Financial sector assessment programme

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New Zealand is scheduled to undergo an assessment by the International Monetary Fund (IMF) later this year under the Financial Sector Assessment Programme (FSAP). The FSAP is a relatively new surveillance and assessment programme developed and jointly managed by the International Monetary Fund and World Bank. It is designed to assess the potential vulnerabilities in a country's financial system and to evaluate the adequacy of financial sector regulation and supervision, using international standards and codes as benchmarks, as well as a number of other analytical tools. There is an expectation that all IMF member countries will undergo an FSAP assessment periodically. New Zealand has volunteered to be assessed this year.

This article explains the FSAP and discusses the key elements within it. Later this year and in 2004, the *Bulletin* will include articles that draw from our experience of the FSAP and the work being undertaken by the Reserve Bank and other government agencies in preparation for it. Indeed, the article on the New Zealand payment system in this issue of the *Bulletin* is one of these, and makes considerable reference to FSAP-related work in the area of the payment system.

1 Introduction

Later this year, New Zealand's financial system will be assessed by a team of external assessors led by the International Monetary Fund (IMF).[1] This will be conducted under an IMF/ World Bank surveillance programme – the Financial Sector Assessment Programme (FSAP). It will involve a comprehensive evaluation of the New Zealand financial system, including an assessment of how resilient the financial system is to economic shocks and the nature of financial sector regulation and supervision.

This article explains the objectives and structure of the FSAP and what it is likely to involve for New Zealand. Later in the year and next year, the *Bulletin* will contain articles that refer to, and draw from, various aspects of the FSAP evaluation of New Zealand. This article therefore lays the groundwork for those future articles and represents another step that the Bank is taking to place greater emphasis on, and give more prominence to, financial stability issues.

2 What is the FSAP?

The FSAP is a relatively new surveillance programme developed and led jointly by the IMF and World Bank. It was initiated in 1999 in the aftermath of the Asian Crisis as a mechanism to assess countries' financial systems, focusing particularly on the adequacy of their regulatory frameworks for promoting financial stability and assessing potential sources of vulnerability in their financial systems. In the latter respect, the FSAP seeks to assess how vulnerable a country's financial system might be to economic shocks, such as a major fall in the exchange rate, a large increase in interest rates, or a sharp and prolonged contraction in the economy.

The FSAP was developed in recognition that there are important and multi-faceted connections between a country's financial system and its economy. An unstable financial system can pose a major threat to economic stability. Equally, economic shocks can trigger or deepen a financial crisis. Moreover, as financial systems and economies of different countries are becoming increasingly interconnected, there is a growing risk that instability in one financial system may trigger or exacerbate instability in another. Ultimately, it is hoped that the FSAP, in combination with international standards and codes and a range of other international financial reforms, will encourage the development of more robust financial systems and reduce the risk of future financial instability and contagion.

[1] Although a joint programme, the FSAP assessments of industrialised countries, such as New Zealand, are typically led by IMF staff, and the assessments of developing countries by World Bank staff. This reflects the relatively more developmental focus of FSAPs conducted in developing countries.

Although the FSAP is not currently a mandatory programme for countries that are members of the IMF, there is a clear expectation that every member country will undergo an FSAP assessment approximately every five to seven years. In the period since its inception in 1999, more than 60 countries have undergone or are currently undergoing FSAP assessments (see box 1).

2.1 Assessment of financial sector regulation against international standards

A key component of the FSAP is the assessment of a country's regulatory framework as it relates to the financial sector, focusing – where relevant – on banking supervision, securities market regulation, supervision of insurance companies and

Box 1: Country participation in the FSAP

Just over one third of the 184 members of the IMF and World Bank had either completed an FSAP at the end of 2002, or were involved in an ongoing assessment.[2] Another 30 countries have indicated their intention to participate in the programme in the near future. There is a strong presumption by the IMF and World Bank Executive Boards – who are member country representatives – that all of their members will complete an FSAP over the next few years.

Table1 lists the 66 countries that have participated in the FSAP to date. (The asterisks denote that the assessment is currently in progress.) This group of countries broadly reflects the membership of the institutions themselves, with a mixture of developing countries, emerging market economies, and industrialised economies. To date, only one G7 country has completed an FSAP (Canada), but 3 others – Germany, Japan, and the United Kingdom – currently have one underway.

