IMF Financial Sector Surveillance

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The strong common interest in preventing and managing economic crises was one reason behind the creation of the IMF directly after the Second World War, where the Bretton-Woods system for fixed exchange rates was one central element. Since then, the system has changed considerably and over the last 25 years this change has been rapid. The most prominent changes concern the increased financial openness and the large financial flows that nowadays dwarf the trade-related flows. However, the IMF's mandate is more related to preventing and managing current account crises than capital account crises and is thus not perfectly fitted to a world where monetary and financial issues are increasingly intertwined and an economic crisis is more likely to originate in the financial sector than in the real sector. The key issue is then how can the IMF adapt its surveillance of the global economy to better capture the new economic picture. This is one of the major issues for debate and reform in the IMF. In this article we describe the IMF's financial sector surveillance, discuss various proposals and give our view on the road forward.

The recent discussion on financial sector surveillance is largely motivated by the rapid development of the financial system. The discussion falls into two broad categories – the longer-term policy issues arising from the IMF's role and strategy regarding financial sector surveillance, and the policy issues arising from the recent global financial sector turmoil. Among the members of the IMF there is broad consensus that the IMF should focus on areas where it has comparative advantages, where surveillance is seen as a central element. However, wiews have been more divergent on the capacity and mandate of the Fund to involve itself more heavily in the surveillance of the financial sector.

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The IMF's core task is to promote international monetary cooperation with a focus on exchange stability and the promotion of a balanced growth of international trade[2]. In its conventional connotation, the mandate is not perfectly fitted to a world where monetary and financial issues are increasingly intertwined and international financial crises can originate in the capital accounts more probably than in the current accounts. Over the last 12 years, for example, the major crises have been financial rather than the current account crises more common in the earlier years of the IMF's operations.[3] In short, a financial sector crisis in one country with its immediate direct or indirect effect on financial markets worldwide constitutes today a much higher risk to international monetary stability than a more traditional current account crisis stemming from the loss of export competitiveness.

The IMF's work on financial sector issues should take into account the 2007 Surveillance Decision (see Box 1) which narrowed the scope of Fund bilateral (country-specific) surveillance to external stability and exchange rate issues. The decision, however, also promised an increased

Box 1: The 2007 Decision on Bilateral Surveillance over Members' Policies

On 15 June 2007, the IMF Executive Board adopted a new decision on bilateral surveillance over member countries' economic policies, which puts exchange rate policies at the centre of the surveillance process.[4] The primary reason for the update was to make bilateral surveillance more effective and transparent and to strengthen the Fund's exchange rate oversight mandate. The 2007 Decision, which replaces the 1977 Decision on Surveillance over Exchange Rate Policies, provides an up-to-date and comprehensive framework for the Fund's bilateral surveillance. While the old decision covered only surveillance of exchange rate policies, the new framework is much broader in scope, including domestic economic and financial policies. In particular, the new framework adds a new principle (principle D) recommending that countries avoid exchange rate policies that cause external instability – regardless of the reason for undertaking them. The new decision elaborates on what is meant by the pre-existing principle of exchange rate manipulation and it introduces the concept of

[2] IMF (1990), Article I Purposes: http://www.imf.org/external/pubs/ft/aa/aa01.htm
[3] IMF (2007a). See also Melander (2002) on different types of crises.

fundamental exchange rate misalignment. The new framework identifies certain developments, which, in the IMF's assessment of a member's observance of the principles, would require thorough review and might indicate the need for the Fund to initiate discussion with the member. Most notably, the indicators have been updated to reflect the increased importance of international capital flows.

It is no secret that the US administration, which has accused the IMF of being "asleep at the wheel" when it comes to exchange rate surveillance, has been pushing this decision in order to pressure China on its exchange rate policy.

focus on financial sector surveillance. The financial sector has a direct bearing on external stability in open economies through its central role in facilitating cross-border capital flows. The ensuing loosening of intertemporal constraints will have a direct impact on the savings and investment decisions of economic agents and, consequently, on the external position of the country concerned. Nevertheless, how the increased surveillance of the financial sector should fit into the 2007 decision is a challenge for the Fund.

As a related issue, it should be remembered that the prerogatives and responsibilities of the IMF in the field of capital movements and their surveillance lack a clear definition. The discussions in the late 1990s on giving the IMF jurisdiction in this area did not result in a legal mandate for capital account issues.

IMF expertise and "toolbox" – is there room for improvement?

