform the Boards that they have decided to launch jointly, on a pilot basis, the IMF–World Bank Financial Sector Assessment Program.

Interim Board discussion of the pilot program, September 1999. Bank and Fund Boards discussed an interim report on FSAP summarizing the early experience of the pilot. Directors provided guidance on scope and procedures of the pilot. The International Monetary and Financial Committee and Development Committee express support for the program in their fall 1999 communiqués.

Comprehensive Board review of the pilot, March 2000. Bank and Fund Boards conducted a comprehensive review of the progress and lessons of the FSAP pilot. Both Boards agreed to continue and expand the program and provided preliminary guidance on how to develop further the FSAP. Guidance covered the scope and pace of the program, links to IMF surveillance and technical assistance, relationship to assessments of standards, confidentiality considerations, and publication and circulation procedures.

Program update, September 2000, and a joint technical briefing on FSAP to both Boards, December 7, 2000. An update of the program was provided to both Boards. The co-chairs of FSLC provided a joint technical briefing for Bank and Fund Boards on the procedures and progress of the program in preparation for a comprehensive program review.

First review of FSAP, December 13, 2000 (Fund), and January 2001 (Bank). Bank and Fund Boards conducted a review of experience with the FSAP and established guidelines for the continuation of the FSAP program for the period ahead; sought priority for systemically important countries in any one year while maintaining broad country coverage; affirmed the value of the Financial System Stability Assessment (FSSA) reports prepared by the FSAP teams as “the preferred tool for strengthening the monitoring of financial systems under the Fund's bilateral surveillance”; and suggested that Bank and Fund staff members should ensure that FSAP assessments are reflected in other aspects of country programming, including appropriate technical assistance.

Second review of FSAP, March–April 2003. Bank and Fund Boards conducted a comprehensive review of the FSAP and provided guidance in streamlining the program; achieving greater selectivity and flexibility in the scope and pace of the program; broadening the range of tools of financial sector surveillance that complement FSAP; increasing the focus on medium-term and structural issues in low-income countries, with a greater role for the World Bank in those countries; and including the anti-money-laundering and combating the financing of terrorism (AML–CFT) assessments in all FSAPs.

Third review of FSAP, February–March 2005. Bank and Fund Boards reviewed the developments in the program since the last review, acknowledged the value of the program, and broadly endorsed the ongoing efforts to strengthen and refine the program, pending the upcoming further reviews of the FSAP by the Fund's Independent Evaluation Office, and the Bank's Operations Evaluation Department, whose recommendations will be considered by the Boards later.

Many Bank–Fund documents relating to the FSAP are available on the Web sites of the IMF (<http://www.imf.org/external/np/fsap/fsap.asp>) and of the World Bank (<http://www.worldbank.org/finance/fsap.html>). For details on the March 2005 review of the FSAP by the Bank and the Fund Boards of Directors, see IMF and World Bank 2005.

a. The World Bank–Fund Financial Sector Liaison Committee was established in September 1998 by the Boards of the two institutions to improve coordination of Bank and Fund operations related to financial sector stability and development. Among other things, the FSLC helps to coordinate country selection for FSAPs, organizes Bank–Fund teams for FSAPs, and builds consensus on various procedural and policy matters related to financial sector assessment. The activities of the FSLC are reported in periodic progress reports. The FSLC has issued guidance on various FSAP procedures.

mote harmonization and international convergence of key financial policy areas. Those developments have increased the demand for guidance on good practices in conducting financial sector assessments and in designing appropriate policy responses.

In response, this Handbook presents a general analytical framework as well as specific techniques and methodologies for assessing the overall stability and development needs of financial systems in individual countries and for designing policy responses. The stability and state of development of a financial system depend on a broad range of structural, institutional, and policy factors that operate through two channels. First, they affect the attitude of the private sector toward risk taking, the scope and reach of financial services, and the quality of financial sector governance. Second, they influence the effectiveness of financial policies in fostering sound and well-functioning financial institutions and markets. Those considerations are reflected in the organization of the Handbook, which is explained more fully in section 1.2 below.

