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The Financial Stability Assessment Framework of the IMF: Experience in Europe

Governor Liebscher, distinguished guests, ladies and gentlemen, good morning to you all. It is a great pleasure for me to be here with you today, at the 33rd Economics Conference hosted by the Oesterreichische Nationalbank – and, I must add, it is a delight to visit again this beautiful and historic city. I have been asked by the conference organizers to speak to the issue of financial sector stability and the IMF's work in this area – and I will seek to stay close to this topic in my remarks.

Financial sector stability has been described as the issue that central bankers worry about when they are not worrying about price stability. Experience regularly reminds us that there is a solid basis for this worry. The East Asian crisis during the late 1990s provided a striking example of how financial sector weaknesses can trigger economic turmoil and amplify the effects of adverse shocks on the economy, with severe economic and social consequences. Several industrial countries, including Japan and some of the Nordic countries, also experienced financial crises that had significant macroeconomic consequences during the decade.

Maintaining financial sector stability is clearly vital, but striking the right balance in financial regulation is not a simple task. On the one hand, we need effective regulatory oversight that limits systemic risk. On the other, we want to ensure that the environment remains conducive to competition and innovation. And getting the balance right is a task that is being made more difficult by the broader processes of innovation and change in the international financial landscape – such as the

expansion of large and complex financial institutions, the rapid introduction of new financial instruments, and the process of monetary unification across regions.

Regulators have been responding to the challenges posed by the changing financial environment. They have intensified their dialogue with the financial institutions they oversee, and are developing closer partnerships with regulators in other countries – who confront similar problems and, in many cases, the same financial institutions. The IMF has sought to help national authorities in this area by introducing its Financial Sector Assessment Program, known by its acronym "FSAP." The FSAP is a tool for conducting systematic assessments of a country's financial sector, and benchmarking regulatory efforts against international best practice.

In my remarks today, I will provide an overview of the FSAP exercise – why it was introduced, what it does, how we see it evolving in the future – and discuss some of the key findings of the FSAP exercises conducted to date in Europe, distinguishing between the high-income industrial economies and the rapidly growing economies of Central and Eastern Europe.

Overview of the FSAP Exercise

The Financial Sector Assessment Program (FSAP) was introduced in May 1999 by the IMF and the World Bank in response to the financial crises of the 1990s. It was designed with the goals of identifying the strengths, risks, and vulnerabilities of financial systems in member countries and highlighting financial sector development needs. From the outset, the FSAP was designed to analyze the linkages between macroeconomic and financial sector policies and help national authorities design appropriate policy responses.

Given the complexity of financial systems, the FSAP covers a wide spectrum of topics. These include, for example:

- the main sources of macro-financial risk and their potential impact – typically analyzed by means of stress test exercises that gauge the resilience of the banking system to adverse shocks;
- the institutional and regulatory frameworks for banking, insurance, and capital markets; and
- the functioning of the payment systems, and other aspects of the supporting infrastructure and related areas.

A key component of the FSAP is the assessment of compliance with international standards and codes in the financial sector – including the Basel Core Principles of Banking Supervision (BCP), the Insurance

Core Principles put forward by the International Association of Insurance Supervisors, the International Organization of Security Commissions (IOSCO) Objectives and Principles for Securities Regulation, the IMF's Code of Good Practices in Monetary and Financial Policies, and the FATF 40+8 Recommendations on Anti-Money Laundering and Combating the Financing of Terrorism. The assessments draw attention to institutional weaknesses in various sub-sectors of the financial system and also provide peer review in these areas. The teams that conduct these assessments typically consist of a mix of IMF and World Bank experts and specialists drawn from other national central banks and supervisory agencies.

The FSAP is designed not as a test to be passed or failed, but as a means to assist national authorities in diagnosing potential vulnerabilities in national financial systems and regulatory frameworks. The outputs of the exercise include detailed reports that are provided to the national authorities. From these reports, a summary of findings – a Financial System Stability Assessment – is provided to the IMF's Executive Board. This summary assessment covers the analysis of stability, development issues and related recommendations, and it reports on the observance of the relevant standards and codes. With the member's authorization, the assessment is published by the IMF. Given that the corrective measures needed to address regulatory weaknesses often require mobilizing broad-based public support for legislative and/or administrative reforms, the IMF's policy is to strongly encourage the publication of these assessments.