This section aims to briefly describe the IMF's surveillance activities and to discuss possibilities. In short, the IMF has the combined role of watchdog and advisor, which is most evident within the policy discussions of the Article IVs and the Financial Sector Assessment Programs (FSAP). The World Economic Outlook (WEO) and the Global Financial Stability Report (GFSR) are the main vehicles for public communication of the Fund's analyses. The Financial Sector Indicators (FSI) comprise a set of indicators that could be used for both purposes. The FSI is compiled to monitor the soundness of financial institutions and markets, and of their corporate and household counterparts. They are a subset of the broader class of macro

[4] For more information on the decision, see http://www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision

prudential indicators that IMF staff use in surveillance of the financial system.

BILATERAL SURVEILLANCE

Article IV consultations are the principal tool of bilateral surveillance. Their primary focus is on the macro analysis of developments, external sustainability and related vulnerabilities, outlooks and recommendations. The overarching focus and methodology of Article IV is determined by the 2007 Surveillance Decision. Article IVs are mandatory and every member is subject to an Article IV every 12-24 months.

The FSAP is the main vehicle for financial surveillance. It assesses legal and regulatory frameworks, financial infrastructure, financial institutions, and markets. A key element is a comprehensive assessment of a country's compliance with key international standards and codes. Stress tests are usually carried out to analyse the financial system's strength and viability against a variety of shocks. A main worry in financial crises is contagion and the FSAP also provides an assessment of the "connections" in the financial system by monitoring the system characteristics and by comparing stress tests with standards in order to identify weaknesses. FSAPs are voluntary and carried out or updated on an approximately five-year cycle.

The Asian financial crisis in the late 1990's prompted the international community to work on structural measures to help avoid such crises in the future. Codes of good conduct concerning the regulation and supervision of the financial sector, as well as the transparency of policies and data, were agreed as a means of making the financial system more robust. Reports on the Observance of Standards and Codes (ROSC) summarize the extent to which countries observe certain internationally recognized standards and codes.[5] This work is usually prepared and carried out in the context of the FSAPs. The ROSC is used to help sharpen the financial institutions' policy discussions with national authorities, and in the private sector (including by rating agencies) for risk assessment. Short updates are produced regularly and new reports are produced every few years.

As indicated earlier, the financial sector plays a key role in shaping a country's external position by having a direct impact on the savings and

[5] The 12 standards and codes have been developed by the Fund or other standard-setting bodies such as the World Bank, the Basel Committee on Banking Supervision or the Financial Action Task Force (FATF). The standards and codes include accounting; auditing, anti-money laundering and countering the financing of terrorism (AML/CFT), banking supervision, corporate governance, data dissemination, fiscal transparency, insolvency and creditor rights, insurance supervision, monetary and financial policy transparency, payments systems, and securities regulation.

investment decisions of economic agents, and in supporting sustained output expansion by intermediating savings to their most efficient uses. Therefore, financial sector analyses should employ an important part of bilateral Article IV consultations. Macroeconomic analyses and sustainability assessments should explicitly take into account the robustness or vulnerabilities of the financial system and regulatory framework.

Integrating the Article IV discussions and FSAPs

Possible ways to step up financial sector analysis in the Article IV consultations include to improvement of financial sector expertise and better integration of the findings from FSAPs into the Article IV consultations. In this context, it should be noted that the progress in integrating financial sector surveillance in Article IV consultations and a better understanding of macro-financial linkages requires the improvement of financial expertise in the IMF departments that carry out the Article IV consultations.

Essentially, there are two potential ways to integrate the findings from FSAPs into the assessment of the general macro frameworks within the Article IVs:

i) FSAP => Article IV; look for financial sector risks and regulatory frameworks and evaluate their impact on the macroeconomic situation.
ii) Article IV => FSAP; look for macroeconomic risks and evaluate their potential impact on the financial system to identify weaknesses in its structure and regulation.

Both alternatives would require intense cooperation between the macroeconomists (area departments, Fiscal Affairs Department, etc.) and the financial sector economists in the Monetary and Capital Markets Department (MCM), by increasing the participation of staff from the MCM in the Article IV missions and through an increased use of interdepartmental forums. It may also be worth examin the form of FSAPs to see if there is scope for improvements, keeping in mind the different fields of application.[6] Moreover, FSAP updates could become more focused and tailored to country specific circumstances in order to maintain their current frequency within the limits of the current resource envelope.