The Handbook draws particularly on the World Bank–IMF experience in conducting the Financial Sector Assessment Program (FSAP) and on the broader operational and policy development work on financial systems in both institutions. The World Bank and the IMF introduced the FSAP in May 1999 to monitor and help strengthen financial systems in the context of IMF's bilateral surveillance and of the World Bank's financial sector development work and has since become a regular part of Bank and Fund operations (see box 1.1 for a chronology of the FSAP). The FSAP has been built on a range of analytical techniques and assessment tools developed in the IMF, World Bank, Bank for International Settlements (BIS), international standard-setting bodies, and national authorities. Appendix A at the end of this Handbook presents an overview of the current procedures for conducting FSAPs, updates, and follow-up work, including the preparation of relevant Reports on Observance of Standards and Codes (ROSCs) in the financial sector.

A key purpose of this Handbook is to help country authorities to conduct their own assessments of the soundness, structure, and development needs of the financial system. It also can be useful for Bank-Fund teams preparing for FSAP assessments and for country authorities preparing for the Bank-Fund assessments under the FSAP. It is not an expert's handbook designed to provide detailed guidance to sectoral specialists. It is mainly designed to provide broad guidance on methodology and policy design to policy makers, team leaders, and specialists in one sector who are seeking background information on issues and topics in other related areas of assessment work. Detailed guidance for specialist assessors is available from standard-setting bodies and other sources that are referred to in the text.

1.2. Overall Analytical and Assessment Framework—Executive Summary

This section provides the overall analytical framework for financial sector assessments, motivates the structure of the Handbook in terms of this framework, explains how the subsequent chapters fit into the overall framework, and presents a high-level summary of those chapters as a broad guide to policy makers and assessment teams.

The objective of financial sector assessments is to achieve an integrated analysis of stability and development issues using a wide range of analytical tools and techniques that include the following:

- Macroprudential analysis, including stress testing, scenario analysis, and analysis of financial soundness indicators and of macrofinancial linkages
- Analysis of financial sector structure, including analysis of efficiency, competitiveness, concentration, liquidity, and access
- Assessment of observance and implementation of relevant international standards, codes, and good practices in the financial sector
- Analysis of specific stability and development issues tailored to country circumstances (e.g., role of public financial institutions, effect of dollarization, reasons for low access or underdeveloped securities markets, etc.)

A broad definition of financial stability and development is used in the assessments. Financial stability refers to (a) an environment that would prevent a large number of financial institutions from becoming insolvent and failing and (b) conditions that would avoid significant disruptions to the provision of key financial services such as deposits and investments for savers, loans and securities to investors, liquidity and payment services to both, risk diversification and insurance services, monitoring of the users of funds, and shaping of the corporate governance of non-financial firms. Financial development is a process of strengthening and diversifying the provision of those services to meet the requirements of economic agents in an effective and efficient manner and thereby support, as well as stimulate, economic growth. Such broad definitions imply that the extent of financial stability can vary from a situation of severe instability to one of sustained overall stability; similarly, the scope of financial development also can vary from being broad based and balanced, covering several financial sector functions and sectors, to being narrowly focused on a specific function or sector. Moreover, overall financial system development could be orderly, with smooth exit and entry of financial service providers and with limited or no interruptions to the provision of financial services and to the real economy, or it could be disorderly, marked by bouts of financial instability and real economic disruption.

The complementarities and tradeoffs between financial stability and development need to be carefully considered in the assessment process. Policies to foster financial stability also support orderly financial development, illustrating the fundamental complementarities between financial stability and development. Nevertheless, in specific contexts, the assessors have to weigh the benefits of stability policies in terms of increased soundness and containment of risks with the costs of regulatory compliance and with the possible side effects of prudential regulations on market functioning and access. Similarly, policies to foster financial development necessarily involve some increase in both macroeconomic and financial risks, which need to be managed. Thus, promoting an orderly process of financial development with stability necessarily involves a proper sequencing and coordination of a range of financial policies.

