Special Topic III

China Initiates "Financial Sector Assessment Program"

The international financial crisis has emphasized the importance to make a comprehensive assessment on financial system of a certain country. Since the crisis, authorities of many countries have regarded it as the most important task to maintain financial stability and promote economic growth, and risk assessment on the financial sector has become a crucial issue. The experiences show that FSAP can help to recognize vulnerabilities of financial system, further push forward financial reforms, and strengthen stability of financial system. In February 2008, in the interview with Mr. Strauss-Kanh, President of IMF, Prime Minister Wen Jiabao announced China would participate in FSAP; Chairman Hu Jintao also committed in G20 Washington Summit that China would undertake FSAP. Thereafter, with consulting with IMF and WB, China formally initiated FSAP in August 2009.

What Is FSAP

Asian Financial Crisis, which broke out in 1997, has indicated that with the deepening of economic and financial globalization, the stability of financial sector is of most importance to the healthy development of macroeconomy. Based on the lessons drawn from Asian Financial Crisis, IMF and WB jointly developed FSAP in May 1999 to help strengthen assessment and monitoring on financial vulnerabilities of IMF member countries (jurisdictions), so as to reduce the possibility of financial crisis and promote financial reforms and development in member countries (jurisdictions).

Pilot FSAPs were firstly conducted by IMF and WB in 12 countries and then extended to all members in March 2001. After several years of development and improvement, the FSAP has become an internationally accepted framework for assessing financial stability. As of the end of 2009, 125 countries (jurisdictions) completed their first FSAPs.

For developed countries, FSAP shall be conducted by IMF, and that shall be conducted by IMF and WB jointly for developing and emerging market countries. The FSAP assessors mainly consist of the staff from IMF and WB, and external experts may be invited in some situations. The focus of IMF is the stability and vulnerability of financial system, and that of WB is the development of financial sector. At the end of FSAP mission, an aide-mémoire will be drafted based on research and analysis and policy recommendations, which is confidential and will not be released to public. Based on the aide-mémoire, *Financial System Stability Assessment* (*FSSA*) will be prepared by IMF, with focus on the stability of financial sector. The FSSA report will become part of the Article IV[1] consultation report presented to IMF's Executive Board for discussion. *Financial Sector Assessment* (*FSA*) will be pre-

1 Article IV consultation: According to the 4th article of *Articles of Agreement of IMF*, IMF and its member countries hold consultations regularly (usually annually) to discuss the economic policies of member countries. Based on the consultation, IMF staff draft and submit reports to IMF Board for discussion.

pared by WB with focus on financial sector development and presented to its Board. After the initial FSAP, updated FSAP will be conducted in every several years. So far, the updated FSAPs have been conducted for about 50 countries.

The Framework, Contents, and Methodology of FSAP

Framework of Assessment

FSAP analytic framework is centered on macro-prudential surveillance and is supplemented by surveillance of financial markets, analysis of macrofinancial linkages, and surveillance of macroeconomic conditions.

Marco-prudential surveillance focuses on diagnosing the risks affecting the stability of financial system, and appraising the health and vulnerability of financial system. The quantitative approaches mainly include Financial Soundness Indicators (FSIs) and Stress Testing. Certain qualitative approaches, such as the appraisals on supervision quality and the completeness of financial infrastructure, are adopted.

Financial market surveillance is employed to assess the risks when financial sector is facing specific individual shock or a portfolio of shocks. Early Warning Systems (EWSs) are usually adopted for the surveillance and analytical indicators usually consist of financial market data, macro-data and other variables.

Macrofinancial linkages analysis focuses on how risks resulting in shocks are transmitted into macroeconomy through financial system. The macrofinancial linkages lie in the reliance of non-financial sectors on the intermediation of financial sector, including financing of non-financial sectors, deposits of households, and transmission of monetary policy through the banking system.

Marcoeconomic surveillance aims at the overall impact of financial system on macroeconomy, especially the impact on the sustainability of debt. Financial instability may cause huge cost for a country, such as lowering economic growth rate and the debt-servicing capacity, and may lead to sovereign default.

Contents of Assessment

The FSAP involves assessment on financial structure and financial development, financial sector, financial supervision and infrastructure.

The assessment on financial structure and development focuses on financial service provision, which analyzes the causes for absent or underdeveloped financial services and markets, recognizes the factors baffling effective and efficient financial services, and emphasizes particularly on the clients of financial services and the efficiency at which financial system meets the clients' demands. The highlights of assessing financial services include the scope, scale, reach, cost and quality of the financial services within the economic system.

The objects of financial sector assessment mainly include banking sector, quasi-banking institutions, securities markets, insurance sector, etc. The assessment contents for banking sector mainly include market depth (measured by several indicators such as total assets), market width (measured by clients basis and product scope), market competition, efficiency, market segmentation, etc. The assessment for securities sector mainly covers whether the market is of depth and liquidity, whether the costs of trading and issuance are reasonable, and whether there are adequate debt- and equity-type instruments available. For insurance sector, the assessment mainly covers whether insurance institutions provide investment and risk-mitigating instruments, whether professional management for long-term funds is provided, and whether deficiencies exist in the range and pricing of products.

