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International Monetary and Financial Committee
Meeting

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The Financial Stability Forum (FSF) held its twelfth meeting on 8-9 September 2004 in Washington. For purposes of this report, the topics addressed fall into six broad categories: potential vulnerabilities in the international financial system; implementation of international financial sector standards; offshore financial centres; financial reporting and governance; credit risk transfer; and reinsurance.

Vulnerabilities in the international financial system

The central view of the Forum was that the macroeconomic backdrop for financial markets had generally improved since its March meeting. Several previous downside risks have become less pronounced: markets have adjusted well to the initial stages of withdrawal of monetary stimulus; and the resilience of key financial systems to shocks has increased further.

Nonetheless, the Forum saw little room for complacency and discussed several areas meriting close monitoring in the period ahead, including the potential impact of removing policy stimulus; the potential impact of sustained high oil prices on growth and inflation; continuing fiscal and external imbalances in several countries; ongoing uncertainties about the trajectory of the Chinese economy; and the resilience of emerging market economies to these developments. Members also reviewed financial sector vulnerabilities. They noted strengthened levels of capital in the financial system and discussed potential sources of heightened market volatility and impairment of market liquidity. The Forum also discussed the impact of rising inflows to hedge funds on market functioning and on the risk profile of financial institutions, and the progress made to date to strengthen business continuity arrangements in key financial centres. I look forward to reporting in more detail on these issues at the IMFC meeting.

Implementation of international financial sector standards

With much practical experience accumulated in assessing the implementation of international supervisory and regulatory standards, the Forum considered ways to improve their implementation in the banking, securities and insurance sectors, based on the experience of the joint IMF/World Bank Financial Sector Assessment Program. The discussion focused on the treatment of preconditions for sound supervision and regulation, the consistency of implementation methodology, cross-sector and cross-border regulation, regulatory and corporate governance and public disclosure. The international standard-setting bodies in these sectors were encouraged to consider cross-sectoral issues with a view to addressing inconsistencies and incompatibilities among the standards in areas where they overlap, in consultation with the Joint Forum and the international financial institutions.

Offshore Financial Centres (OFCs)

The Forum reviewed work in various international fora, notably IOSCO, the Basel Committee on Banking Supervision (BCBS), the IMF and the Offshore Group of Banking Supervisors, to improve information sharing and cross-border cooperation between on- and offshore authorities on supervisory and regulatory matters. Cooperation and information sharing has generally improved with regard to banking and prudential concerns, but problems remain with respect to information exchange in respect of investigations involving violations of securities laws. Moreover, the experience of offshore cooperation differs across onshore jurisdictions. The Forum concluded that further progress is necessary and that tools should be developed, based on objective criteria and due process, to recognise and catalyze improvements, drawing on assessments of OFCs by the IMF and IOSCO.

Financial reporting and governance

The progress and international coherence of work to strengthen financial reporting and governance have been a focus of the Forum. In Washington, Forum members were briefed on the latest developments in the area of International Financial Reporting Standards (IFRS) and on discussions on convergence between the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). The Forum noted that attention now needed to shift to the effective implementation of IFRS standards. The FSF is organising a roundtable on the challenges to the implementation of international accounting and auditing standards with the IASB and the International Federation of Accountants (IFAC) in October.

As regards audit quality and auditor oversight, the Forum expressed concern about delays to the establishment of the Public Interest Oversight Board (PIOB) to oversee the standard-setting activities of the International Federation of Accountants (IFAC), including the continuing development of International Audit and Assurance Practice Standards. These standards are utilised by many countries and more will adopt them in 2005 alongside the move to International Financial Reporting Standards. The formation of the IFAC PIOB has been held up by discussions about audit reform in Europe.

Credit risk transfer (CRT)

The FSF reviewed and welcomed a final Joint Forum report on CRT activities. The report concluded that to date CRT transactions have generally experienced a good record of accomplishing a clean transfer of risk. Market players appeared to have absorbed lessons of past experience and have employed mechanisms to address counterparty risk and legal risk. Moreover, participants seemed to understand the main risks involved in CRT activity. However, certain risk management issues such as the role of implicit leverage, correlation assumptions, model risks and reliance on credit rating agencies called for particular attention, particularly in the context of complex structured products. The report set out a number of recommendations in relation to risk management practices, disclosure and supervisory approaches. The Forum urged market participants and the regulatory community to support and apply the recommendations of the report.

Reinsurance

The FSF welcomed the progress by the International Association of Insurance Supervisors (IAIS) in the preparation of the first global reinsurance market report, scheduled to be published by the end of the year, which will further enhance the transparency of the reinsurance industry.

FSF Asia-Pacific Regional Meeting in Beijing, May 2004

As members of the IMFC are aware, the Forum holds regional meetings. At the end of May this year, the Forum held its third Asia-Pacific regional meeting, kindly hosted by the China Banking Regulatory Commission. Senior representatives from finance ministries, central banks, and supervisory and regulatory authorities of the major regional economies plus Canada, France, Italy, Netherlands, United Kingdom and the United States, as well as senior officials from international institutions and standard setting bodies, attended the meeting.

The meeting covered three broad subjects: potential vulnerabilities in international and regional financial systems; progress in strengthening regional financial systems; and improving financial sector governance, transparency and audit quality. The meeting had an extensive discussion about the likely adjustment path of the Chinese economy, including the policy responses needed to curb overheating and engineer a gradual slowdown. Most participants expressed confidence in the ability of Chinese authorities to manage the situation.

Though strong growth in the region has generally reduced levels of non-performing loans and increased capital and profitability of banks, challenges remain in a number of regional financial sectors. These include: risks from increased consumer lending including credit card loans; renewed insider and directed lending in some banking systems; the need to further enhance supervisory capacity, including the adoption of prompt corrective action schemes for banks and legal protection for supervisors; and the need to strengthen and clarify the regulation of securities investment products and to ensure that the investors understand the risks they bear. Further development of domestic and regional bond markets was also emphasised as a means of deploying regional savings more effectively and increasing financial resiliency. Views were exchanged on ways to facilitate access to the market by a wide variety of issuers and to create an environment conducive to developing bond markets.

Ensuring strong corporate governance in financial institutions in Asia, particularly banks, is a priority, given their dominant role in regional financial systems and their wider impacts on the overall economy. However, enforcement of regulations was sometimes recognised as a problem, due in part to weak legal protection of supervisors and poor enforcement of laws related to the operation of financial markets.