In line with the broad definitions, a sound and well-functioning financial system is viewed as comprising three pillars that make up the major policy and operational components that are necessary to support orderly financial development and sustained financial

stability; the three pillars outlined in the following list also constitute the basis of the assessment framework.

- **Pillar I**—Macroprudential surveillance and financial stability analysis by the authorities to monitor the impact of potential macroeconomic and institutional factors (both domestic and external) on the soundness (risks and vulnerabilities) and stability of financial systems
- **Pillar II**—Financial system supervision and regulation to help manage the risks and vulnerabilities, protect market integrity, and provide incentives for strong risk management and good governance of financial institutions.¹ Good practices in most areas of financial system supervision and regulation are reflected in various international standards and codes and the related assessment methodologies; for some areas of supervision and regulation such as microfinance institutions, agreed international standards do not yet exist.
- **Pillar III**—Financial system infrastructure:
 - Legal infrastructure for finance, including insolvency regime, creditor rights, and financial safety nets
 - Systemic liquidity infrastructure, including monetary and exchange operations; payments and securities settlement systems; and microstructure of money, exchange, and securities markets
 - Transparency, governance, and information infrastructure, including monetary and financial policy transparency, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements for financial and non-financial firms, and credit reporting systems

Those elements of financial system infrastructure constitute the preconditions for effective supervision and regulation that contribute to stability and serve as the foundations for adequate access to financial services and sustained financial development. Again, international standards and guidelines exist to highlight good practices in some areas of infrastructure design (e.g., payment and settlement systems, monetary and financial policy transparency) but not in other areas (e.g., deposit insurance, design of market microstructure).

Elements within all three pillars support both development and stability. The information base for the technical analysis needed for stability assessments and that which is needed for development assessments overlap and provide a common analytical platform for the prioritizing and sequencing of financial sector policy measures. The overall analytical framework for those assessments and the way it is reflected in the organization of the Handbook are described in the following paragraphs.

The first step in the assessment process outlined in the Handbook is to compile a set of key indicators of financial structure, soundness, and state of development of the sector. Chapter 2 provides guidance on key system-wide and sectoral indicators of structure and soundness, including core and encouraged financial soundness indicators (FSIs), market-based indicators of financial soundness, and indicators of access. Key data sources for those indicators are explained in appendix C. The precise scope and content of needed data will be country specific to reflect their structural and institutional circumstances.

Nevertheless, chapter 2 seeks to present and motivate some generally useful indicators; more-detailed listing of the sort of quantitative data that may be collected for financial sector assessments are shown in appendix B. Detailed analysis of and processes to determine benchmarks for those indicators is needed to assess financial stability and development. Chapters 3 and 4 form the core of the analytical framework needed for this kind of an integrated assessment, with all other chapters, in effect, providing the specific building blocks for the assessment.

Chapter 3 presents the overall framework of financial stability assessment, which consists of the analysis and assessment of financial sector soundness and its economic and institutional determinants. It encompasses not only quantitative analysis of risks and vulnerabilities but also qualitative assessments of the institutional capacity and financial infrastructure that help manage the risks. The quantitative analysis typically involves monitoring at a suitable level of aggregation; analyzing the economic and institutional determinants for a range of financial soundness indicators (FSIs) of banks, of key non-bank financial sectors, and of relevant non-financial sectors; and examining the impact of various plausible, but exceptional, macroeconomic and institutional shocks on the financial soundness indicators. This type of monitoring and analysis of FSIs—referred to as macroprudential surveillance—includes testing stress levels of the system in response to plausible shocks, which helps identify the key sources of risks and the vulnerabilities to various risk factors. Macroprudential surveillance also encompasses (a) a surveillance of financial markets that helps assess likelihood of economic shocks and (b) an analysis of macro-financial linkages that focuses on the extent to which shifts in financial soundness may itself affect macroeconomic and real sector developments. This combination of approaches captures the two-way linkages between the macroeconomy and financial soundness in formulating an overall stability assessment. In addition, analysis should consider the linkages of domestic financial markets to global markets and the extent to which government policies with respect to taxes, subsidies, monetary and exchange policy regime, and so forth generally affect market discipline and risk taking.

