

Statement by Mario Draghi
Chairman of the Financial Stability Forum
International Monetary and Financial Committee
Meeting
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Washington, D.C.

The Financial Stability Forum (FSF) held its seventeenth meeting on 29 March 2007 in Frankfurt. The issues discussed included: global risks and vulnerabilities in the international financial system; hedge funds and counterparty risk management issues; planning for and communication in crises; effective and efficient regulation; international audit and accounting issues; and offshore financial centres.

Global risks and vulnerabilities

The FSF reviewed the turbulence in global equity, credit and foreign exchange markets in late February and early March. As is typical in such episodes, a broad range of markets moved sharply in concert, and there was some evidence of positive feedback effects amplifying price movements. Markets generally functioned well amidst large volume increases, and remained liquid during the episode. Counterparties met margin calls without causing further market disruptions. However, members noted that the episode occurred in an environment of generally good macroeconomic fundamentals, strong balance sheets, and no significant counterparty concerns. Market participants need to ensure that risk management scenarios take appropriate account of the potential consequences that would arise from a more pronounced and prolonged reduction of risk-taking.

Credit risk transfer instruments have facilitated the management and diversification of credit risk. However, questions have remained about how these instruments might behave during a period of stress. The problems in the US sub-prime mortgage market largely reflect a progressive weakening of credit standards in this market segment. But they offer some insight into how sectoral credit problems could play out more generally in the new “originate-and-distribute model” of credit intermediation. Members discussed steps that can be taken to strengthen the underpinnings of credit risk transfer activity, and asked the Joint Forum to consider the extent to which its 2005 paper on Credit Risk Transfer merits updating.

The FSF also discussed the increase in private equity and leveraged buyout transactions. Members believe that the private equity market plays an important role in efficient capital allocation. At the same time, it was agreed that the FSF should continue to monitor developments in this area, particularly as they relate to overall corporate leverage, the credit exposures of intermediaries and other potential implications for financial stability.

Hedge funds and counterparty risk management

The FSF discussed developments in the hedge fund sector and the supervisory, regulatory and private sector actions taken in recent years to strengthen market discipline, risk management practices and market infrastructure. The role of hedge funds in price discovery, market liquidity and the risk-bearing in markets has increased. More recently, hedge funds have significantly expanded their involvement in credit markets, where complex products can pose

substantial risk management and valuation challenges. This heightens the importance of sound counterparty risk management practices by all financial intermediaries, including with regard to margining, collateral, and stress testing practices. The FSF emphasised the importance of enhancing the effectiveness of market discipline and of continuing supervisory attention to strengthening counterparty risk management practices. In this context, the FSF took note of the recent principles and guidelines regarding private pools of capital issued by the US President's Working Group on Financial Markets and the draft principles for the valuation of hedge fund portfolios issued by IOSCO. Members noted that both documents set expectations for hedge fund managers, including that they have information, valuation and risk management systems that enable them to provide accurate and relevant information to investors, creditors and counterparties with appropriate frequency, breadth and detail. The FSF is updating its 2000 report on highly leveraged institutions.

European regional FSF meeting

In January this year, the FSF held a European regional meeting in Stockholm. The vulnerabilities discussion centred on the financial stability implications of the rapid growth of private sector credit in central and eastern Europe, of which a significant portion in several countries is denominated in foreign currency. Supervisory challenges were noted concerning cross-border financial groups and the accompanying need for further improvements in cross-border exchange of supervisory information and coordination. The meeting also discussed prioritisation of financial system reforms and progress in developing domestic capital markets, including the scope for region-wide initiatives.

Planning and communication for crises

In November 2006, the FSF jointly hosted with the UK authorities a workshop on planning and communication for financial crises and business continuity incidents. FSF members agreed that it would be useful to continue to share experiences in this area, including lessons learned from crisis exercises and business continuity incidents.

Efficient and effective regulation

Following discussions of effective regulation at recent FSF meetings, members of the Forum from national regulatory bodies are undertaking a stocktaking exercise on the principles and procedures they follow in the development and interpretation of regulations and other forms of major policy initiatives. The information gathered will facilitate comparison of national practices.

International audit and accounting issues

At the FSF meeting the Chairman of the new International Forum of Independent Audit Regulators (IFIAR) gave a presentation on IFIAR projects and the outcomes of its first meeting, held in Tokyo on 22-23 March. The FSF supported IFIAR's planned work program, which aims to enhance and bring more global consistency to audit oversight and quality. Moreover, the FSF encouraged its own members to continue efforts that will promote higher audit quality. Members also took stock of the recent progress of accounting standard setters in addressing various international issues, including ongoing efforts to harmonise accounting standards and to ensure consistent interpretation of standards.

Offshore financial centres

Based on a report from its Offshore Financial Centre (OFC) Review Group, FSF members noted progress by several OFCs in improving compliance with international standards,

including cross-border cooperation and information exchange. The FSF urged its member bodies to continue to address remaining problems in OFCs. The FSF encouraged OFCs that fall short of international standards, that have not published their detailed IMF assessments, or are not actively contributing to the IMF Information Framework Initiative to make further progress in these regards. The FSF will undertake a review of its OFCs initiative, which it will discuss in September.

Other issues

The FSF welcomed the third report of the International Association of Insurance Supervisors (IAIS) on the global reinsurance market, which was published last November. They noted that the annual report adds significantly to knowledge about this important market sector, and encouraged the IAIS to explore possible ways to further enhance the report's useful analysis of reinsurance groups' role in risk transfer.

The FSF also welcomed the general principles for international remittance services, which were published by the Committee on Payment and Settlement Systems and the World Bank in January. Members encouraged countries to adopt these principles, which aim at assisting countries who want to improve the payment systems and other aspects of the market for remittance transfers.