

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

REVISED PROPOSED DECISION

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

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

Introduction

1. Article IV, Section 1 of the Fund's Articles requires each member to “collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates” (“systemic stability”). Recognizing the important impact that a member's domestic economic and financial policies can have on systemic stability, Article IV, Sections 1(i) and (ii) establish obligations for members respecting the conduct of these policies, including their financial sector policies.
2. In accordance with the framework set out in Article IV, the *2007 Surveillance Decision* provides that systemic stability is most effectively achieved by each member adopting policies that promote its own “external stability”—that is, a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. In the conduct of their domestic economic and financial policies, members are considered to be promoting external stability when they are promoting their own domestic stability—that is,

when they comply with the obligations of Article IV, Sections 1 (i) and (ii) of the Fund's Articles. For this purpose, the *2007 Surveillance Decision* requires the Fund's bilateral surveillance to assess, in particular, whether a member's domestic policies are directed towards domestic stability. It provides that "financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects)" will always be the subject of the Fund's bilateral surveillance with respect to each member.

3. While an examination of members' financial sector policies is important in all cases of bilateral surveillance, the Fund decides that, taking into account the framework described above and the overall purpose of surveillance, heightened scrutiny should be given in bilateral surveillance to the financial sector policies of those members whose financial sectors are systemically important, given the risk that domestic and external instability in such countries will lead to particularly disruptive exchange rate movements and undermine systemic stability. As financial stability assessments are a key tool for assessing members' financial vulnerabilities and financial sector policies, it is appropriate that financial stability assessments be conducted with such members as provided for in this Decision.

4. This Decision does not impose new obligations on members or, in particular, modify the scope of their obligations under Article IV, Section 1. The Fund, in its bilateral surveillance, will continue to assess whether a member's domestic economic and financial policies are directed toward the promotion of domestic stability.

Scope and modalities of financial stability assessments

5. **Determination of systemic importance.** The Managing Director, in consultation with the Executive Board, will identify those members that have systemically important

financial sectors. This determination will be made in the context of each review that is conducted under paragraph 10 below, and will be based on an assessment of the size and interconnectedness of members' financial sectors as contemplated in paragraphs 23 to 26 in SM/10/235.

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

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

- a. **An evaluation of the source, probability, and potential impact of the main risks to macro-financial stability in the near-term for the relevant financial sector.** Such an evaluation will involve: an analysis of the structure and soundness of the financial system; trends in both the financial and nonfinancial sectors; risk transmission channels; and features of the overall policy framework that may attenuate or amplify financial stability risks (such as the exchange rate regime). Both quantitative analysis (such as balance sheet indicators and stress tests) and qualitative assessments will be used to evaluate the risks to macro-financial stability.

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

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

9. **Frequency.** Where the financial sector of a member is determined to be systemically important pursuant to this Decision, it will be expected that a financial stability assessment will be conducted and the FSSA resulting from such an assessment will be discussed by the Executive Board by no later than the first deadline for completion of an Article IV consultation with the member that follows the fifth anniversary of such determination or, in the case of the financial sector of a territory of a member, the first deadline for completion of an Article IV consultation discussion with respect to that territory by the Executive Board

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

Miscellaneous

10. **Review.** It is expected that the Fund will review this Decision no later than five years following the date of its adoption and subsequently at intervals of no longer than five years. In particular, as “systemic importance” is a dynamic concept, the Fund will, in the context of each such review, examine and revise, as necessary, the criteria and methodology for determining members with systemically important financial sectors. Moreover, the Fund may review this Decision at any time to take into account major advances in the availability of data and in the development of methodologies for assessing the systemic importance of financial sectors.