

**Statement by Caio Koch-Weser**  
**Interim Chairman of the Financial Stability Forum**  
**International Monetary and Financial Committee Meeting**

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Since its last report to the IMFC, the Financial Stability Forum (FSF) has focused on three priority areas: identification of **potential vulnerabilities** in the international financial system; monitoring progress in various initiatives to strengthen **market foundations**; and following up on **earlier concerns** relating to credit risk transfer activity, the lack of transparency in the reinsurance industry, information gaps on Large Complex Financial Institutions and assessments of offshore financial centres.

**Vulnerabilities in the international financial system**

At its meeting in Berlin on 24-25 March 2003, the FSF reviewed the global economic situation and various underlying sources of economic and financial strength and weakness. Developments in the financial system have obviously been affected by shifting assessments of the geopolitical situation related to the war in Iraq and members felt that it was hard to evaluate the impact of the war at this early stage. Geopolitical clouds aside, economic fundamentals were still affected by the adjustment of past imbalances, the pace of which varied across sectors and countries.

The global financial system has, on the whole, continued to hold up well despite the accumulation of additional strains. Financial authorities were confident that in the absence of further shocks, existing problems could be resolved by the financial industry itself. However, simultaneous and continued pressure from equity and credit markets had significantly eroded the capital cushions of some financial institutions, subjecting the global financial system to increased vulnerabilities should other shocks occur. Insurance companies are particularly susceptible to further asset price declines given their large bond holdings and still significant exposure to equity markets and their eroded capital base. Protracted low growth or further asset price falls could cause problems in some financial systems. It was critical to raise the profitability, in some cases capital levels, of financial institutions to buttress their resiliency.

Members considered the ongoing adjustment in emerging market economies (EMEs) and their improving access to international capital markets in recent months. Most EMEs were considered to be pursuing sound macroeconomic policies. However, concerns could arise if the global economy were to remain weak or if sound policies were not sustained. The Forum encouraged further work by international financial institutions on debt sustainability and currency mis-match problems in EMEs.

Against this background, the Forum emphasised that enhanced vigilance and close co-operation among financial authorities will be needed in the period ahead. Should significant downside risks materialise or risk aversion greatly intensify, financial authorities will act, as appropriate, to contain market deterioration. However, policy responses should not prevent the necessary shedding of excess capacity built up in previous years.

## **Progress in addressing weakness in market foundations**

The FSF has reviewed the progress achieved in various national reform initiatives in addressing weaknesses in market foundations and their international convergence. Forum members welcomed the encouraging progress achieved to date and considered that national reform initiatives have on the whole aimed at similar objectives across countries and cross-border consultations have been extensive. This is laying the basis for stronger and more internationally coherent market foundations for the future.

Members concurred that high-level international principles in the areas of corporate governance, auditing, accounting and disclosure are invaluable to restoring confidence in financial markets and to achieving a level of convergence in regulatory approaches that could eventually form the basis for mutual recognition across jurisdictions. In this regard, members welcomed the work by various bodies, including the ongoing OECD review of its Corporate Governance principles; IOSCO's recently released principles on auditor independence and public oversight arrangements; the convergence project between the IASB and the US Financial Accounting Standards Board, and the IASB's open consultation on IAS 39 on fair value accounting; and the work by the US SEC and international bodies, notably the IOSCO, to address possible conflicts of interest and issues relating to credit rating agencies.

To sustain the current momentum, the FSF advocated the desirability of further progress in the following areas. On **corporate governance**, members urged that recent improvements in national standards be reflected in a strengthening of the OECD's Principles. They also encouraged the OECD and World Bank to build on their experiences with assessing adherence to corporate governance standards and examine how the dialogue on good practices can best be sustained.

Concerning **accounting standards**, members urged the IASB to continue its work with national accounting standard setters to achieve convergence on a single set of high quality principles-based accounting standards, with due regard to financial stability concerns, and their adoption within the framework established by the IASB.

With respect to **audit practice standards**, there is a strong public policy interest in sound international audit practice standards and their implementation, especially given the move towards principles-based, internationally convergent accounting standards. Forum members urged that an independent, external body acting in the public interest be established to oversee the work of IAASB.

The FSF also underscored the need for strong **auditor independence and public oversight arrangements** to restore confidence in the integrity of the financial reporting framework. They urged relevant authorities and concerned parties to ensure the speedy implementation of IOSCO's recent principles at national levels, including through enactment of legislation where required. Resistance by the audit profession should not be yielded to.

The FSF also reviewed work underway to address possible conflicts of interest and issues relating to **credit rating agencies**. These are priority areas for the Forum, which is well placed to ensure that progress is sustained in a well-coordinated manner.

