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The Financial Stability Forum (FSF) held its tenth meeting on 10 September in Paris and focused on three topics: potential vulnerabilities in the international financial system; progress in addressing weaknesses in market foundations and corporate governance; and offshore financial centres.

Vulnerabilities in the international financial system

Members took note of the improvement in financial conditions, such as the rebound of stock prices and the substantial reduction of corporate and emerging market spreads, and the increasing, if uneven, signs of global recovery and noted that risks to financial stability are now more balanced than when the Forum last met in March. Comfort was taken from the fact that financial institutions had mastered the past wave of shocks, most notably the mid-June back up in long-term yields, rather well. While some sources of vulnerability remain, these should not constrain the ability of financial systems to provide support for a resumption of growth.

Nonetheless, the sustainability of the present financial situation is dependent to a large extent on developments in economic fundamentals going forward. Current financial market valuations may prove overly optimistic in the face of the mixed picture actual data show. And on a longer horizon, questions remain about the sustainability and robustness of the global upturn. A renewed economic downturn combined with a fall in asset prices could expose remaining vulnerability in the insurance sector, and poor underlying profitability in the banking and corporate sectors of some countries.

The increasing levels of household indebtedness and real estate lending in many countries also require monitoring. The Forum will review more fully the risks these pose to financial systems at its March 2004 meeting. However, the Forum noted that regulators and policy makers from some jurisdictions remain confident that debt service burdens are unlikely to pose a problem even as interest rates rise from current very low levels.

In a wider context, large international imbalances pose a continuing potential for disorderly exchange rate adjustments. The imbalances reflect several persistent elements, including low savings in the US, low growth and structural rigidities in Europe and Japan, the desire of some Asian countries to build reserves and of others to promote growth through exports. The Forum recognized that China faces complex and difficult policy choices. In view of current weaknesses in China's banking and financial system, members considered that full capital account liberalization and a floating of the exchange rate could have destabilising consequences, and thought that a gradual and pragmatic approach on both accounts would be advisable.

Members took note that many emerging market economies (EMEs) have been able to take advantage of the current favourable financing condition to satisfy their 2003 official financing needs. At the same time, they noted that many EMEs remained heavily indebted and vulnerable to shifts in market sentiment. Therefore, they considered that EMEs should use the present opportunity to strengthen macroeconomic policy frameworks, including a more proactive stance on liability/debt management, and vigorously implement structural reforms.

The Forum reviewed a number of ongoing initiatives to reduce vulnerabilities, including improved transparency in the reinsurance industry and work to address credit risk transfer issues. Members encouraged reinsurance regulators to ensure that expanded information availability helped strengthen market discipline. Questions remain as to where the credit risk that banks are shedding via credit risk transfer instruments is ending up. An unchecked, concentrated accumulation of credit risk is a concern from a financial stability perspective. In this regard, the Forum decided to continue coordinating with the Joint Forum and the Committee on the Global Financial System to develop information in this area.

Market foundations and corporate governance

Members reviewed progress and international coherence in the critical areas underscored at the FSF Berlin meeting: (i) auditor oversight and audit practice standards; (ii) accounting standards; (iii) credit rating agencies and financial analysts; and (iv) corporate governance.

Auditor oversight and audit practice standards

The FSF hailed the significant progress made in discussions between the International Federation of Accountants (IFAC) and the international regulatory community on reforms to provide assurance that IFAC's audit-related standards setting activities are conducted in a manner consistent with the public interest. The reforms envisage the establishment of a Public Interest Oversight Board for IFAC's public interest activities, notably the standard setting role of the International Audit and Assurances Standards Board, and other changes to IFAC's governance arrangements. Members looked forward to the final deliberations on these reforms in the regulatory community and their adoption by IFAC's Council in November.

However, strengthened audit practice standards will not by themselves necessarily generate the needed step-up in auditor professionalism. This will depend on the effectiveness of national oversight and enforcement arrangements, as well as their consistency across countries. The Forum therefore called for stocktaking of national auditor oversight arrangements, and will encourage heads of national oversight bodies to come together to exchange experiences and consider policy options. The FSF will keep these matters under review.

Accounting standards

The FSF noted that good progress has been made in the short-term convergence project between the International Accounting Standards Board (IASB) and Financial Accounting Standards Board and in strengthening accounting standards internationally. However, some complex and difficult issues remain unresolved, with some jurisdictions expressing concern about IAS 39. Addressing these will require close consultations and a willingness on all sides to come to reasonable solutions in a cooperative manner. The Forum urged parties not to lose sight of the larger objectives - including financial stability, efficiency and transparency - that motivate the need for internationally convergent standards.

Credit rating agencies and financial analysts

The FSF discussed issues relating to the operation of credit rating agencies (CRAs), based on the US SEC's Concept Release and a set of international guidance principles being developed by IOSCO. Members attached importance to improving the transparency of the rating process and protecting it from conflicts of interest. CRA issues will remain on the FSF agenda to facilitate debate and international coherence in this important area.

Members also took note of work underway in IOSCO to develop high-level principles for addressing conflicts of interest faced by financial analysts and looked forward to the final publication of IOSCO's guidance principles.

Corporate Governance

The FSF noted that the work in the OECD on the survey of corporate governance developments in the OECD countries and the review of the Principles on Corporate Governance is progressing as planned. It reiterated that improvements in national corporate governance standards should be reflected in the revised Principles.

Offshore Financial Centres

The FSF reviewed the Offshore Financial Centres (OFCs) initiative it launched in May 2000, based on a report prepared by IMF staff on their OFCs assessment program. The IMF's first round of OFC assessments is now nearing completion. The Forum welcomed the improvements that have occurred in supervisory and regulatory arrangements in many OFCs, as well as in offshore/onshore supervisory and regulatory cooperation.

Given the growing integration of financial markets, the FSF, recognizing that individual progress differs widely, continues to stress that OFCs need to progressively strengthen their supervisory, regulatory, and information exchange arrangements. To this end, it supports making the monitoring of OFCs an integral part of the IMF's financial sector surveillance work. The FSF attaches particular importance to the publication of the IMF assessments as a means of enhancing transparency and enabling the position of individual OFCs to be evaluated by all concerned parties.

The FSF will continue to take a close interest in the IMF's financial surveillance work and in the progress made by OFCs in strengthening their supervisory, regulatory, and information exchange arrangements. It looks forward to the IMF's Executive Board's discussion of the OFC program in November and will review the overall effectiveness of its OFC initiative in March 2004.