Assessment of financial supervision mainly covers banking supervision, securities market regulation, and insurance supervision. By comparing supervisory practices of countries under assessment with the *Basel Core Principles for Effective Banking Supervision* (BCPs) issued by BCBS, the *Objectives and Principles of Securities Regulation* issued by IOSCO, and the *Insurance Core Principles and Methodology* (ICPs) issued by IAIS, the observance of international supervisory standards and codes is assessed item by item, its regulatory efficiency is evaluated, risks and vulnerabilities are identified, and then reform recommendations are made accordingly.

Assessment of infrastructure mainly includes legal framework, information and transaction techniques. The core of legal infrastructure includes creditor protection, bankruptcy laws and their implementation. The assessment indicators include: enforcement of contracts, pace and efficiency of bankruptcy procedure, and rights of creditors and minority equity. The assessment of information infrastructure includes: regulations and practices of accounting and auditing, and legal and institutional requirement for public and private institutions for credit and property right registration. The assessment of transaction technique infrastructure focusing on large/small value payment systems includes: efficiency of currency transfer in terms of time and cost, and the access to the services.

Assessment Methodology

The major methods of FSAP include analysis of FSIs, stress testing, assessment on observance of international standards and codes.

FSIs are indicators of the soundness of the financial markets and institutions, as well as of their clients, which are employed to analyze and evaluate the strengths and vulnerabilities of financial systems. With the analysis of FSIs, the vulnerability of financial sector facing shocks and its effects on macroeconomy can be assessed. FSIs include two groups: core FSIs and encouraged FSIs. The core FSIs, which merely cover banking sector, taking the framework of *CAMEL rating* for reference, include 12 indicators that can be grouped into 5 categories: capital adequacy, asset quality, profitability, liquidity and sensitivity to market risks. The encouraged FSIs consist of 27 indicators capturing the aspects of depository institutions, other financial institutions, non-financial corporate sectors, market liquidity, household and real estate market, etc.

The stress testing analyzes the possible effects from the changes of macroeconomic variables on the soundness of financial system, and assesses the risks and vulnerabilities resulting from the linkages between macroeconomy and finance. Stress testing is applicable for individual institution or the entire financial system. Risk factors of the stress testing include interest rate, exchange rate, credit, liquidity, asset price, etc. Methods of the stress testing include sensitivity analysis, scenario analysis, contagion analysis, etc.

The assessment of observance of international standards and codes evaluates the stability of financial system from the aspects as: the stability and transparency of macroeconomic policy, the impact of prudential supervision on the operations of financial institutions, and the effectiveness of financial infrastructure (including corporate governance, accounting and audit standards, etc.). The outcome of the assessment is reflected in *Reports on Observance of Standards and Codes (ROSCs)*. FSB identified 12 key international standards and codes, of which the following 9 are covered in the assessment of FSAP: the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies*, the *Basel Core Principles for Effective Banking Supervision*, the *Core Principles for Systemically Important Payment Systems*, the *Anti-Money Laundering and Combating the Financing of Terrorism: FATF's* 40 + 9 *Recommendations*, the *Objectives and Principles for Securities Regulation*, the *Insurance Core Principles and Methodology*, the *OECD's Principles of Corporate Governance*, the *International Accounting Standards*, and the *International Standards on Auditing*.

Reviews and Improvements to FSAP

In the year 2009, IMF conducted the third review on FSAP, following the previous two conducted in 2003 and 2005 respectively. This review, drawing on the experiences of the last decade and lessons from the recent global financial crisis, raised reform proposals, the directions and emphasis for the next decade. As a result, four reports were developed: *FSAP After Ten Years—Background Material*, *FSAP After Ten Years—Experience and Reforms for the Next Decade*, *Revised Approach to Financial Regulation and Supervision Standards Assessments in FSAP Updates*, *Financial Sector and Bilateral Surveillance—Toward Further Integration*.

Deficiencies of Current FSAP Framework

Overall, FSAP covered the right topics, and in many cases, suitable adjustments were made according to the changes of circumstance. However, non-financial sectors, global macroeconomy, and potential systemic liquidity risk were not given adequate concern. Similarly, asset securitization, crisis management, disposals of problem banks, capital market were not analyzed with adequate depth.

For the countries under assessment, although FSAP identified vulnerabilities of financial systems, the recommendations were not detailed, clear or direct; the recommendations were not implemented in time. The different extent of countries involvement affected the implementations of the recommendations. Because of the principle of voluntary participation, not all systemically important countries had been covered before the outbreak of the crisis.