The taskforce on integrating finance and financial sector analyses into Article IV concludes in its report that an overly-detailed or prescrip-

[6] On 30 May 2008, the Executive Board decided to integrate the offshore financial centre assessment programme with the FSAP (see IMF(2008c)). This can be seen as part of the attempt to simplify, standardise and streamline parts of the Fund's financial surveillance.

tive framework within the IMF was not recommended, given the variety in the IMF membership and the lack of widely-accepted methodology for assessing financial sector stability. There were, however, some general conclusions to be drawn for the Article IV mission chiefs, including more systematic cooperation with the MCM, increased use of existing interdepartmental forums (e.g. the preparatory processes for the WEO and the GFSR) and continued experiments with a wider range of analytical tools and data sources.

REGIONAL SURVEILLANCE

A potential problem with FSAPs is that they involve little analysis of financial cross-border issues. One of the conclusions from the IEO evaluation of FSAPs was that in countries with extensive cross-border financial sector participation, they generally made little inroad into the broader global and regional dimensions, with limited contribution to identifying and highlighting potential spill-over channels and effects.[7] In a world of increasing financial integration, this would suggest a need for more regional FSAPs.

From the perspective of the Nordic-Baltic region, where financial sector integration is at a very high level, and in the context of ongoing EU discussions on regulatory and crisis management frameworks, the focus of the regional FSAPs could be twofold. First, a regional FSAP could look closely at financial sector integration and its implications and try to identify possible risks. Second, considering the increasing need for policy cooperation as a result of ever closer financial sector integration across borders, the FSAP could assess the cross-border functioning of supervisory frameworks, including crisis prevention and resolution mechanisms.

MULTILATERAL SURVEILLANCE AND GFSR

When it comes to multilateral financial surveillance, the GFSR is the main instrument for global financial market surveillance. Its key objectives are to identify potential vulnerabilities in the international financial system from a multilateral perspective and to analyze linkages between developments in mature financial centres and capital flows to emerging markets. The GFSR takes a macroeconomic and aggregate stance and does not currently involve deeper analysis of the situation in different key financial institutions. However, the two most recent GFSRs, in April and October 2008, have already sought to draw policy lessons from the turmoil and

[7] IMF (2006)

have placed a particular emphasis on asset valuation, central bank liquidity frameworks and risk management.

The need for further modifications of the GFSR remains to be discussed. A possible idea for the Fund is an increased dialogue with a few key financial institutions in order to improve early awareness of new financial instruments that could cause risks to financial stability. The link between the GFSR and the FSAP could also be strengthened. For example, a country with weak financial supervision and an unclear division of responsibilities will experience more difficulties in preventing and managing a crisis than a country or region with more powerful supervision. This is also true for regions with significant financial cross-border integration. Today, the GFSR does not account for institutional weakness of this type. The knowledge stemming from FSAPs could thus be used to further strengthen and broaden the analysis in the GFSR.

The state of the debate

There have been a number of initiatives on how to adjust the Fund's work to the challenge of increasing financial sector surveillance. The most central ones are briefly described below.

IMF'S OWN ANALYSIS

In the reports IMF (2008a) and IMF (2008d), staff suggest that the Fund can increase financial sector surveillance through its Article IV consultations and FSAP Assessments.[8] In particular this would sharpen surveillance and policy advice in a number of areas. The most prominent strands of work are:

Risk monitoring and risk management: Staff propose to monitor macro-economic related risk profiles in individual financial institutions and the adequacy of risk management practices in financial institutions, including stress testing and capital adequacy with extra vigilance on liquidity issues. This includes aspects of eventual procyclicality in regulation, accounting frameworks and risk management practices. Monitoring the transition to Basel II is also important.[9]

Crisis management and resolution: This work will focus on legal frameworks and institutional set-ups for regulation, supervision, and crisis

[8] IMF (2008a).

[9] In most countries the law requires banks to hold a certain amount of capital to provide a cushion against losses and discipline bank owners. The Basel II framework is a consistent and internationally adopted framework for determining the capital requirement for individual banks. The basic idea is that the capital buffer should increase with the size and the level of risk in the bank's asset portfolio. Basel II has been implemented in EU law since January 1, 2008. For more on Basel II, see Lind (2005).

management and resolution. It includes issues such as central bank liquidity facilities, the powers and authority of supervisory authorities, deposit insurance schemes etc.

It is clear that the delegations from the Fund need to have the right knowledge of these issues in order to be able to provide real added value for the member country.

COOPERATION WITH THE FSF

Many members have proposed closer cooperation with the Financial Stability Forum (FSF, see Box 2), whose main mandate is to coordinate work on financial supervision and surveillance. The main argument is the natural complementarity between the IMF's broad surveillance activities and the FSF's gathering of senior national policy makers representing key regulatory and supervisory authorities. On the other hand, the FSF has a much narrower membership than the IMF since the FSF comprises the G7, a few other countries with financial centres and international organisations including the IMF, while 185 countries are members of the IMF. The cooperation between the IMF and the FSF has so far mainly involved Fund participation in FSF working groups and the exchange of information.