The above analysis should be complemented by information from qualitative assessments of effectiveness of financial sector supervision (Pillar II), and of the robustness of financial sector infrastructure (Pillar III). Such qualitative assessments help identify key elements of the institutional framework and financial stability policies that would mitigate the identified risks and vulnerabilities and thereby help formulate an overall financial stability assessment and identify key policies to foster stability. Chapter 3 motivates and explains the tools of quantitative analysis noted above, including system-wide stress testing of the financial system (elaborated in appendix D), and illustrates how qualitative information on financial supervision and infrastructure can complement the quantitative analysis.

Chapter 4 presents the overall framework for financial structure and development assessment. It consists of an assessment of the functioning of the financial sector, including its scope, concentration, efficiency, competition and adequacy of access, and its institutional and economic determinants. The chapter attempts to analyze the factors behind missing or underdeveloped services and markets, as well as the obstacles in the country that prevent the provision of a broad range of financial services. The goal is to identify policy adaptations and structural changes in financial infrastructure, in supervision and

regulation, in governance, and in the broader policy environment designed to strengthen the contribution of the financial sector to economic growth and poverty reduction. This type of assessment involves both quantitative analysis of financial structure and qualitative assessments of a range of institutional and financial policy factors affecting the structure and performance of the sector.

The analysis will typically consider many of the factors already covered under financial stability analysis, notably, the qualitative assessments of key legal and institutional features. However, the analysis will go beyond stability issues and focus on the breadth and efficiency of financial intermediation from a user perspective. Chapter 4 motivates and outlines the tools used in the quantitative benchmarking of financial structure and illustrates how developments in various dimensions of financial sector structure—efficiency, access, scope, and so forth—can be analyzed. The chapter also provides an overview of how those kinds of quantitative analysis can be combined with information from the qualitative assessments of legal and institutional infrastructure as well as from supervisory regimes to formulate an overall development assessment and identify policies to enhance financial development.

Key steps in an integrated analysis and assessment of stability and development can be summarized as follows:

1. *Assess conditions in the non-financial sector* by analyzing financial soundness indicators for those sectors and financial structure and access indicators.
2. *Assess macroeconomic, sectoral and tax-subsidy policies affecting financial stability and development* by analyzing macroeconomic forecasts, early warning indicators, financial market indicators, and tax and sectoral policy. This type of information typically would be drawn from other sources such as local and external official sources as well as data vendors and would help to form a view on the likelihood of shocks to the financial system from the broader economic environment and the way this environment affects financial sector structure and functioning.
3. *Assess financial system risks and vulnerabilities* (a) by analyzing FSIs for banks, insurance companies, the securities market, and key non-bank financial institutions (such as exposures to credit risk, market risk, liquidity risk, and operational risk as well as availability of capital, earnings, and liquid assets that can be used to absorb risk); (b) by monitoring market-based indicators; and (c) by conducting stress tests. The analysis in this step will draw on plausible shocks and linkages identified in steps 1 and 2 above.
4. *Assess financial sector structure and development needs, including its scope, competitiveness, and access*, by conducting quantitative benchmarking and analyzing structural indicators and the data on access (survey-based data, if available). The above analysis will take into account macroeconomic and sectoral conditions affecting financial development and access, drawing on analysis in steps 1 and 2 above.
5. *Assess legal and institutional frameworks and operational effectiveness of financial policies*, both financial supervision and financial infrastructure, including institutional and market development policies (Pillars II and III). This qualitative assessment feeds into step 3 to design policies to foster overall financial stability. This qualita-

tive assessment also feeds into step 4 to formulate a program of reforms to foster financial development.

