

**Legal Aspects of the Financial Sector  
Assessment Program (FSAP)**

by

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The FSAP was initiated in 1999. It is a joint program of the World Bank and the International Monetary Fund designed to strengthen the assessment and monitoring of member countries' financial systems, so as to develop strategies and policies for strengthening those systems, as needed. The program is intended to provide a comprehensive coverage of financial systems, with a focus on selected issues of significance for financial stability and orderly development. This program includes an assessment of compliance with relevant standards and codes and a Report on Observance of Standards and Codes (ROSC) is prepared for the information of the Fund's Executive Board. However, the assessment of compliance with standards and codes can also take place outside the context of FSAP (stand-alone ROSCs). Therefore FSAP reports and ROSCs are related but separate concepts.

Some of the standards used in ROSCs have been developed by the Fund or the Bank. Others have been developed by other standard setters. The development and acceptance of international standards raise a number of issues. In most cases, the standard setters have no authority to impose obligations. Therefore, standards cannot generally be seen as international obligations. A related question is whether and how standards can be made

effective. A third question is the degree of precision standards must meet to be recognized as such. Beyond the “one size fits all” and the “depending on local circumstances” approaches there are many variations, but the former is closer to the concept of standard than the latter. Finally, in the design of standards, to what extent should fundamental moral or legal principles be observed (e.g., in the area of human rights or privacy)?

After examining FSAP procedures, the relationship between FSAP reports and ROSCs will be discussed and finally the legal nature of FSAP and ROSCs will be analyzed.

### **1. FSAP Procedures**

Stage 1. The FSAP report is prepared at the request of a member country, by the staff of the Bank and the Fund with the participation of experts from national or international agencies (e.g., IOSCO for securities and IAIS for insurance). The report covers financial sector issues in areas determined by agreement between the member and Fund and Bank arrangements. An FSAP report consists of three volumes.

**Volume 1** (“Main Report”) is an overall assessment of the member’s financial sector, with its strengths and weaknesses. It is confidential and made available only to the country’s competent authorities. It contains the staff’s appraisal of the financial sector’s short- and medium risks and makes recommendations on priority policy actions. It contains a summary of the assessments of observance of standards and codes undertaken under the FSAP.

**Volume 2** (“Selected Financial Sector Issues”) is a detailed and technical analysis, which is the basis for the main report. It is also confidential and may be given to the authorities, depending on its relevance and usefulness.

These two volumes are not published by the member, the Fund or the Bank. They are not communicated to the Executive Boards of the Bank or the Fund.

**Volume 3** (“Assessment of Observance of International Standards and Codes”) contain a detailed assessment of the observance of selected financial sector standards, codes and good practices. The assessment is divided into modules, the list may vary from country to country. Each module is the responsibility of specialists from the Fund, the Bank or other agencies.

These detailed assessments are communicated to the country’s authorities; they are not circulated to the Executive Boards of the Fund and the Bank.

The member’s authorities may publish the detailed assessments but only with the consent of Bank and Fund managements (or Fund managements alone if the member is not a current borrower from the Bank or IDA).

Stage 2. On the basis of the findings of the FSAP team, the staffs of the Fund and the Bank will prepare separate reports to their respective Executive Boards. These reports cover areas of interest for each organization. The report to the Fund’s Board is a Financial System Stability Assessment. The report to the Bank’s Board is a Financial Sector Assessment.

The FSSA focuses on stability issues of relevance for Fund surveillance. Part I discusses issues of macroeconomic significance and financial stability. Part II contains the summary assessments of observance of standards and codes (volumes 3 of the FSAP report). These summary assessments constitute financial sector modules of the Report on Observance of Standards and Codes (ROSC). As will be explained, the ROSC may include other

modules, which are not derived from the FSAP because they do not relate to the financial sector (data dissemination, fiscal transparency) or because the member has requested a stand-alone ROSC.

The FSSA will be part of the documents considered by the Fund's Board in the exercise of surveillance, i.e., when completing the Article IV consultation with the member. Therefore it does not contain information that would not be available to the Board in the exercise of surveillance. In particular, the FSSA will not disclose information concerning the health or prospects of any identified or identifiable financial institution (Article VIII, Section 5).

The FSSA report can be published by the Fund with the consent of the member, together with the staff report for the Article IV consultation (whose publication is also subject to the member's consent).

ROSCs are placed on the Fund's website, subject to the member's consent.

From a legal standpoint, the two stages of FSAP procedures are separate. The FSAP report is for the member's own use, while the FSSA report is for the exercise of Fund surveillance. With respect to the observance of standards and codes there is also a difference between the detailed assessments provided to the country and the ROSC modules provided to the Fund's Executive Board. As these modules are available for the exercise of Fund surveillance, the standards and codes on which they are based could gradually come to be regarded as criteria for assessing a member's compliance with its obligations under

Article IV. These standards are not limited to the financial sector and their number and scope are expected to grow in the future.

