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August 23, 2002

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Financial Stability Forum—An Update of Activities—May–July 2002**

Attached for the information of the Executive Directors is an update on the activities of the Financial Stability Forum for the period May–July 2002.

Questions may be referred to Mr. H. Tran, ICM (ext. 37324), Mr. Schinasi, ICM (ext. 36613), and Mr. Sensenbrenner, MAE (ext. 39965).

Att: (1)

Other Distribution:
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INTERNATIONAL MONETARY FUND

Financial Stability Forum: An Update of Activities—May-July 2002

Prepared by the International Capital Markets and Monetary and Exchange Affairs Departments

(In consultation with the Policy Development and Review Department)

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Executive Summary

- The FSF held an interim assessment of vulnerabilities in the international financial system in the form of a teleconference among members in early-June. A summary of the teleconference is attached.
- FSF members and the Secretariat are preparing reports for the next FSF meeting, including on issues for financial stability arising from recent corporate failures and the investment activities of reinsurance companies.
- The next FSF meeting will be held in Toronto, from September 3 to September 4, 2002, hosted by the Canadian authorities.
- A second FSF regional outreach meeting with financial stability authorities from Asia-Pacific economies will be held in mid-October in Beijing, China.

I. Introduction

1. This note provides an update of the Financial Stability Forum (FSF) activities from May through July 2002.[1]

II. FSF Teleconference on Vulnerabilities

2. As had been suggested at the FSF meeting in March 2002, an ***interim assessment of vulnerabilities in the international financial system*** was held via teleconference on June 5. Messrs. Häusler (ICM) and Ingves (MAE) participated on behalf of the Fund. Members exchanged views on persisting imbalances, latent weaknesses, and other concerns, beyond those that had been identified earlier (i.e., corporate failures, reinsurance, and government-sponsored agencies). The discussion focused on four issues: the state of global recovery; corporate sector adjustment and financing conditions; developments at large financial groups; and the impact of the Argentine crisis. A summary of the teleconference prepared by the FSF Secretariat is attached. The FSF Chairman intends to hold such interim assessments by teleconference on a regular basis between FSF plenary discussions.

III. Work Underway by the FSF

3. Background work is underway for the report on financial stability issues raised by recent ***corporate failures***. The Secretariat is preparing the report for discussion at the September FSF meeting.[2] Information on the various national and international initiatives that have been undertaken is being compiled. As part of the preparations for the paper, in mid-July the FSF Chairman held a teleconference with the chairpersons of various international groupings (e.g., International Accounting Standards Board, International Organization of Securities Commissions, OECD) to exchange information on the current status of various initiatives.

4. A draft outline of the issues note on the ***reinsurance*** sector with a focus on possible financial stability implications has been circulated to those FSF members that had earlier indicated interest in contributing to the note. Contributions have been received and the Secretariat expects to have a draft paper prepared by mid-August.

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[1]See SM/02/189, June 14, 2002, for the previous update.

[2]An informal round table discussion on corporate failures, originally planned for July, has been postponed. It will now take place from October 20 to October 21, 2002.

5. Based on assessments of the operational issues that arose in financial markets in the context of September 11, a short note will be prepared for a discussion at the next FSF meeting on the lessons to be drawn for ***contingency arrangements***, including how the FSF might facilitate dissemination and implementation of recommendations.

6. The Secretariat is compiling protocols or other arrangements that FSF member countries have developed for information exchange and cooperation among the various national bodies involved in ***combating terrorism financing***. This document will be available for the Toronto meeting.

7. Work is progressing on developing a ***large and complex financial institutions (LCFIs)*** "fact book" template designed to provide a roadmap of important questions and critical information relevant in an LCFI wind down situation. In mid-July, a meeting was held in Basel among supervisory authorities (France, Italy, the Netherlands, the United Kingdom, and the United States) that are conducting field tests of the template with financial institutions in their jurisdictions. Drawing on these experiences, the draft template will be revised and a short interim note will be prepared for the FSF on the lessons learned thus far and possible next steps. The FSF meeting in March revealed difficulties in identifying potential systemic risk posed by ***highly leveraged institutions*** because of a lack of reliable information. The BIS and the Fund, therefore, are reviewing data shortcomings and how they might be addressed, and will prepare a note for the FSF's consideration.

8. Drawing on input from FSF members, the Secretariat has compiled information for the regular note on ***Ongoing and Recent Work Relevant to Sound Financial Systems*** that will serve as background material for the next FSF meeting. Previous notes are available on the FSF website (www.fsforum.org).

IV. OTHER ACTIVITIES

9. The next meeting of the Forum will take place in Toronto, from September 3 to September 4, 2002, hosted by the Canadian authorities. The German authorities have offered to host the Spring 2003 FSF meeting, which will take place from March 24 to March 25, 2003 in Berlin.

10. A second FSF regional outreach meeting with financial stability authorities from Asia-Pacific economies will take place in Beijing, from October 11 to October 12, 2002, hosted by the Bank of China.