Assessment of legal, institutional, and operational aspects of financial policies involves a wide range of tools, particularly, assessments of observance of international standards and codes as well as of good practices relevant to a stable and well-functioning financial sector. The Handbook provides an overview of the scope, assessment methodology, and assessment experience for those areas of financial supervision and financial infrastructure for which international standards, codes, and good practices exist. A list of international standards used in Bank-Fund operational work is listed in appendix A (box A.2) of the Handbook. For areas of financial policies and institutional design where international standards do not exist, the Handbook provides an assessment framework drawing on good practices identified in operational work and country experience. In some of the areas (e.g., public debt management, bank insolvency regimes, etc.), guidelines based on distillation of country experiences are available. The principles, methodology, and lessons of experience for assessing the legal, institutional, and operational frameworks are presented in chapters 5–11 of the Handbook, and are summarized in the following paragraphs.

Chapter 5 provides an overview describing the process for assessing the effectiveness of financial supervision and regulation of banking, insurance, and securities markets. The assessments are based on the Basel committee's Core Principles for Effective Banking Supervision (BCP); the International Association of Insurance Supervisors' Insurance Core Principles (ICP) and methodology; and the International Organization of Securities Commissions' Objectives and Principles of Securities Regulations.

Those supervisory standards consist of a set of core principles that can be grouped into four core components:

- *Regulatory governance*—relating to the objectives, independence, enforcement authority, and decision-making arrangements of the regulator
- *Regulatory practices*—consisting of practical application of laws, rules, and procedures
- *Prudential framework*—referring to rules and guidance on internal controls and governance of supervised entities
- *Financial integrity and safety net*—dealing with policies and instruments to promote fairness and integrity of operations of financial institutions and markets as well as safeguards of depositors, investors, and policy holders in times of stress and crises

Chapter 5 outlines the assessment methodology that provides detailed criteria—or practices—for each of the core principles. Those criteria can be compared with country practices to identify significant gaps, if any, in the supervisory regime and to assess the materiality of the gaps from a stability or development perspective. In addition, assessment of observance of each of the core principles will take into account the risk profile and sources of vulnerability of the sector as well as the robustness of infrastructure components (such as accounting and auditing, payments system, insolvency regime) that serve as preconditions for effective supervision. Chapter 5 also explains the basic coverage of legal and institutional frameworks for financial supervision and outlines key issues in designing institutional arrangements for supervision (see appendix F). Special attention is

paid to elements of financial safety nets consisting of liquidity support, deposit insurance and policyholder-investor's protection, and crisis management arrangements, including the bank insolvency regime (see appendix G). The chapter also summarizes the main areas of weakness identified in many recent assessments, for example, weak independence and weak legal protection for banking supervisors, weak organization of the supervisory agency and weak supervision of asset risk management in insurance, lack of authority to investigate and the limited enforcement mandate in securities regulation, and weak corporate governance of financial institutions.

Chapter 6 and chapter 7, respectively, discuss assessing regulatory frameworks for other financial institutions (specialized financial institutions and pension funds) and for rural and microfinance institutions. The sectoral and regional significance of many specialized financial institutions (such as housing finance, leasing and factoring companies) and the key role of pension funds in asset allocation and capital markets call for risk-focused and well-tailored regulation that is proportionate and consistent with costs and benefits. Those considerations and the special supervisory issues that arise in leasing, factoring, and pension fund industry are discussed in chapter 6. The provision of financial services to the poor and very poor, particularly those in rural areas, is the purpose of microfinance institutions (MFIs), and the assessment of the regulatory framework for MFIs is part of a broader assessment of adequacy of access. Chapter 7 explains the rationale and scope of regulation of various categories of MFIs as well as the elements of a regulatory framework that are consistent with the MFI functions, risk profile, and operational characteristics.