Table 1
Completed and ongoing FSAP participation as at December 2002

Argentina*	Ghana	Nigeria
Armenia	Guatemala	Peru
Bangladesh*	Honduras*	Philippines
Barbados	Hong Kong*	Poland
Bolivia*	Hungary	Russia*
Brazil*	Iceland	Senegal
Bulgaria	India	Singapore*
Cameroon	Iran	Slovak Republic
Canada	Ireland	Slovenia
Colombia	Israel	SouthAfrica
Costa Rica*	Japan*	Sri Lanka
Cote d'Ivoire*	Kazakhstan	Sweden
Croatia	Korea*	Switzerland
Czech Republic	Kyrgyz Republic*	Tunisia
Dominican Republic	Latvia	Uganda
Egypt	Lebanon	Ukraine*
El Salvador	Lithuania	United Arab Emirates
Estonia	Luxembourg	United Kingdom*
Finland	Malta*	Uruguay*
Gabon	Mauritius*	Yemen
Georgia	Mexico	Zambia*
Germany*	Morocco*	

Source: IMF

2 See http://www.imf.org/external/country/index.htm for a complete list of IMF countries.

pension funds, payment systems, anti-money laundering frameworks, and the transparency arrangements applicable to monetary policy and financial sector regulation. Assessments are made by experts, either within the IMF or World Bank, or drawn from central banks and financial regulatory agencies.[3] Assessments are made against the relevant international standards and codes covering a wide range of elements within the financial system.

There are six international standards and codes that are regarded as core elements in the FSAP. These are:

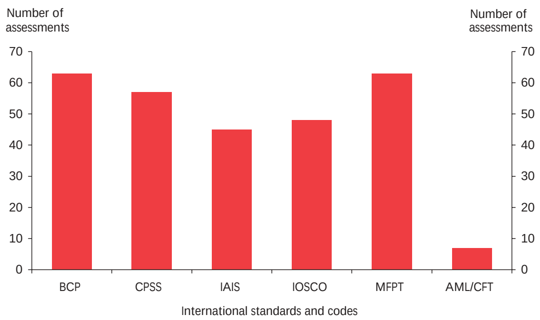
- the bank licensing and supervision principles developed by the international standard-setting body for banking supervision, the Basel Committee on Banking Supervision (the Core Principles for Effective Banking Supervision);
- the securities market regulation principles developed by the International Organisation of Securities Commissions (the Objectives and Principles of Securities Regulation);
- the payment system principles developed by the Committee on Payment and Settlement Systems, under the auspices of the Bank for International Settlements (the Core Principles for Systemically Important Payment Systems);
- the insurance regulatory principles developed by the International Association of Insurance Supervisors (the Insurance Core Principles);
- the anti-money laundering principles developed by the Financial Action Task Force (the Recommendations for Anti-Money Laundering and Combating Financing of Terrorism); and
- the transparency code for monetary and financial policies developed by the IMF (the Code of Good Practices on Transparency in Monetary and Financial Policies).

In addition to these core standards, some countries elect to undergo assessments in other aspects of financial sector regulation, such as:

- the OECD Corporate Governance Principles;
- World Bank Principles for Effective Insolvency and Creditors Rights;
- CPSS-IOSCO Recommendations for Securities Settlement System (RSSS); and
- International Accounting and Auditing Standards.

It is probable that New Zealand will complete most of the core standards and codes, but not the additional four. The determination of which standards and codes are included in the FSAP involves an assessment of the relevance of each standard and code for the given country, and the agreement of the authorities and the World Bank and IMF. Figure 1 demonstrates that not all 66 countries have completed all of the core standards and codes. The small amount of countries that have undertaken the anti-money laundering assessment to date reflects the fact that it is a relatively new standard.

Figure 1
Number of FSAP assessments of core international standards



In preparation for the FSAP, the Reserve Bank is currently completing comprehensive self-assessments of New Zealand's compliance with those international standards and codes for which the Bank has responsibility: those relating to banking supervision, the payment system and transparency. In addition, other government agencies, such as the Ministry of Economic Development and the Securities Commission, are completing self-assessments of the codes for which they have responsibility – particularly those relating to securities market regulation.

