Statement by Andrew Crockett

Chairman of the Financial Stability Forum

International Monetary and Financial Committee Meeting

20 April 2002
Washington, D.C.

In its recent review of potential ***vulnerabilities*** affecting the international financial system, the Financial Stability Forum (FSF) noted that, despite an unprecedented confluence of shocks over the recent period, financial systems have shown significant resilience. This resilience reflects improvements in capital cushions, in risk management practices, and market innovations that have facilitated a greater dispersion of risk exposures. However, past experience suggests that credit losses will rise for some period of time after the recovery gets underway. Although the situation varies across countries, these are not likely to constrain the ability of financial systems to support the economic recovery now in train.

Alongside this more reassuring general outlook, there are a number of specific concerns that could impart volatility beyond the immediate conjuncture. One aspect is how a modest recovery might interact with high levels of household and corporate indebtedness in many countries. The situation in the financial system in Japan is also a matter of continuing concern. And while Argentina's default has produced little direct financial impact elsewhere, slower acting contagion might affect foreign direct investment flows and banking systems in other emerging markets.

Another aspect is how financing conditions and credit availability will adjust to the spate of recent ***corporate failures*** and heightened uncertainty about the strength of balance sheets and earnings. The FSF's recent meeting had a thorough discussion of these issues, the wider regulatory implications raised and initiatives set in train to address them. While the direct causes of many recent and large failures appear to be bad business judgments and possibly in some cases fraud, they have revealed weaknesses in the system of internal and external checks and balances on which public confidence in financial markets relies. Key aspects highlighted by the FSF on which rapid progress is seen as particularly important include the need to improve corporate governance, strengthen accounting standards, raise audit quality, and enhance public disclosure and external monitoring practices. To be fully effective, and avoid fragmenting global markets, public responses will need to involve mutually consistent actions by authorities in key financial centres.

A fair amount of work is in train by national authorities and by the key international regulatory bodies notably the International Organisation of Securities Commissions (IOSCO), the International Accounting Standards Board (IASB), and the Basel Committee on Banking Supervision (BCBS) to address these issues (see attached annex). The FSF will facilitate coordination of this work. A more comprehensive analysis of the issues involved and possible courses of action will be considered by the FSF at its next meeting in September.

The FSF has also reviewed the operational issues that arose in financial markets in the context of 11 September and had a preliminary discussion of the lessons to be drawn for ***contingency arrangements***. The importance of improving the resiliency of private sector facilities, ensuring adequate market liquidity and continuity of central banking and payment system functions were highlighted. A number of comprehensive analyses are still under preparation and the FSF will come back to these issues at its September meeting, including how the FSF might facilitate dissemination of conclusions drawn and implementation of recommendations made. In this connection, the FSF has developed a ***Crisis Management Contact List*** to facilitate crisis management. The list covers central banks, supervisory/regulatory agencies, finance or treasury departments in over 30 countries, as well the key international financial institutions and global financial infrastructure service providers.

Combating the Financing of Terrorism

Following requests by the G7 and G20, the FSF has reviewed progress in international efforts to combat the financing of terrorism. Members underscored the heightened importance for all jurisdictions of enhancing their implementation of international standards to contribute to this global effort. A number of important initiatives are underway by national authorities, the Financial Action Task Force, the IMF and World Bank and standard-setting/regulatory bodies. This work is progressing impressively and in a well-coordinated fashion. In discussing ways in which the blocking of assets could be made more effective, a recurrent theme was the importance of good coordination and cooperation among financial, supervisory, intelligence and law enforcement authorities within each jurisdiction. A number of FSF member countries have developed protocols for information exchange and co-operation among these bodies. The FSF Secretariat will compile and circulate these protocols as models that other countries may wish to adopt.

Follow-up on Previous Concerns

As part of its modus operandi, the FSF reviews efforts that have been taken to address concerns identified earlier, and in so doing aims to enhance information exchange and coordination, to provide impetus to work underway, to facilitate broad dissemination of completed work and to foster effectiveness in implementation. A note on *Ongoing and Recent Work Relevant to Sound Financial Systems* is compiled regularly and is available on the FSF's web site (***www.fsforum.org***), where the published reports of the FSF can also be found.

Offshore financial centres (OFCs): The FSF welcomed the acceleration of the IMF assessment program for OFCs. Such assessments have been completed in a number of OFCs and are underway in many others. Good progress by some OFCs in strengthening their supervisory, regulatory, information sharing and cooperation practices was seen by FSF members on many fronts. Other OFCs were seen to be lagging behind. The FSF will regularly consider progress by OFCs, drawing on supervisory experiences gathered through contact meetings, IMF assessment results publicly disclosed by OFCs, and periodic updates by the IMF. On the basis of these considerations, the FSF will draw public attention to those OFCs that give cause for serious concern, while it may also point out positive developments by OFCs as a model for others. The FSF will assess the overall effectiveness of its initiative once the IMF has completed its assessment program, which is expected in 2003.

Highly leveraged institutions (HLIs): The FSF has assessed how far previous concerns about HLIs have been allayed by the implementation of the recommendations made by the FSF in March 2000 following the Asian Crisis and the LTCM debacle. Members noted that improved counterparty risk management, strengthened regulatory oversight of hedge fund counterparties and gains in information flows have contributed to reduce the leverage deployed by hedge funds.

