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Chairman of the Financial Stability Forum
International Monetary and Financial Committee
Meeting

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The Financial Stability Forum (FSF) held its thirteenth meeting on 11 March 2005 in Tokyo. The issues discussed included: risks and vulnerabilities in the international financial system; risk transfer to the household sector; offshore financial centres; financial reporting and audit-related matters; international standards, codes and best practices; and reinsurance.

Vulnerabilities in the international financial system

The FSF noted that the near-term outlook for global growth and inflation and the current balance sheet strength of financial institutions provided a positive backdrop for financial stability. However, members identified risks with the potential to cause strains in financial systems. These included the current level of global funding and market liquidity and the associated low levels of risk premia and long-term interest rates. Other risks discussed included the process of unwinding global current account imbalances, the continued tightness of commodity markets and possible spillovers to other economies from future capital account or economic developments in China.

The FSF observed that levels of spreads and long-term interest rates could partly be explained by the benign current conjuncture, but some expressed a view that market participants may be underpricing risks. In particular, credit spreads and implied volatility in a number of markets remained historically low, and this may in part be attributable to high liquidity and the ongoing “search for yield”. Long-term bond yields, despite their recent rise, were also still low. While this too in part reflected fundamentals such as low long-term inflation expectations, other factors, such as accounting and regulatory changes affecting institutional investors, together with high liquidity, were keeping rates lower than they otherwise would be. This could cause problems either in the event of a disruptively sharp rise in yields and spreads, or if long-term rates remained low.

The FSF noted that major banks and securities firms seemed well placed to manage potential changes in the economic and financial environment. Nonetheless, members encouraged market participants to monitor and manage evolving risks closely, including through stress-testing of exposures to more adverse scenarios. Such stress tests should include not only market risks but also market liquidity, credit and operational risks.

The FSF also discussed the continued rapid growth of the hedge fund sector and the systemic importance of hedge funds’ counterparty relationships. It will continue to review developments at with respect to hedge funds at subsequent meetings.

Risk transfer to the household sector

The FSF discussed longer-term issues relating to financial risks faced by households and the corresponding policy implications. Major changes in financial tools and risk exposures are underway on both the asset and liability sides of household balance sheets. Analysis of the implications of these developments for financial stability is still at an early stage. Members observed that these changes allow households either to avoid or take on greater financial risk, by taking advantage of the greater range of financial products available. They highlighted the need to foster greater financial education for households.

Offshore Financial Centres (OFCs)

The FSF agreed on a new process, based on objective criteria and due process, to promote further improvements in OFCs. This initiative reflects the need to address remaining problems in several OFCs, notably in the areas of effective cross-border cooperation and information exchange and adequacy of supervisory resources.

The Forum has taken a close interest in the progress made by OFCs in strengthening their regulatory, supervisory, cooperation and information exchange arrangements. In May 2000, the Forum encouraged OFCs to undertake needed reforms and asked the International Monetary Fund (IMF) to put in place an assessment program that would ensure progress on a lasting basis. At the time, the FSF also issued a list of 42 OFCs to help the IMF to set priorities for its assessment program.

With the first phase of the IMF's assessment program now almost complete, the list of OFCs issued by the FSF in 2000 has served its purpose and is no longer operative. The new process includes a set of initiatives by Forum members at both international and national levels and appropriate steps by the FSF itself. The FSF will establish a group to review reports by IOSCO, the IMF and other bodies on the status of their efforts and the results that have been achieved. Drawing on the advice of this group, the FSF will consider as necessary follow-up actions, either to recognise improvement in cooperation or to highlight non-cooperation with ongoing assessment processes. Unless other considerations call for acceleration of the process, the FSF will review the adequacy of these initiatives in addressing the current concerns held by its members in two years' time.

Financial reporting and audit-related matters

The FSF welcomed the establishment in February 2005 of the Public Interest Oversight Board (PIOB) to oversee the International Federation of Accountants' (IFAC) standard-setting activities relating to auditing and assurance practices and member body compliance programmes. There is a strong public policy interest in sound international audit practice standards and their effective implementation. The Forum, which had urged the establishment of the PIOB, will continue to support its activities.

Relatedly, the heads of the newly established independent national auditor oversight bodies met for a second time in Washington on 24 March, following their first meeting last September, to share experiences and discuss common challenges.

The FSF also noted progress towards international convergence in accounting standards and encouraged a positive outcome with regard to the finalisation of IAS 39 and other important conceptual accounting issues. In this regard, the FSF, the International Accounting Standards

Board and IFAC, had organised a roundtable last October on challenges associated with the implementation of international accounting and auditing standards. The Forum intends to continue to seek ways to contribute to ongoing consideration of the systemic implications of accounting standards.

International standards, codes and best practices

The FSF discussed the findings and recommendations of a report by an IOSCO Chairmen's Task Force on IOSCO's response to recent high-profile incidents of securities fraud and market abuse. The report stressed the need to devote resources to implementation of existing best practices and also identified a few areas in which development of new best practice principles may be warranted.

The FSF agreed to review at its next meeting progress and issues with respect to implementation of standards and codes more generally, including priorities in standards assessments and the availability of resources to assist implementation. As input into that discussion, the FSF Secretariat, with the World Bank and IMF, will convene a meeting of standard setters, assessors, and others involved with standards and codes to refine the issues that could usefully be addressed. The Fund's and World Bank's own forthcoming review of standards and codes will also provide input to the FSF discussion.

Reinsurance

The FSF welcomed the publication of the first global reinsurance market report by the IAIS in December 2004 and encouraged the IAIS to further develop data collection and analysis of the structure and resilience of the sector. The report highlighted the improving overall financial strength of the reinsurance industry during 2003 and the statistics do not so far indicate any significant concentration of exposures by reinsurers to other sectors or by other sectors to reinsurers. The FSF will continue to support efforts to enhance transparency, regulation and supervision of this sector.

Other issues

The FSF also discussed work in a number of other areas, including a Joint Forum group examining financial institutions' liquidity risk management practices; another Joint Forum group seeking to develop high-level principles on business continuity for financial authorities and market participants; and finally a task force co-chaired by the Committee on Payments and Settlement Systems and the World Bank to establish general principles on international remittances. The FSF has an ongoing interest in these subjects and looks forward to the final reports.