The process of self-assessment is an important element in preparing for the FSAP and provides a good opportunity for the regulatory agencies to "take stock" of New Zealand's regulatory arrangements and assess objectively how the

[3] The World Bank and IMF are not regulators *per* se, and so draw on outside experts in areas that require deep technical understanding – typically found in central banks and financial regulatory agencies. The outside experts sign confidentiality agreements as a part of their contracts with the World Bank and IMF.

arrangements currently in place compare to the principles set out in international standards and codes. This inevitably involves the identification of areas where New Zealand's regulatory arrangements differ from international standards and where there may be gaps in the regulatory framework, and whether these differences or gaps warrant further policy work or merely represent a conscious decision by the New Zealand authorities to do things differently from the approach specified in international standards and codes.

Updated versions of these self-assessments will be made available to the FSAP team to assist in their preparation for the FSAP. They will also provide a useful basis for "comparing notes" with the assessors and identifying points of difference between the self-assessments and the FSAP team's assessments.

The Bank plans to publish, either later this year or next year, summaries of its self-assessments against the international standards for which the Bank has responsibility. This will provide a useful opportunity to explain the areas in which the New Zealand regulatory frameworks depart from international standards and to discuss the rationale for these different approaches and the possible implications arising from them. We have made a start in this issue of the *Bulletin*, with the article on the New Zealand payment system.

2.2 Stress testing

As discussed earlier in this article, another important part of the FSAP is the assessment of the potential vulnerability of a country's economy and financial system to shocks, such as a sharp fall in the exchange rate, a large increase in interest rates, a contraction in real GDP, a fall in asset prices, or a combination of these types of shocks. Through the use of certain analytical techniques, such as stress tests, the FSAP assessment attempts to analyse the nature of the "fault lines" in the financial system, the damage to the financial system that may result from particular shocks, and the possible flow-on effects to the wider economy. The IMF will also probably assess the nature of New Zealand's broader external vulnerability, such as the potential for economic difficulties in Australia or Asia to destabilise the New Zealand economy and financial system.

The focus of stress tests is on the wider financial system, although in New Zealand, the main focus will be on the banking system, given its prominence in the financial system. In order to stress test the banking system, we will assess the impact of selected shocks on the largest banks operating in New Zealand. In preparation for the FSAP, the Bank has been working with a number of registered banks to develop a framework for stress testing the systemically important banks, using a range of simulated economic and financial shocks. This will not only be an important input into the FSAP, but will have wider benefits, by enriching our collective understanding of how resilient the core of the banking system is to economic shocks. If this exercise proves as useful as we hope it will be, some form of stress testing might become a regular component of the Bank's financial stability toolkit.

2.3 Assessment of the institutional capacity to respond to financial crises

The FSAP team is also likely to assess New Zealand's institutional capacity to respond to a range of financial crises, such as a bank failure situation, a liquidity crisis in the banking system, or a sudden capital withdrawal from the economy. In this context, the FSAP is likely to evaluate the legal framework for addressing these kinds of crises, the strategies developed (and under development) by the Reserve Bank and other relevant agencies for responding to crises, and the institutional capability in these areas.

In the case of banking, particular attention will be given to statutory and policy frameworks in place for responding to a bank distress or failure situation, particularly statutory management and lender of last resort powers. The Bank has been undertaking considerable work in these areas in recent years, as part of maintaining an ongoing capacity to respond to financial distress events if and when they arise. The FSAP will therefore provide a good opportunity for the Bank to exchange perspectives on crisis management issues with the FSAP team and to assess any advice or comments the team makes in relation to the crisis management arrangements in place and being developed.

2.4 Assessment of overall regulatory structure

In addition to the above areas, the FSAP usually involves an assessment of the overall regulatory framework for the financial sector. This varies from country to country, but usually includes the extent of coordination between regulatory agencies, the nature of their transparency, governance and accountability arrangements, the relative merits of a "mega-regulator" framework versus sectoral regulation, and the nature of cooperation between regulatory authorities.