Chapter 8 considers issues in assessing financial system integrity based on the Financial Action Task Force's (FATF) recommendations for the anti-money-laundering and countering the financing of terrorism (AML–CFT) regime. This chapter covers the scope and coverage of AML–CFT standards, preconditions for effective implementation of those standards, the content of assessment methodology, recent assessment experience, and special topics in AML–CFT assessments such as customer due diligence, financial intelligence units, and scope of UN conventions and Security Council Resolutions.

Chapter 9 discusses key components of the legal infrastructure for the effective operation of financial markets. The legal framework for the financial sector is wide ranging, covering the overall governance and rule of law, laws governing financial infrastructure, and sector-specific laws. It includes the legal framework that empowers and governs the regulator and the rules for the regulation of various institutions and markets as well as the broader legal framework that governs insolvency and the creditor rights regime, ownership, contracts, contract enforcement, accounting auditing and disclosure, and formation of trusts and asset securitization. A review of the overall legal framework should cover both groups of laws. In particular, central banking law, legal foundations of payment system functioning, and government debt management should be reviewed together with the laws governing banking, insurance, and capital markets to ensure that a sound legal basis for macroeconomic policies is available to support stable financial markets. In addition, an overview of company laws, other corporate governance laws, consumer protection laws, and land laws are also important for good governance of financial institutions. Finally, the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights regime can help assess enforcement systems for secured and unsecured credit, leg-

islative procedures for liquidation and rescue (restructuring), procedures for debt recovery and informal workout practices, and mechanisms for carrying out legal procedures.

Chapter 10 contains an overview describing key components of information and governance infrastructure for finance and explains their role in both financial development and effective market discipline. Those infrastructure components refer to the legal and institutional arrangements that affect the quality, availability, and transparency of information on monetary and financial conditions and policies at various levels as well as the incentives and organizational structures to set and implement policies by regulators, regulated institutions, and their counterparts. The components of this infrastructure consist of the following:

- The framework for Monetary and Financial Policy Transparency, assessed using International Monetary Fund's *Code of Good Practices on Transparency of Monetary and Financial Policies* (chapter 10, section 10.1)
- The accounting and auditing framework that helps to define and validate the information that is disclosure, assessed according to *International Financial Reporting Standards and International Standards for Auditing* (chapter 10, section 10.2)
- Credit reporting and financial information services designed to compile, process, and share information on financial conditions and credit exposures of borrowers and other issuers of financial claims (chapter 10, section 10.3)
- Corporate governance arrangements for financial and non-financial firms, which are assessed according to Organisation for Economic Co-operation and Development (OECD)'s Principles of Corporate Governance and which take into account special considerations that apply to corporate governance of banks and other financial institutions (chapter 10, section 10.4)
- Disclosure practices of financial institutions, determined by the supervisory framework, listing requirements and company laws, which are assessed, in part, according to the disclosure standards under the New Basel Accord (chapter 10, section 10.5)

Chapter 11 presents a framework for assessing systemic liquidity infrastructure. This framework refers to a set of institutional and operational arrangements that have a first-order impact on market liquidity and on the efficiency and effectiveness of liquidity management by financial firms. Key elements of this infrastructure consist of the following:

- Design and operation of payments and settlement systems as well as securities settlement systems, which are assessed according to the Committee on Payment and Settlement Systems' (CPSS's) *Core Principles of Systemically Important Payment Systems*, and International Organization of Securities Commissions (IOSCO)–CPSS *Recommendations for Securities Settlement Systems* (chapter 11, section 11.1)
- Design of monetary policy instruments as well as procedures for money and exchange markets operations, which are analyzed from the perspective of their impact on money market liquidity and on banks' ability to manage short-term liquidity (chapter 11, section 11.2)