The Direction and Measures of FSAP Reform in the Next Decade

Overall goals will be adjusted. First, make the program more flexible and better aligned with country needs. Second, enhance the quality, candor, and comparability of assessments. This entails developing further tools and methodology for assessing both the stability and the development aspects of financial sector and their linkages to the rest of the economy, and strengthening the analysis in the areas of financial stability, macroprudential analysis, and cross-border linkages. Third, combine FSAP analysis and results with core work of IMF and WB. IMF aims to integrate FSAP with Article VI surveillance more closely and WB aims to put FSAP analysis and recommendations into its country assistance strategy and work of other financial agencies.

Primary principles should be followed. Two key aspects of FSAP are proposed to remain the same: First, the FSAP would remain a joint IMF/WB program in developing and emerging market countries, and FSAPs in advanced economies would continue to be the sole responsibility of IMF. Second, participation in the FSAP would continue to be voluntary for members.

Focus should be highlighted and functions be clarified. FSAPs have always encompassed assessments of both financial sector stability and development needs. These two assessments provide complementary perspectives on the financial sector. However, the distinction between the two issues is not clear-cut. Hence, the functions should be clarified: IMF focuses on the assessment of stability with more short-term consideration, while WB focuses on that of development needs with middle-term issues.

Flexibility and continuity need to be strengthened. Due to the resource constraints, the average time lags between updates have been kept to about six years. The experiences of the recent international financial crisis have shown that long lags between updates weaken the effectiveness of FSAP. In the future, "modular assessments" would be introduced based on initial assessments: IMF focuses on financial stability issues and WB on development issues, and both of the two assessments can be conducted respectively to enhance the flexibility and continuity of FSAP.

Analytical methods need to be improved and contents to be strengthened. In addition to the measures of improving macro stress testing, constructing indicator system, building up risk models, increasing risk-monitor frequency and developing contingent debt instruments, macroprudential risk assessments need to be strengthened. It is necessary to pay more attention to systemically important financial institutions, develop instruments monitoring cross-sector and cross-market risks, strengthen surveillance and management over systemic risks, and clarify functions between central bank and other supervisory agencies.

Progress of China FSAP

Preparation

With the requirements of understanding financial risks and maintaining financial stability in China, considering the applicability of FSAP framework and the promotion of FSAP by IMF, PBC, with relevant government agencies, presented the proposal on China's participation in FSAP to the State Council in December 2001. In July 2003, PBC and relevant agencies conducted financial stability self-assessments in line with FSAP framework, in a period of more than a year. The self-assessments gave important contribution to understanding China's situation, preventing and tackling financial risks and maintaining financial stability. Since 2006, PBC together with relevant agencies had positively prepared for China's participation in FSAP according to related arrangements.

On 14 February, 2008, in the interview with Mr. Strauss-Kahn, then President of IMF, Prime Minister Wen Jiabao announced China's participation in FSAP. IMF and WB had planned to visit China in November 2008 to discuss the arrangements of initiating China FSAP, which had to be deferred due to the spread and deterioration of the sub-prime crisis. In G20 Washington Summit held in November 2008, Chairman Hu Jintao, together with leaders of other nations, promised to participate in FSAP. The promise was ingeminated in the second G20 Summit held in London in April 2009.

Formal Initiation

In August 2009, PBC, together with other agencies including the Ministry of Foreign Affairs, National Development and Reform Commission, MOF, Ministry of Human Resources and Social Security, Ministry of Commerce, NBS, Legislative Affairs Office of the State Council, CBRC, CSRC, CIRC, State Administration of Foreign Exchange, etc., discussed the initiation issues of FSAP, built up relevant working mechanism, and established FSAP Cross-agency Leading Group and Cross-agency Working Group respectively.

All participating agencies unanimously agreed that in recent years China's financial legal framework had been improved further, accounting system and standards had gradually converged to international ones, the key financial indicators and regulatory indicators reflecting financial institutions' conditions had been generally sound, the corporate governance of financial institutions had been standardized gradually and the strength of financial sector and the soundness of financial system had been improved remarkably. In this context, initiating FSAP is the action to fulfill Chinese leader's solemn commitment, and it is also helpful for China to review financial system stability from the viewpoint of international experiences and lessons, so as to promote the steady and healthy development of financial sector in longer term.

Working Progress

In September 2009, IMF/WB FSAP scoping mission visited China. The member agencies of the FSAP Cross-agency Working Group had full communications and discussions with IMF/WB FSAP scoping mission. Both sides came to an agreement on the scope and procedures of China FSAP, and hereby: *Financial Sector Assessment Program (FSAP) Memorandum on the Scope of Work* (hereinafter referred to as MOU) was signed as China FSAP's guideline.

The MOU specified the scope of China FSAP. First, macrofinancial risks and financial system vulnerability analysis. Second, institutional regulatory and supervisory framework. Third, systemic liquidity framework and financial stability. Fourth, financial market infrastructure including law, accounting, information disclosure, etc. Fifth, financial development issues and access to financial services; sixth, contingency planning and crisis resolution arrangements.

According to the MOU, IMF/WB FSAP team will visit China to carry out spot assessment in June and November 2010 respectively, and the overall FSAP process will be concluded in July 2011. Currently, the related agencies are pushing forward FSAP tasks orderly according to the plan.