The FSAP team will probably spend about two to three weeks making their assessments, and may conduct the assessments in one or two visits. At this stage, it seems likely that the main FSAP assessments will be made in the latter part of this year. The FSAP team will spend most of their time in New Zealand talking to the regulatory agencies (the Bank, Ministry of Economic Development, Securities Commission and Treasury), but may also meet with a number of other parties, including commercial banks, stockbrokers, audit firms, the Bankers' Association, the Financial Services Federation and the Stock Exchange, among others. They may also seek meetings with the Minister of Finance and other ministers with responsibilities in the financial sector. It is therefore likely to be a broad-ranging process, involving many different participants in, and overseers of, the financial system.

The FSAP results in the completion of a range of reports, including detailed written assessments of compliance with international standards and codes, a comprehensive report pulling together the complete FSAP assessment, and a summary report. Some of these reports must remain confidential to the authorities of the country and the IMF and World Bank, but there is an option for the summary report (which is itself usually quite comprehensive) to be publicly released, with the consent of the government of the country in question.[4] Any publicly released reports to emerge from the New Zealand FSAP assessment could be expected to be available in the first half of 2004.

[4] While many IMF and World Bank reports are able to be published with the joint agreement of the authorities and the IMF or World Bank, there are some which are not able to be published even if a country wishes to. The rationale for this is that the higher level of confidentiality encourages wider participation and franker discussions.

3 Why is New Zealand undergoing an FSAP?

As noted above, although the FSAP is not mandatory for IMF member countries, there is a strong expectation that all member countries will undergo an FSAP assessment. The more advanced economies, such as New Zealand, are under some pressure to volunteer for an FSAP sooner than later in order to show leadership to the less developed economies and to demonstrate that the FSAP is being applied fairly to all, and not just to the economies with known financial sector weakness. Having a broad mix of participation also assists the IMF and World Bank to continually refine the FSAP and improve their capacity to assess financial sector vulnerability.

New Zealand's participation in the FSAP is considered beneficial for a number of reasons:

- Participation in the FSAP is consistent with New Zealand's general stance at the IMF and in other international forums, where we have consistently argued the merits of strengthening financial systems, better understanding the causes and dynamics of financial crises, and enhancing the transparency of regulatory frameworks. Undergoing an FSAP demonstrates New Zealand's commitment to these principles and shows that we are willing to practise what we preach.
- Undergoing an FSAP assessment is consistent with New Zealand's undertakings in APEC, where Finance Ministers have endorsed the FSAP and agreed that all APEC economies should subscribe to the programme.
- The FSAP presents an opportunity for the relevant government agencies to enhance their collective understanding of the potential stress points in the financial system and whether existing policy frameworks are sufficient to respond to a financial crisis. Given that New Zealand has a high level of external debt and an open capital account, and in view of the extent of volatility in international financial markets in recent times, the FSAP can be viewed as a helpful framework within which to more comprehensively assess the nature of New Zealand's potential vulnerability.
- The FSAP provides an opportunity for the relevant government agencies to review the totality of the

financial sector regulatory framework and related issues in a more holistic way than has been done to date. It might also provide a timely opportunity to tap into international expertise in ways that may assist the domestic reform agenda in the financial sector area.

Overall, therefore, the FSAP presents New Zealand with a number of potential benefits. However, there are also some risks associated with the FSAP, including the potential for the assessments of the regulatory and supervisory frameworks in New Zealand being made in an inflexible manner, possibly resulting in harsher judgements about the adequacy of the regulatory arrangements than is warranted. This risk reflects the fact that, in some important respects, the New Zealand regulatory framework differs from the approach prescribed in international standards and codes, with the area of banking supervision being a good example. As we have noted previously in the *Bulletin*, although the New Zealand supervisory framework does depart from international standards in some respects, we are satisfied that the approach adopted in New Zealand has served New Zealand well, contributing to a sound and efficient financial system.

4 Conclusion

The FSAP assessment of the New Zealand financial system later this year will be the most comprehensive external assessment of the financial sector undertaken in New Zealand. It will involve the assessment of most of the significant components of the financial system, including the regulatory frameworks applicable to banks, securities markets and payment systems. It will involve a wide range of financial sector participants, including the regulatory agencies, the financial institutions, auditors and financial analysts. Although the FSAP will involve a great deal of work by many people, we are hopeful that it will provide a good opportunity to assess the New Zealand financial system in a more holistic manner than is normally the case, and that it will provide insights and perspectives that enable government, in liaison with the private sector, to continue to take appropriate further steps to maintain a sound and efficient financial system.