Providing an "early warning system"

The UK has been very active in the discussion on "early warning systems" (EWS) and has proposed a joint FSF/IMF biannual report listing the main risks to financial stability and the probability that they will occur. The IMF would rank the main global risks to financial stability and the FSF would set out a working plan for the relevant international bodies and committees to address these risks, recognising that most policy actions will ultimately be up to the individual countries. The report would be discussed at the IMFC meetings and then published.[10]

There are several potential problems with this suggestion. First, assessing the probability of occurrence and the magnitude of different sources of risk is not straightforward. Most likely it will be as much a computation exercise as a matter of judgement and gut feeling. In the end it may be difficult to distinguish one from the other. There are also data and modelling difficulties. Secondly, it would also require substantial

[10] The International Monetary and Financial Committee (IMFC) is an advisory body to the IMF. It consists of the Ministers of Finance of the 24 countries and constituencies represented on the Executive Board of the IMF. In practice, even though the communiqués of the IMFC are not formally binding policy documents for the IMF, the statements of the IMFC guide the work of the IMF. For more information on the governance of the IMF, see http://www.imf.org/external/about.htm.

resources, not least regarding the collection and evaluation of financial data. The need for extensive and trustworthy financial data might also limit the possible coverage to advanced economies where such data is available. Thirdly, the signalling effect might be severe if markets take a formal EWS very seriously with possibly unwanted consequences. Finally, the proposed division of labour between the IMF and the FSF will move policy decisions away from the IMF with its broad membership to a much more limited circle of countries. This may undermine the legitimacy and usefulness of the IMF.

Box 2: FSF – The Financial Stability Forum

The FSF was created in April 1999. Its aim is to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The FSF does not have permanent working groups but ad hoc working groups have worked on particular issues in greater detail, for example the operation of highly leveraged institutions, capital flows, implementation of standards, offshore financial centres, large and complex financial institutions and deposit insurance. The FSF Chair briefs the G7 Finance Ministers and Central Bank Governors and the International Monetary and Financial Committee of the IMF.

The FSF meets biannually or more frequently as needed. It also holds regional meetings in Latin America, the Asia-Pacific region, Africa and Central and Eastern Europe. In these meetings, Forum members and regional non-members exchange views on issues relevant to the stability of the global financial system and of regional systems. Such a meeting was hosted by the Riksbank in January 2007.

The FSF is managed by a small secretariat at BIS (Bank for International Settlement) in Basel. Analytical resources are contributed by members by forming ad hoc working groups.

Members of the FSF

Central banks, as well as regulatory and supervisory authorities from Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, United Kingdom and the United States.

International organisations: BIS, European Central Bank (ECB), IMF, Organisation for Economic Cooperation and Development (OECD), and the World Bank.

Standard-setting bodies: Bases Committee on Banking Supervision (BCBS), Committee on Global Financial Systems (CGFS), Committee on Payment and Settlement Systems (CPSS), International Association of Insurance Supervisors (IAIS), International Accounting Standards Board (IASB), and International Organisation of Securities Commissions (IOSCO).

For more on the FSF, see http://www.fsforum.org/

A difficult trade-off – macro or micro approach to financial sector surveillance?

This section attempts to discuss the crucial trade offs regarding the approach adopted in the IMF's financial surveillance. The first trade off to decide on is the proper balance between the micro and macro approach. The IMF's surveillance is today centred on the macro dimensions, which stems naturally from its role as a "global overseer" and the fact that the macro economic environment also affects the financial sector, for example through asset prices, credit losses and demand for financial services. The Fund has the role of "supervising the supervisors", where more long-term and macro-oriented issues such as legal and regulatory frameworks and market structures are assessed in the FSAPs and the macroeconomic policies are overseen in the Article IV consultations. Its comparative advantage with respect to surveillance is therefore not within a micro approach (assessing different financial institutions' balance sheets). On the other hand, meaningful financial sector surveillance might require deeper insight into the micro data of individual financial institutions and the IMF's broad knowledge of surveillance and its established contacts in all the member countries should make it possible for the Fund to adapt to new challenges. This would not be without resource implications and the need to prioritise scarce resources is evident. A thorough analysis of the financial sector in all member countries, in combination with the demands stemming from the 2007 surveillance decision, seems hard to manage within the limited budget envelope. Furthermore, the Article IV consultations are limited to a maximum of one visit per year and would not grasp all the continuous movements on the financial markets. Introducing a system of "Article IV updates", where the member states provide the IMF with data updates in the areas identified as vulnerable during the mission, could be a potential solution to the continuity problem, but this would also require resources. Another potential problem, with such a solution is that it may only work for a limited set of IMF's members who already have well-developed data-gathering routines in place.