Some two-thirds of the IMF's 184 members have participated in an FSAP assessment, covering countries at all stages of development and most systemically important countries. European countries embraced the FSAP exercise early on and by now most EU member countries have either completed the FSAP process or are in the process of conducting one. FSAPs have also been conducted for most of the Balkan countries, and for Russia and Ukraine. I am pleased to note that, with only one exception, all of the 28 financial stability assessments

completed for European countries to date have been published on the IMF's website – *www.imf.org* – providing a valuable information resource for those interested in analyzing financial sector issues in Europe.

Lessons from FSAPs in Europe

Let me now summarize some of the themes that have emerged from the FSAPs completed for European countries, focusing on two distinct groups of countries: (a) the high income economies of what used to be called Western Europe – the pre-enlargement EU, plus Switzerland, Iceland, and Norway; and (b) the economies of Central and Eastern Europe, now either members of the European Union or well on the road to membership. Given the diversity of the various reports, and the fact that they were conducted at different points in time over the past 5 years, I will keep my presentation at a broad level, stressing common issues and focusing on the main findings in the two key areas of *banking sector soundness* and the *quality of banking supervision*.

FSAP Findings in Western European Countries

Let me begin first with the findings from FSAPs in high-income industrial countries, with particular emphasis on the smaller countries, and using Austria as a specific example. FSAPs have been completed for 12 of the 18 countries in this group, with 3 currently underway (Italy, Belgium, Greece) and 3 to commence shortly (Spain, Portugal, and Denmark).

Bank Soundness

On the issue of banking sector soundness, the FSAPs have typically concluded that the systems are healthy and resilient to shocks, characterized by strong capital positions, good asset quality, good profitability, and very sophisticated risk management systems.

But the FSAPs also pointed to potential vulnerabilities in some areas.

1. A first issue is the increasing exposure of domestic banking systems to economic cycles and developments in other countries, as banks extend their operations outside their home bases. In some cases, stress tests conducted during the FSAPs found that depreciation of the dollar combined with a global slowdown could be a source of significant risk to the loan portfolios; in other cases, growing exposure to transition economies in Central and Eastern European countries, while important for boosting profitability, was identified as a potential source of risk.
2. A second risk factor is the sizeable exposure of banking systems to what appear to be substantially over-valued property markets in several countries. This point has been flagged by the IMF in its regular analyses of global economic developments in recent years.
3. A third risk factor is conglomeration across financial sectors and, in particular, between insurance and banking – an issue flagged in a number of FSAPs. Insurance companies and banks generally maintain very different risk profiles, on both the asset and the liability sides of their balance sheets. Insurance companies often have relatively high exposures to commercial real estate, equities, and long-term bonds among their assets. Banks, on the other hand, face more credit risk from their lending activities and liquidity risk from the short-term nature of their liabilities. Although conglomeration can help spread risks, it can also give rise to new ones, including reputational risks – an important factor in a business where public confidence is a pre-requisite for doing business. The complexity of conglomerates can also make effective supervision and proper corporate governance more difficult. I shall return to some of the challenges posed by the development of financial conglomerates in the region later.

Supervisory Frameworks

Turning to the issue of supervisory frameworks, the FSAPs have indicated that banking supervision in the smaller Western European countries is, by and large, anchored in a well-developed institutional infrastructure, an adequate and longstanding body of commercial and banking laws, and a respected judiciary. In some countries, the surveillance of the banking system has been entrusted to a supervisory authority located outside the central bank, but mechanisms are generally in place to ensure close cooperation and exchange of information between the central bank and the supervisor. National central banks and supervisory authorities enjoy a high degree of operational independence, and in most countries there is adequate legal protection for individual supervisors discharging their duties in good faith. Licensing regimes and the processes for regulating ownership of significant shareholdings in banks are quite robust – although the presence of industrial-financial conglomerates is a source of concern in a few cases.

The level of compliance with the Basel Core Principles of Banking Supervision is generally high – although in some cases there is scope for enhancing supervisory oversight of banks' risk management and internal controls and bolstering market discipline through better disclosure and transparency. Off-site analysis carried out by supervisors is of high quality and most supervisors have well qualified personnel that are highly respected by market participants, including the regulated institutions themselves. Nevertheless, given the relatively small size of the supervisory bodies, supervisory resources seem to be quite constrained. This limitation is only partially compensated for by focusing resources on the larger systemically important institutions and relying on external auditors.

