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The Financial Stability Forum (FSF) reviewed vulnerabilities in the international financial system at its meeting in early September and in a subsequent teleconference. Financial systems and institutions have thus far weathered well the deterioration of the economic and financial environment. However, the intensification of earlier strains, coupled with additional aggravating factors stemming from the tragic events of 11 September, will put the resiliency of the financial system to serious test. In light of the deteriorating outlook, the FSF has taken action to intensify its monitoring of vulnerabilities in the financial system.

Core financial systems have shown a high degree of resilience due in part to strengthened risk management and to improved capital positions following several years of strong profitability. However, credit losses will accelerate further as corporate and household balance sheets become more fragile and as a result of problems affecting certain large borrowing sectors, such as telecoms and related sectors and those badly affected by recent events. Heightened risk also prevails in the insurance and reinsurance sector from under-reserved claims and falling asset prices, and may have wider effects from the increase in risk transfer activities between insurance and banking firms in recent years. In emerging market economies, the effects on contagion risk of greater risk awareness and strengthened country defences are being tempered by the global slowdown and increased risk aversion. An aggravation of financial problems in Japan could also have adverse spillover effects, including through counterparty relationships among Japanese and foreign financial institutions.

The rest of this statement briefly reviews some of the FSF's other recent activities. A note on *Ongoing and Recent Work Relevant to Sound Financial Systems* is compiled regularly by FSF members, for the purpose of enhancing information exchange, co-operation and co-ordination. It is available on the FSF's web site (www.fsforum.org), where the published reports of the FSF can also be found.

Follow-up on Previous Concerns

At its September meeting, the FSF reviewed efforts to address earlier concerns on offshore financial centres (OFCs), highly leveraged institutions (HLIs) and challenges relating to winding down large and complex institutions (LCFIs).

On *Offshore Financial Centres (OFCs)*, the FSF took note of the steps that had been taken by some OFCs to enhance their supervisory, regulatory, cooperation and information practices. It emphasised that continuing efforts were needed to translate these changes into day-to-day practices. More remains to be done and the FSF will monitor closely the progress made by OFCs. The FSF encouraged OFCs that had not already done so to take the necessary steps to enhance

their implementation of relevant international standards and urged the IMF to complete its assessment program as soon as possible. FSF members underscored that disclosure of action plans and assessment findings are a useful means for OFCs to help demonstrate their progress towards meeting such standards. The FSF will return to these issues at its next meeting in March 2002. In the meantime, and with the FSF's encouragement, a contact meeting will be held in late November with onshore and offshore supervisors, the IMF and other groupings to facilitate efforts to strengthen supervisory, information sharing and cooperation practices in OFCs, which have taken on increased urgency following 11 September and the global efforts to combat terrorism financing.

On *Highly Leveraged Institutions (HLIs)*, the FSF has set in train an assessment of how far previous concerns have been allayed since the recommendations it made in March 2000 following the Asian Crisis and the Long Term Capital Management debacle. In March 2002, the FSF will review this assessment, which will take into account changes in financial markets and the industry in recent years.

Following the preventative measures identified by a multidisciplinary task force to address spillover effects from a disorderly failure of a *large and complex financial institution (LCFIs)*, FSF members have set in train work, including to create fact books on LCFIs and to consider the effectiveness of national contingency procedures. In addition, members agreed that it would be useful to update and convert the Market Authorities Communications Services (MACS), which was launched by the Joint Year 2000 Council for Y2K, into an ongoing contact application.

Guidance on Deposit Insurance Systems

The FSF welcomed the final report of the working group that sets out guidance for the benefit of countries establishing or reforming a *deposit insurance* system. In drawing up such guidance, an extensive consultative process had been undertaken, which would enable it to be adaptable to a broad range of country circumstances, settings and structures. The report builds on three general interrelated findings. First, explicit and limited deposit insurance is preferable to implicit coverage if it clarifies obligations to depositors and creditors and limits the scope for discretionary decisions. Second, deposit insurance systems must be properly designed, well implemented and understood to be credible and avoid moral hazard. Third, to be effective, the deposit insurance function needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes. A conference was held at the BIS in October to disseminate and discuss the guidance, which was well attended with participation from a wide range of developed, emerging and developing economies. The guidance is available on the FSF web site and should be useful both for practitioners and external advisors.

Implementation of International Standards

The FSF, drawing on the final report of the Follow-up Group on Incentives to Foster Implementation of Standards, considered that good progress had been made in a number of areas, including in engendering closer co-operation between international financial institutions and standard-setting bodies and in raising market participants' general awareness of standards. Nevertheless, it emphasised the challenges that still lay ahead, particularly in providing technical

assistance and its effective co-ordination and in encouraging market participants to take further into account a country's observance of standards in their investment and lending decisions. The Group's report is available on the FSF web site.

The FSF also welcomed the completion of the Joint Forum's work on comparing the Core Principles for banking and insurance supervision and securities regulation. Members considered that this work would help facilitate implementation of these principles by clarifying their similarities and differences and ensuring a coherent framework, as appropriate. The report is available at www.bis.org.

Regional Outreach by the FSF to Widen Consultations

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 their perspectives into the FSF's work. A first such regional meeting was held in Mexico City in April 2001. A second meeting was held in October in Tokyo with representatives from ministries of finance, central banks and, where relevant, the separate supervisory authorities in eight non-member countries in the Asia/Pacific region. A third regional meeting with representatives from Central and Eastern European countries is planned for early in 2002.