## **2. Relationship between FSAP and ROSC**

FSAP and ROSCs are related but separate concepts. Both are prepared in response to a request by a member country but FSAP reports are joint reports of Bank and Fund staff on financial sector issues while ROSCs can be prepared separately by Bank and Fund staff and are not limited to financial sector issues. It is even possible that other agencies express interest in preparing ROSCs on areas within their mandate. There are already private initiatives in this field: a US pension fund has commissioned a consultancy firm to prepare a report on observance by certain countries of the Fund's codes on fiscal and monetary transparency. There is also a growing demand from countries which are willing to adapt their legislation, regulations or practices to certain international standards.

Ideally, observance of standards should be assessed by the institution that has developed them. However, the institution's resources may be limited. Sometimes the standard-setter is even a private association. Therefore, the Fund and the Bank have been urged to offer their services, in cooperation with standards-setters, to assess compliance with standards within their respective mandates and to provide technical assistance.

In the case of the Fund, however, the assessment of compliance with standards goes beyond the provision of services. The origin of ROSCs in the Fund can be traced to a number of initiatives in 1998-99 which were intended to achieve greater transparency in the implementation of standards through Fund surveillance. In October 1998, there was a

recommendation to that effect by the G-22 Working Group on Transparency and Accountability, followed on October 30, 1998 by a Declaration of the G-7 Finance Ministers and Central Bank Governors and on June 18, 1999 by a Report of the G-7 Finance Ministers to the K► In Economic Summit on Strengthening the International Financial Architecture.

The thrust of these proposals was that the Fund should monitor the implementation of codes and standards developed by standards-setting bodies. The monitoring would be part of Fund Surveillance and the conclusions reached by the Fund would be published. The Fund would work in close collaboration with the World Bank and standards-setting bodies.

The “transparency reports” as they were called by the G-22 would have used the “name and shame” approach now used by the FATF against non-cooperative countries and territories, who do not comply with the FATF standards on money laundering. This is not an approach used by the Fund. Moreover, the publication of findings of the Fund without the consent of the member concerned would have been contrary to the principle of confidentiality which governs the expression of views by the Fund on a member’s policies (Article XII, Section 8).

The outcome of the discussions on the role of the Fund and the Bank in the assessment of compliance with standards and codes was that Fund and Bank staff would prepare joint or separate reports in the common or respective areas of competence of the two organizations. These reports would be prepared only at the request of members and on the basis of standards endorsed (but not necessarily developed) by the Fund and the Bank. In the

Fund, these ROSCs would be circulated to the Executive Board which could use them in the exercise of surveillance under Article IV.

There are now 11 areas covered by ROSC modules, 10 of which have been endorsed, by the Executive Boards of the Fund and the Bank; the eleventh module has not been endorsed by the Executive Boards of the Bank and the Fund.

The ROSC modules are divided into three groups.

**Group 1** covers the areas where the Fund has developed standards, within or outside the financial sector:

- ✓ data dissemination (based on the Fund's Special Data Dissemination Standard/General Data Dissemination System) and
- ✓ fiscal transparency (based on the Fund's Code of Good Practices on Fiscal Transparency),  
which are stand-alone modules, that is, not included in FSAP reports;  
and
- ✓ monetary and financial transparency (based on the Fund's Code of Good Practices on Transparency and financial Policies),  
which is usually included in FSAP reports.

**Group 2** covers modules that are usually included in joint Fund/Bank FSAP reports:

- ✓ banking supervision (based on the Based Committee's Core Principles for Effective Banking Supervision),
- ✓ securities (based on the International Organization of Securities Commission's (IOSCO) Objectives and Principles for Securities Regulation),
- ✓ insurance (based on the International Association of Supervisors' (IAIS) Insurance Policy Principles) and
- ✓ payments systems (based on the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems).

**Group 3** covers areas which, while they are recognized by the Fund's Board as important for the effective operation of domestic and international financial systems may be included in the FSAP and are assessed by the Bank:

- ✓ corporate governance (based on the OECD's Principles of Corporate Governance),

- ✓ accounting (based on the International Accounting Standards Committee's International Accounting Standards) and
- ✓ auditing (based on the International Federation of Accountants' International Standards of Auditing).

The World Bank staff also uses its Principles for Effective Insolvency and Creditor Rights Regimes for stand-alone pilot ROSCs; these standards have not been endorsed as standards by the Fund and the Bank, and UNCITRAL is working on a model law on this topic.

There are also standards outside the ROSC modules. For instance, the FATF 40 recommendations on money laundering and 8 recommendations on terrorism financing are recognized as standards by the Fund and the Bank but not for purposes of a ROSC; a common methodology based on the 48 recommendations is being developed by Fund and Bank staff in cooperation with the FATF for a future ROSC module.