The rapid development of new financial instruments and the integration of financial markets across sectors and across borders raises a number of issues to be dealt with. In general, the FSAPs found that the smaller Western European countries have sound regimes for cross-border supervision. In most cases, information sharing with overseas supervisors is open and cooperative, and seems to work satisfactorily even in cases where formal agreements are not perfected due, for example, to differences in legal systems.

In all the FSAPs conducted in Western Europe, the supervisory authorities were able to assess the risks associated with the overseas subsidiaries of large international banks, although in some cases on-site supervision of overseas subsidiaries was limited. Countries have been also responding to the supervisory challenges posed by increasing concentration in the banking industry and the rise of large and complex financial institutions by implementing systems of consolidated supervision, transposing the European Commission Directive on Financial Conglomerates into their national laws, and assessing internal risk transfers within the conglomerates.

FSAP Findings for Austria

Let me briefly mention the main conclusions of the Austria FSAP, completed in July 2004, which reflects a number of the broader themes already mentioned.

– The banking system was found to be generally sound and resilient, with high asset quality and strong capitalization. Expansion into Central and Eastern Europe had substantially enhanced bank profitability – an important benefit because profitability and efficiency in the home market are low compared with other industrialized European countries. Stress tests confirmed the strong capitalization of the banking system and its resiliency to large but plausible shocks.

– There was a high level of observance of international standards in the areas of banking, insurance, securities, and anti-money laundering, based on strong institutions and a comprehensive legal framework. The consolidation of supervision in the new Financial Market Authority in 2002 was found to be smooth, supported by an effective inter-institutional cooperation with the Oesterreichische Nationalbank and the Ministry of Finance.
– Issues warranting the attention of policymakers included: (a) the supervision of financial conglomerates (where ongoing reforms and EU directives in the pipeline would address most concerns); (b) the unusual prevalence of foreign currency lending to un-hedged domestic borrowers, especially for house mortgages; and (c) the need for continued monitoring of the growing exposure to Central and Eastern European countries. I understand from the IMF mission that visited Vienna a few weeks ago that the authorities have been tracking these issues closely.

FSAP Findings for Central and Eastern European Countries

Banking Soundness

Let me turn now to the situation in the countries of Central and Eastern Europe. These countries have been implementing wide-ranging financial reforms as part of the transition process to market-based economies and integration into the European Union. These reform programs share many commonalities – including the privatization of publicly-owned banks, the strengthening of prudential and supervisory frameworks, and the passage of new legislation across a range of areas, including central banking, commercial banking, insurance, and securities markets.

With implementation of the reform agenda largely in place, and aided by significant inward foreign direct investment, financial sectors in Central and Eastern Europe have become more diversified. Insurance companies and pension and investment funds have become important players, and strong foreign strategic investors now own key shares in banking and insurance. All this has facilitated the development of new instruments and markets and improved the health and resilience of financial institutions.

That said, the various FSAPs pointed to a number of risks, including those stemming from rapid credit growth in new and potentially riskier sectors. In nearly all the Central and Eastern European (CEE) countries, credit risk in loan portfolios, including that arising from exchange rate fluctuations, remains the main systemic vulnerability, although sensitivity analysis suggests, in many cases, considerable banking system resilience to a deterioration in credit quality. Another risk factor is that growing banking competition in CEE countries, and the ensuing pressure on profit margins, may encourage some banks to venture into more risky lending in order to protect returns.

To a large degree, the trends in bank behavior reflect normal financial sector deepening and the extension of intermediation as systems develop.

However, they are also changing the risk profile of the system, straining the capital adequacy of some banks, and posing a challenge both to their internal risk management systems and to the supervisory authorities.

Supervisory Frameworks

Turning to the supervisory frameworks in Central and Eastern Europe, certain common themes emerged from the various FSAP assessments. The major structural changes and liberalization in banking sectors in these countries during the 1990s uncovered significant weaknesses in many banks, including in their internal control and external audit systems. At the time of the FSAP assessments, the authorities in these countries were seeking to strengthen regulatory and supervisory frameworks, enhancing the disclosure requirements, and setting stricter requirements for the audit function.

In general, the public infrastructure supporting financial sector oversight has been improving in CEE countries, but further reform efforts are needed. Most CEE countries have been adapting their prudential regulatory frameworks to conform to Directives of the European Union, which has required the overall realignment of the commercial and bankruptcy laws. Despite progress, the implementation mechanisms and court procedures to support contract enforcement and creditor rights remain an important priority area for reform.