Since FSAPs are voluntary, not all members with important financial markets are reviewed, for example systemically important countries such as the US and China have not been assessed yet[11]. In total, initial FSAP reviews have covered 2/3 of IMF members so far, and about the same in terms of world GDP. Consequently, prioritization of countries of systemic importance, where there are risks of contagion across borders, seems unavoidable if the IMF is to be able to perform the deepened analysis needed to properly evaluate the financial sector. Many countries would claim that such a prioritization would break the obligations the IMF has towards all its members. The middle way would be to integrate findings from the different instruments to a greater extent but without the intention of taking on new responsibilities for financial sector surveilance, which are currently handled on the national level. Today, the IMF assesses the macro aspects of the financial sector by looking at aggregates, potential bubbles and risk pricing. The macro assessment sometimes leads to a deeper micro assessment on the institutional level if deemed necessary – but how often and to what extent this is done is unclear. If this is to be performed on a more regular basis then access to micro financial data is crucial.

Today the IMF is represented in the FSF, but the potential for working with other international committees, such as CEBS and IAIS, could be further explored, especially to share the data sets needed for these micro assessments.

Conclusion

For the IMF to remain relevant for its members it is important to increase the IMF's surveillance of the financial sector. The IMF is well placed to integrate its findings and make policy recommendations in this area. It is, however, important that the changes evolve within the institution's comparative advantages, where an overly micro-orientated, resource-intensive approach should be avoided. Such an approach would make it more necessary to prioritize than can be justified by its mandate and principles of equal treatment of members; that is if the IMF has to concentrate its surveillance on a few systemically-important countries while more or less abandoning a large majority of its members. Both sides could argue that this is unfair and it would decrease the usefulness of the IMF in the latter group of countries and thus undermine the legitimacy of the Fund, further eroding its main comparative advantage – its universal membership. However, this should not rule out the use of micro data on an ad-

[11] The US has, however, promised to undergo a FSAP during 2009 (see speech by US Under Secretary McCormick, 25 February 2008)

hoc basis when deemed necessary; for example, if aggregated indicators signal significant weaknesses, there may be a need to study the balance sheets of one or a few systemically-important financial institutions to evaluate the probability of a default with profound contagion effects. Given these restrictions, the road forward as outlined by the IMF staff seems well advised.

It seems possible to increase the awareness of financial risks and to generate dialogue on proper policy responses by modifying already existing instruments. One way to improve surveillance is by more consistently linking the identification of financial weaknesses, including authorities' crisis management capacities, to the assessment of the macroeconomic developments, and vice versa. We would welcome an attempt to step up financial sector analysis into the Article IV consultations, including work to improve the financial sector competence and a better integration of the findings from FSAPs.

The regional and global perspective could be emphasized even further. One of the reasons for the magnitude of the recent turbulence was that it spread more rapidly across borders and markets than earlier crises. The IMF's surveillance must therefore increasingly aim at a more cross-border perspective, by taking a regional stance in regions or markets that are closely interdependent. One way is to expand the bilateral FSAPs to also cover regions with important cross-border flows, which was tried in a Nordic-Baltic Regional FSAP exercise in 2006-2007. In the context of increasing financial sector integration and policy coordination, the regional FSAPs should focus on financial system stability and crisis prevention and resolution frameworks.

The IMF has much to gain by cooperating with other international organisations and committees, such as the FSF. In any such cooperation it is important that the IMF continues to be a central actor when it comes to policy advice. The suitability of the more radical suggestions (e.g. EWS) is not as evident and there are several potential problems with these suggestions. First, assessing the probability of occurrence and the magnitude of different sources of risk is not straightforward. Most likely it will be as much a computation exercise as a matter of judgement and gut feeling. In the end it may be difficult to distinguish one from the other. There are also data and modelling difficulties. Secondly, it would also require substantial resources, not least regarding the collection and evaluation of financial data. The need for extensive and trustworthy financial data might also limit the possible coverage to advanced economies where such data are available. Thirdly, the signalling effect might be severe if markets take a formal EWS very seriously with possibly unwanted consequences. Finally, the proposed division of labour between the IMF and the FSF will

move policy decisions away from the IMF with its broad membership to a much more limited circle of countries. This may reduce the influence and transparency of non-FSF members and thereby undermine the legitimacy and usefulness of the IMF as a central forum for analysis and dialogue.

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