- Microstructure of money, exchange, and securities markets consisting of trading systems, price discovery mechanisms, and other institutional determinants of market liquidity and efficiency (chapter 11, section 11.3)
- Public debt and foreign exchange reserve management strategies and operations, which are analyzed according to IMF–World Bank *Public Debt Management Guidelines* and IMF's *Foreign Exchange Reserve Management Guidelines*; both guidelines are supplemented by supporting documents that summarize country experiences (chapter 11, section 11.4)

Chapter 12 provides guidance on sequencing of financial sector reforms. The subject of sequencing of reforms deals with factors that should be considered when setting priorities among a multitude of policy, institutional, and operational reforms that have been identified in a financial sector assessment exercise. Appropriate sequencing and coordination of reforms will facilitate implementation of reforms in support of financial development while avoiding financial instability that could arise from inappropriate sequencing. Thus, appropriate sequencing is an important aspect of financial sector assessments.

Although the assessment framework outlined above is comprehensive, a tailoring of assessments is necessary to reflect country-specific circumstances such as those mentioned in Annex 1.A. Countries with less developed systems will need more attention to medium-term development issues such as institution building and financial market development. Governance, transparency, and legal issues are often at the core of underdeveloped financial systems. In countries that are systemically important, particular attention to contagion and cross-border issues as well as the consequences of globalization and consolidation may be required. Countries also differ in structural features such as extent of dollarization, scope of state-owned financial institutions, the scale of foreign-owned banks, degree of vulnerability to shocks, and the level of market discipline and quality of internal governance. Those differences will affect the assessment priorities, design of policies, and the sequencing of reforms and policy measures.

Annex 1.A Tailoring Financial Sector Assessment to Country Needs

Countries with less-developed financial systems may need more attention with respect to medium-term development issues such as institution building and financial market development. Coverage of the financial sector in those countries may thus need to focus on specific aspects of financial sector development, including capacity of banking supervision; the legal and regulatory framework for bank and non-bank institutions and payment systems; credit information systems, enforcement of creditor rights, and insolvency regimes; accounting and auditing practices and disclosure rules; the status of the central bank and monetary policy implementation; and bank restructuring. Also, an analysis of factors explaining why markets are missing can help to identify the important structural and capacity building needs for the country.

Systemically important countries need attention to contagion and cross-border issues. Countries particularly vulnerable to a rapid increase in competition from foreign financial institutions may need particular attention with respect to (a) the appropriate sequencing of liberalization, including institutional preconditions, and (b) the ability of domestic

incumbents to withstand more intense competition. Of particular note are countries participating in new free-trade arrangements or undertaking substantive financial services commitments in the World Trade Organization. Those types of agreements may facilitate the cross-border provision of services or the establishment of subsidiaries and branches. Countries may commit to dispute settlement provisions and to constraints on their recourse to capital controls. In those cases, emphasis might be placed on (a) the capacity of the regulatory authorities to conduct cross-border consolidated supervision of financial institutions; (b) the conditions that might lead to an unsustainable buildup of short-term financial flows; (c) the dependence of local incumbents, including public service banks, on fee-based and large-customer business that may be particularly vulnerable to foreign competition; and (d) any systemic vulnerabilities that may result from their failure.

In many countries, dollarization poses unique financial risks that need to be addressed. Where available, assessors should provide supporting quantitative information such as shares of foreign currency deposits and loans, the degree of cocirculation, short-term foreign assets and liabilities of the main financial institutions, net foreign assets, and net open foreign currency positions of banks (Gulde and others 2003).