At the time of the assessments, the operational areas requiring most attention from supervisory agencies were the conduct of day-to-day supervision and development of the capacity to identify emerging threats. In many countries, there was a need for more qualitative assessments of bank safety and soundness, management practices, and risk management. In other cases, the FSAPs pointed to the need to increase supervisory powers to ensure accurate regulatory reporting, validate supervisory information, and take remedial actions against banks failing to report accurately. In this important area, the supervisory work needs to be supported by improved and more transparent accounting practices and increased market discipline through strengthened governance and disclosure rules.

On consolidated and cross-border supervision, the FSAPs found implementation gaps in most CEE countries. Due to the increase in foreign participation, this is an important area, and many supervisors from CEE countries were actively pursuing formal agreements with a number of foreign supervisors at the time of the assessments. However, the capacity to conduct supervision on a consolidated basis, both domestically and internationally, suffered from implementation problems. In some cases, this was hampered by secrecy requirements that restricted information sharing with foreign supervisors. In other cases, there was a need to build supervisory capacity and reputation to support cooperative arrangements with domestic and foreign supervisors. The authorities, however, were generally aware of these limitations and moving expeditiously to address them.

In closing this part, let me emphasize again the need to enhance supervisory skills. The build-up of technical capacity and supervisory tools seemed to be a common medium-term challenge in CEE countries. In recent years, extensive training programs and technical assistance – including from the IMF – have enhanced the expertise of the banking supervisors, but work remains to be done in some areas, such as the assessment of risk management systems and market risks.

Issues Going Forward

To conclude my presentation, I would like to point to the policy issues that need to be addressed to strengthen the financial supervision framework in Europe – against a backdrop of continuing integration of European, and indeed global, financial markets. The key actors in this regard are the European Union and the national supervisors in individual member countries

Over the last few years, the European Union has been responding to the process of increasing financial integration with various initiatives to promote regulatory and supervisory convergence. These include the Financial Services Action Plan, the ongoing adoption of International Financial Reporting Standards, the streamlining of rule making under the Lamfalussy process, and the common scheduled introduction of Basel II. Despite the substantial progress made, the supervisory systems still rely on exchanges of information and allocations of responsibility that could be severely tested, especially in a crisis situation. It will be important to ensure that financial sector supervisory structures keep up with the rapid evolution of financial conglomerates and the integration of European financial markets. I will emphasize three areas that require continuous attention:

- First, cross-border consolidation and supervisory cooperation need further strengthening. As the European single market in financial services develops and financial institutions increasingly operate in multiple jurisdictions, national supervisory authorities need to cooperate effectively on an ongoing basis. In this context, the EU has been putting in place a number of mechanisms to facilitate cross-border consolidation and supervisory cooperation, for example, the Lamfalussy supervisory committees and the bilateral Memorandum of Understanding between different supervisory agencies. However, there is substantial scope to further strengthen information sharing and coordination between host and home country supervisors.
- Second, the supervision of financial conglomerates needs to keep up with market developments. In this area also, the EU has been making progress, including through the Financial Conglomerates Directive, which introduced supplementary supervision of financial conglomerates on a group-wide basis and the establishment of the European Financial Conglomerates Committee. But the task is complicated by the differing structures and frameworks of various financial activities, and further work is needed to ensure that similar risks are equally treated across sectors.
- Third, putting in place an efficient cross-border crisis management mechanism remains a top priority. At the EU level, after a slow start, a working group has been created and there have been some practical real time exercises involving the supervisors of multiple countries and a hypothetical banking sector problem. But more progress needs to be made with this effort before a real case has to be handled.

Finally, let me comment on the prospects for the IMF's FSAP program, where some fine-tuning is needed to respond to the experience to date. In particular, efforts are underway:

– to establish a pattern of well-targeted FSAP updates, adapted to the needs of individual countries and timed to capture important changes in the financial sector structure or risk environment;
– to place stronger emphasis on the assessment of cross-sector and cross-border linkages;
– to introduce projects covering regional financial sector issues, such as the supervision of regional financial conglomerates; and
– to develop new means to provide more continuous financial sector surveillance as part of the Fund's on-going policy dialogue with its member countries, and to integrate our financial sector work with our macroeconomic and specifically our monetary analysis.