While the industry as a whole is growing, hedge funds are generally smaller than in the past. These developments have lessened the risks that hedge funds pose for the international financial system. However, FSF members warned against complacency and urged continued improvements in public disclosures by hedge funds to strengthen market discipline and reduce systemic risk. To this end, the BCBS and IOSCO will repeat at a future stage a review of counterparty risk management and regulatory oversight practices. The FSF also placed importance on follow-up work by the Joint Forum on enhancing public disclosure. While generally not seen as a direct concern for financial stability per se, IOSCO was encouraged to examine investor protection concerns that may arise in connection with hedge-fund products being marketed to retail investors. The FSF Secretariat's paper for this assessment is available on the FSF's website.

Large and complex financial institutions (LCFIs): Work is progressing on the development of an LCFI "Fact Book" template designed to provide a roadmap of important questions and critical information relevant in a LCFI wind down situation. The LCFI Fact Books correspond to one of the preparatory measures recommended by a multidisciplinary task force which the FSF had encouraged earlier to consider the issues that arise in preventing a disorderly failure of a LCFI. The fact books have a strong risk-focused perspective and highlights areas with the greatest potential to lead to problems of a systemic nature. They provide an additional means for supervisors to enhance their understanding of the LCFIs they oversee and the different business lines in which they are engaged. Supervisory authorities in a number of key financial centres are conducting field tests of the template for selected LCFIs in their jurisdictions.

Credit risk transfer mechanisms: In response to earlier concerns expressed in the FSF, the International Association of Insurance Supervisors (IAIS) and the Committee on Global Financial Systems (CGFS) are examining credit risk transfer instruments and potential issues for financial stability. Survey data is being gathered to build a better understanding of participation in these markets. Despite a number of credit events over the past year, the credit derivatives markets have functioned smoothly; there have been no major settlement difficulties. The IAIS is considering the regulations that apply to insurance companies' investment in complex instruments. The CGFS is considering the impact of credit risk transfer instruments on monitoring and analysis of credit risk, the adequacy of data collection, market standards and practices and the role of rating agencies in this market.

Supervisory Guidance on Dealing with Weak Banks

The FSF welcomed and recommended broad dissemination of the BCBS' *Supervisory Guidance on Dealing with Weak Banks* (***www.bis.org***, and ***www.fsforum.org***). Prepared by experts from developed and emerging market economies, working through the BCBS's Core Principles Liaison Group, the Guidance provides a practical toolkit for dealing with weak banks ranging from preconditions of bank weakness to resolution issues and market exit, relevant to a broad audience. This initiative follows up on the FSF's discussion in March 2001, which highlighted the need to develop international guidance for dealing with weak banks and systemic banking problems. The Guidance will also provide useful input into and complement other initiatives, such as that being led by the World Bank, to establish the appropriate legal, institutional, and regulatory framework to deal with bank insolvency, including in the context of systemic crises.

Regional FSF meetings

The FSF has initiated regional meetings to promote discussion among regional FSF and non-FSF members on financial system vulnerabilities and to enable non-members to inject perspectives into the FSF's work. Regional meetings have been held with authorities responsible for financial stability in Latin America (April 2001), Asia-Pacific (October 2001), and Central and Eastern Europe (April 2002).

The initial response to these meetings has been positive. Building on these efforts, a second round of regional meetings will be held, in Rio at the end of April 2002, and in the Asia-Pacific region towards the end of 2002.

Annex

Summary of work by international bodies in response to weaknesses revealed by recent corporate failures

FSF member	Issues and provisional timetable
International Organisation of Securities Commissions	The Chairs' Committee will assist in identifying and examining the strategic issues of common interest to securities. Among the issues under consideration for the forthcoming May meeting are: • Accounting standards in liaison with IASB • Auditing standards • Disclosure and transparency issues • Unregulated entities/scope of supervision • Effects of consolidation in the auditing industry • The role of rating agencies A progress report will be ready at the time of the FSF September meeting.
International Accounting Standard Board	In the IASB's work plan, some topics are directly related to the weaknesses revealed by recent corporate failures, such as off balance sheet items and off income statements: • Securitisation and leasing transactions • Creation of unconsolidated entities (using Special Purpose Entities for instance) • Pension obligations • Stock options
OECD	The Steering Group on Corporate Governance will develop a work programme aiming to ensure that the Principles will maintain their relevance as an instrument for market integrity. Areas of particular interest include board practices, disclosure practices and the use of private contracting practices for building efficient corporate governance and incentive structures. The Committee on Financial Markets has identified financial integrity as a major theme in its work programme for 2003-2004 to be discussed at the next meeting in April and related work on pensions issues will be conducted by the Working Party on Private Pensions
Basel Committee on banking supervision	The Basel Committee is: • surveying structural and principal issues relating to internal audit; • preparing an overview survey of issues relating to the use of Special Purpose Entities; • developing – with the FSI – a training program for banking supervisors on international accounting and auditing issues; • analysing approaches for provisioning and significantly updating and expanding its sound practice paper on loan accounting and disclosure; and • identifying and monitoring important accounting and auditing questions flowing from recent high profile corporate failures.
Joint Forum	The Joint Forum has recently decided to assess progress in implementing the Multidisciplinary Working Group on Enhanced Disclosure's recommendations (Fisher report) and to examine the need for further follow-up on disclosure of financial risks.
Committee on the Global Financial System	The Committee will be considering at its May meeting some of the lessons to be drawn from recent corporate failures, from a market dynamic perspective. For example, it will revisit the issue of the effectiveness of market-based mechanisms of corporate control (information policy) as well as the challenges for assessing and managing credit risk in presence of rating triggers and other contingent commitments.