In non-crisis countries with significant financial distress where a large share of banks (or insurance companies or other financial institutions) are undercapitalized and underperforming, the assessors will have to focus on vulnerabilities to various plausible shocks and to resolution measures.² Vulnerabilities could be detected through stress testing and estimation of likely macroeconomic consequences. In case a macroeconomic shock were to occur, sufficiently rapid financial restructuring could avert a crisis. This reasoning suggests that the focus of assessment should be on measures to restore normalcy and implementation of resolution strategies, including contingency planning and structural reforms that could bolster the capacity for restructuring and liquidation of banks and non-banks. In cases such as those, FSIs would need to be carefully interpreted, possibly until exceptional resolution arrangements have run their course and normalcy has been fully restored (Hoelscher and Quintyn 2003).

In countries that are part of a currency union, assessors would have to be sensitive to the division of supervisory responsibility between the national and the supranational level (Van Beek and others 2000). In particular, supervisory responsibilities for financial institutions may reside at the national level with varying degrees of harmonization of rules and practices such as loan classification and provisioning as well as licensing and other entry requirements. The degree of control over cross-border transactions in relation to third countries may also differ. By contrast, monetary–exchange rate policy functions in those cases are performed at the supranational level, creating the potential for ambiguities about lender of last resort and crisis resolution arrangements.

In countries with significant presence of Institutions offering Islamic Financial Services (IIFS), assessors would need to consider whether the supervisory framework is adequately adapted to address the specific risk characteristics of IIFS. Risks in IIFS may differ from those in conventional finance because of the contractual design of instruments based on Islamic Law (*Sharia'a*), and the overall infrastructure governing Islamic finance. In the absence of adequate institutional infrastructure and effective risk mitigation, IIFS may be more vulnerable than conventional institutions for a range of risks (operational, liquidity, and market risk—including commodity prices). Where available and appropriate, assess-

sors should also provide quantitative information on the size of the industry; the share of Islamic modes of financing; and FSLs on capital, non-performing loans, provisioning, and earnings for Islamic banks. The definitions of those variables would need adjustments to reflect the specific accounting treatments of Islamic financial contracts. Although some guidance is available in the IMF's *Compilation Guide on Financial Soundness Indicators* (International Monetary Fund 2004), work in this area is evolving.

Notes

1. For the purposes of the Handbook, a narrow definition of market integrity is used mainly to cover anti-money-laundering initiatives and efforts to counter the financing of terrorism. A broader concept also will cover transparency and governance elements.

References and Other Sources

- Gulde, Anne-Marie, David S. Hoelscher, Ize Alain, David Marston, and Gianni De Nicola. 2003. *Financial Stability in Dollarized Economies*. IMF Occasional Paper 230. Washington, DC: International Monetary Fund.
- Hoelscher, David S., and Marc Quintyn. 2003. *Managing Systemic Banking Crises*. IMF Occasional Paper 224. Washington, DC: International Monetary Fund.
- IMF (International Monetary Fund). 2004. *Compilation Guide on Financial Soundness Indicators*. Washington, DC: International Monetary Fund. Available on the IMF external Web site: <http://www.imf.org/external/np/sta/fsi/eng/2004/guide/appendx.pdf>.
- IMF (International Monetary Fund), and World Bank. 2005. "Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward." Papers prepared for the IMF and World Bank Board Review. Washington, DC: International Monetary Fund. Available at <http://www.imf.org/External/np/fsap/2005/022205.htm>.
- Lindgren, Carl-Johan, Tomás J. T. Baliño, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie Teo. 2000. *Financial Sector Crisis and Restructuring—Lessons from Asia*. IMF Occasional Paper 188. Washington, DC: International Monetary Fund.
- Van Beek, Frits, José Roberto Rosales, Mayra Zermeno, Ruby Randall, and Jorge Sheph. 2000. *The Eastern Caribbean Currency Union-Institutions, Performance, and Policy Issues*. IMF Occasional Paper 195. Washington, DC: International Monetary Fund.
- World Bank. 2001. *Finance for Growth, Policy Choices in a Volatile World*. New York: Oxford University Press.

This page intentionally left blank