The latter is particularly important given the emphasis of the Fund's shareholders – its 185 member countries – on the integration of financial stability issues into Fund surveillance. The presentations and discussions at this conference will stimulate our thinking on how the FSAP can evolve to suit the needs of our members and shareholders.

Thank you for your attention, and my thanks to the Oesterreichische Nationalbank for the opportunity to speak with you today. ❧

FSAP Participation in Europe

Country	Status (Article IV Board Date)	FSSA Document Number	FSSA Document Date	Published
EU 15 (Big five)				
France	10/20/2004	SM/04/335	9/24/2004	Yes
Germany	11/3/2003	SM/03/342	10/6/2003	Yes
Italy	*Underway*	*Pending*	*Pending*	...
Spain	*Pending*	*Pending*	*Pending*	...
United Kingdom	2/26/2003	SM/03/60	2/10/2003	Yes
EU 15 (Small ten)				
Austria	8/2/2004	SM/04/226	7/8/2004	Yes
Belgium	*Underway*	*Pending*	*Pending*	...
Denmark	*Pending*	*Pending*	*Pending*	...
Finland	11/9/2001	SM/01/291	9/25/2001	Yes
Greece	*Underway*	*Pending*	*Pending*	...
Ireland	8/1/2000	FO/Dis/00/88	7/20/2000	No
Luxembourg	5/22/2002	SM/02/130	5/3/2002	Yes
Netherlands	9/8/2004	SM/04/277	8/10/2004	Yes
Portugal	*Pending*	*Pending*	*Pending*	...
Sweden	7/31/2002	SM/02/212	7/11/2002	Yes
EU 10				
Cyprus[1]	...	...	...	...
Czech Republic	7/26/2001	SM/01/189	6/27/2001	Yes
Estonia	6/30/2000	FO/Dis/00/73	6/15/2000	Yes
Hungary	5/4/2001	FO/Dis/01/52	4/20/2001	Yes
Latvia	1/18/2002	SM/02/1	1/2/2002	Yes
Lithuania	1/14/2002	SM/01/368	12/26/2001	Yes
Malta	8/18/2003	SM/03/256	7/31/2003	Yes
Poland	3/9/2001	SM/01/74	2/27/2001	Yes
Slovak Republic	8/9/2002	SM/02/251	8/7/2002	Yes
Slovenia	5/11/2001	SM/01/129	4/24/2001	Yes
Other Western Europe				
Iceland	5/2/2001	SM/01/106	4/11/2001	Yes
Norway	6/3/2005	*Pending*	*Pending*	...
San Marino	*Pending*	*Pending*	*Pending*	...
Switzerland	5/29/2002	SM/02/143	5/14/2002	Yes
Others (including Balkans)				
Albania	*Underway*	*Pending*	*Pending*	...
Belarus	6/17/2005	*Pending*	*Pending*	...
Bosnia and Herzegovina	*Pending*	*Pending*	*Pending*	...
Bulgaria	7/22/2002	SM/02/221	7/15/2002	Yes
Croatia	8/5/2002	SM/02/244	7/26/2002	Yes
Israel	7/30/2001	SM/01/217	7/11/2001	Yes
Macedonia, FYR	10/17/2003	SM/03/336	10/1/2003	Yes
Moldova	2/7/2005	SM/05/13	1/18/2005	Yes
Romania	11/1/2003	SM/03/330	9/23/2003	Yes
Russia	5/2/2003	SM/03/134	4/14/2003	Yes
Serbia and Montenegro	*Underway*	*Pending*	*Pending*	...
Turkey	*Pending*	*Pending*	*Pending*	...
Ukraine	5/14/2003	SM/03/148	4/23/2003	Yes
FSAP Updates				
Completed				
Hungary	5/22/2002	SM/02/131	5/6/2002	Yes
Iceland	8/22/2003	SM/03/268	7/31/2003	Yes
Slovenia	5/7/2004	SM/04/152	4/27/2004	Yes
Ongoing				
Hungary	6/15/2005	*Pending*	*Pending*	...
Planned				
Ireland	*Pending*	*Pending*	*Pending*	...
Poland	*Pending*	*Pending*	*Pending*	...

Source: IMF.

[1] *Has not participated in an FSAP.*

Note: Pending means that the country has accepted to conduct an FSAP but the work has not yet started, in which case it would be labeled Underway.