The FSF will continue to closely monitor the initiatives underway, focus attention on gaps and areas of important divergence in reform efforts and initiatives, and promote international and cross-sectoral coherence when these entail opportunities to increase the efficiency, integrity and stability of financial markets. It will also make use of its regional outreach

initiatives to discuss evolving best practices and promote wider reforms. The FSF will review progress in reform efforts at its September 2003 meeting.

### **Progress in addressing earlier concerns**

The FSF has also reviewed progress in addressing earlier concerns relating to credit risk transfer activity (CRT), reinsurance issues, information gaps with regard to large and complex financial institutions (LCFI) and assessment of offshore financial centres.

Following recent FSF discussions, the IAIS and the CGFS have produced reports on **credit risk transfer activities**. These reports identify a number of issues being followed up by these bodies. The Forum noted that the concentration of the CRT market on a small number of players requires close monitoring. It also noted that the lack of information on the flow of credit derivatives and the ultimate bearer of credit risk transferred make it difficult to assess the incidence and impact of credit deterioration. The FSF urged speedy and decisive action to close information gaps in this area. In this respect, the FSF, in conjunction with the CGFS, IAIS and other bodies will explore how the information needs relating to CRT can best be satisfied.

Since last fall, a Task Force of the IAIS has been developing proposals to enhance transparency and public disclosures in the **reinsurance industry**. The Forum expressed strong support for the work of the Task Force to develop a global reinsurance market database. This will help close an important gap in the information available on the global financial system. Members felt that reporting to such a database could be done on a voluntary basis and called upon major reinsurance companies to work with this Task Force to this end.

Work has also been underway to improve the information available to relevant financial authorities on **Large Complex Financial Institutions**. The FSF encouraged Forum member countries that had yet to participate in the LCFI fact book exercise to do so and to share experiences and draw lessons for supervisory practice and contingency planning. Members encouraged old and new field testers and other interested authorities to get together from time to time to take stock of the fact book experiences. Members also proposed to review certain issues relating to the provision of emergency liquidity assistance for institutions operating across borders and in different payment systems.

With regard to **Offshore Financial Centres (OFCs)**, the FSF emphasized again the importance of progress by OFCs in bringing their supervisory, regulatory, information sharing and cooperation practices up to international standards. The FSF welcomed the significant advances achieved in the IMF's assessment program and its timetable to complete the assessment of all significant jurisdictions listed in the FSF groupings of May 2000 by the end of 2003. Members also welcomed the recent publication by Andorra and Barbados of their IMF assessments, as well as the declared intention of Monaco and Vanuatu to do so. The FSF encouraged those OFCs that have undergone assessments to make public the results when the assessment process is completed and to act speedily to implement any recommendations. It also called on those that have requested assessments of observance of standards under the IMF's Module 2 or the FSAP and those whose assessments are underway to make public the results of these assessments when they have been completed, along with action plans to implement recommendations. The FSF will assess the overall effectiveness of its OFC initiative in September 2003.

## **Regional FSF Meetings**

As members of the IMFC are aware, the FSF has held regional meetings since 2001. The Forum held its second regional meeting in the Asia-Pacific region in Beijing, China in October last year, with the participation of senior representatives from finance ministries, central banks, and supervisory and regulatory authorities of six FSF member economies and nine regional non-member economies, and senior officials from the international financial institutions, standards setting bodies and the Asian Development Bank.

The Beijing meeting reviewed vulnerabilities in domestic and international financial systems. The recovery underway in many regional economies reflected internal demand driven by expanding consumer credit as well as intra-regional trade, which might weaken if global demand fell. The adjustments implemented in regional financial sectors following the Asian crisis were now bearing fruit. However, in a number of economies, addressing non-performing loan (NPL) problems was regarded as a continuing challenge, especially in the context of deflationary pressures. The meeting agreed that further reforms in the financial sector through, e.g., consolidation and privatisation, must be pursued vigorously.

The meeting also discussed policy responses needed to address weaknesses in market foundations. Opaque corporate governance practices were cited as one of the factors that had led to the Asian financial crisis: although progress had since been made, participants noted that the present environment provided a window of opportunity to further pursue these reforms. While priorities differed from market to market, enhancement of corporate governance practices and strengthening of accounting and auditing standards and practices were of critical importance. In this context, meeting participants expressed hope that an improved and coherent set of international principles and standards in these areas be agreed upon as soon as possible so that all economies can begin to implement them in their respective jurisdictions.

The Forum's third Latin American regional meeting will take place in Santiago de Chile in late May 2003.