A ROSC consists of a description of the country's practice, an assessment of its observance of standards, and prioritized recommendations.

As of December 31, 2001, 201 ROSC modules had been completed (for 67 economies, some of which are not sovereign countries), of which 141 have been published (for 45 economies). 58 percent of the ROSC modules completed were included in FSAP reports.

### **3. Legal nature of the FSAP and ROSCs**

Calculated ambiguities are the supreme form of international diplomacy but a nightmare for lawyers.

From documents of the Fund and communiqués of the IMF Committee it is clear that assessment of standards and codes is seen as an element of Fund surveillance, at least for those that are within the Fund's jurisdictional mandate. Nevertheless, FSAP reports and ROSCs are prepared only at the request of individual countries; they are not mandatory. Moreover, even when requesting an FSAP or a ROSC, the member may specify the areas that will be covered by the report.

In response to an objection by a Finance Minister, at a meeting of the IMF Committee, to the inclusion of standards and codes in Fund surveillance, it was explained that it would be surveillance on a voluntary basis.

Unfortunately, this is a logical impossibility. Surveillance is mandatory, both for the Fund and for each member. What is voluntary for the Fund and its members is the provision of advisory services by the Fund, which is called technical assistance.

Between surveillance and technical assistance, there are several fundamental differences.

(i) Surveillance must be performed by the Fund under Article IV of its Articles of Agreement. This responsibility cannot be delegated.

Technical assistance may be provided by the Fund, the Bank, both together, or other organizations. A fee may be charged for technical assistance, not for surveillance.

(ii) Surveillance is an assessment by the Fund of each member's compliance with its obligations under Article IV. The Fund is not vested with the power to expand the

scope of these obligations. It may define criteria for the exercise of surveillance; standards and codes may be used as criteria if they are recognized as relevant by the Fund, but nonobservance of standards is not by itself a breach of obligation under Article IV. A finding of breach of obligation has to be based on the provisions of Article IV.

In contrast, technical assistance is purely advisory and cannot lead to a finding by the Fund of breach of obligation.

(iii) Surveillance is mandatory for all Fund members. Technical assistance is a service provided to individual countries upon request; compliance with the advice provided is voluntary, which does not exclude the possibility of peer pressure.

(iv) Surveillance applies to all the territories of each member. Technical assistance may be provided to a member for a particular territory.

(v) In the conduct of surveillance, the Fund requires certain information from its members. This is an obligation under international law; a member cannot invoke its national laws to limit the scope of this obligation. However, the members' obligation to provide information is limited: it does not include information that is specific to individuals or entities; only aggregates have to be provided.

In the provision of technical assistance, the Fund and the member agree on the information to be provided, which may include data on particular individuals or entities. National laws may limit the scope of information that the authorities are allowed to provide.

(vi) Surveillance is conducted on behalf of the Fund by the Executive Board. Technical assistance is provided by the staff under the authority of the Managing Director.

(vii) Staff reports prepared for the exercise of Fund surveillance are communicated to the Executive Board for its consideration. They are Board documents and, as such, can only be published with the approval of the Executive Board. Moreover, the Executive Board has decided that these staff reports would not be published by the Fund without the member's consent.

Staff reports for technical assistance are for the exclusive use of the member country's authorities. They are not circulated to the Executive Board without the consent of the member. As they are products of the Fund's staff, the Managing Director can authorize their publication by the member. Their publication by the Fund requires the member's consent. The member may decide against publication to preserve confidential information or to avoid the negative impact of an unfavorable assessment.

(viii) The conclusions reached by the Executive Board in completing an Article IV consultation with a member are confidential, which means that they cannot be published without the consent of the member. One exception would be if the Board found that the member is in breach of its obligations, which has never happened, and even in that case only the finding of breach, with the precise motive, could be published. Another exception, also never used, would be if the Fund found that the member's policies are a major threat to international equilibrium.

There are no Board conclusions in the context of technical assistance.



In summary, the Fund cannot expand the scope of its surveillance beyond the provisions of Article IV. A finding of noncompliance with standards and codes would not constitute a finding of breach of obligation under the Articles.

FSAP reports and ROSCs are not by themselves an exercise of surveillance; participation is voluntary for each member concerned and the rules of technical assistance apply.

The only thing that can be said in support of their inclusion in surveillance is that, through the FSAAs, the FSAP reports “feed into” surveillance, i.e., provide material which deepens the Fund’s understanding of the member’s circumstances. The same is true of ROSCs, but the same would also be true of any technical assistance report, prepared for the use of a member, if the member decided to communicate it to the Executive Board.

Actually, while expanding the sources of information available to the Fund in the exercise of surveillance, FSAP reports and ROSCs illustrate the evolution of surveillance from an assertion of jurisdictional powers as contemplated by the Fund’s Articles to a policy dialogue coupled with peer pressure.