FSF Interim Assessment of Vulnerabilities

Teleconference, 5 June 2002

Summary

An interim assessment of vulnerabilities was held by teleconference, as had been suggested at the FSF meeting in Hong Kong SAR. It provided FSF members with an opportunity to share views on persisting imbalances, latent weaknesses and other concerns prior to the June G7 meeting.

The following points were highlighted by participants on the four issues raised in the discussion:

1. The state of the global recovery

Participants generally agreed with the assessments made by the US and European members that the recovery was well underway in North America and picking up in Europe, even though financial markets seem less sanguine about the outlook. Even in Japan, a cyclical pick-up appeared evident. There were also good signs that inflation would remain low, though it was noted that Euro Area inflation may not move below 2 percent in the near term.

In considering possible down side risks to the outlook, a number of points were raised:

- Uncertainty was expressed over the continued resiliency of consumer demand, particularly in the US, and the sustainability of the US current account deficit. Some comfort was drawn from the relatively smooth and contained movements in the G3 exchange rates to date, and it was noted that these would help to lower inflation expectations in Europe. Looking from a more micro perspective, the question was raised as to whether recent turbulence in equity markets, in part related to recent corporate failures, could affect capital inflows into the United States and increase the cost of capital, which in turn could affect the outlook for investment growth.

- On the impact of the risk of political/military disturbances to the global outlook, it was noted that while there were always such risks, these risks should not be too great so long as policies could be adaptable. The current low level of inflation is a favorable factor in terms of a potential impact on oil prices.

- The Indo-Pakistani conflict was highlighted as a noteworthy change relative to the FSF's assessment of the outlook at the time of the meeting in Hong Kong. While the direct impact on international financial institutions appeared small, the question was raised as to whether an intensification of the conflict could give rise to significant effects on confidence, in particular given its characteristics (i.e., nuclear capabilities) relative to other conflicts.

- The possible impact of recent trade tensions were generally not seen as an obstacle in the short-term for the global recovery. Nevertheless, it was noted that these tensions needed to be contained so as to avoid an overreaction that could have longer-term implications.

Authorities had a responsibility to work together, including in the context of the next WTO round, to help ensure that any negative long-term impacts were avoided.

Some questions were raised about recent developments in the Japanese financial system, including about the interpretation of the recently published NPLs figures and on whether monetary policy was sufficiently accommodating. The Japanese members explained that the increase in NPLs announced by major banks reflected not just the difficult economic environment but also the strict FSA special inspection. They noted that the announcement had been favorably received by the stock market. While a liquidity drain from the financial system or a credit crunch may be reported in some areas, these were not apparent at an overall level. It was noted that the Japanese authorities were taking the right measures (e.g., in encouraging banks to write off bad loans), if a little belatedly, and undue external criticism might be counterproductive.

In summing up, the Chairman noted that members generally agreed that there was little change to the outlook assessment made at the March FSF meeting. As for Japan, it was important for the FSF to be kept abreast of developments and to play a constructive role in encouraging progress.

2. Corporate sector adjustment and financing conditions

Participants were generally comfortable with the outlook for the corporate sector, although it was noted that some sectors, e.g., technology, were still facing difficulties. A number of features/concerns were highlighted:

- Confidence in the corporate sector continues to be low, reflecting in part high gearing ratios and a more demanding environment in light of recent corporate failures. This contrasts with a more positive outlook by consumers.
- It was noted that many companies that had previously engaged aggressively in mergers and acquisition activities and/or aggressive accounting were now being "punished" by the market relative to others. The continuation of such forces could effectively cap equity valuations and constitute a restraining factor on future corporate performance.
- It was underscored that the actions being taken to address issues highlighted by recent corporate failures (i.e., enhancing transparency, corporate governance and accounting practices), notably in the US but also in other jurisdictions, will have positive effects, particularly in the long run. Nevertheless, it was noted that there might be short-term consequences for the valuations of some firms in the transition phase, which bore watching.
- Looking ahead, corporate earnings, which had benefited from pension holidays in the last few years, may be hit by significant pension costs in the future, given recent deteriorations in the investment performance of pensions.
- The enhanced transparency of rating triggers in corporate financing arrangements was a positive development -- increased information would facilitate the effectiveness of market discipline. However, concern was expressed as to whether the increased use of innovative financing techniques, which may not be well understood, could lead to a

greater reliance by investors on external ratings to monitor corporate performance. The question was raised as to whether this could lead to greater emphasis on short-term performance, compound conflicts of interest for rating agencies, and possibly result in increased volatility of market valuations through increased herd behavior. It was suggested that a further assessment of the implications of financing innovations was needed.

3. Large financial groups

Large financial institutions were generally seen to be in good shape, despite the significant shocks that had been faced. Participants highlighted a number of factors contributing to the general resilience of banking systems:

- The earlier build up of capital positions and reserves;
- An avoidance of excess concentration of exposures, e.g., real estate;
- Broader distribution of corporate debt across the financial system so that there was less reliance on bank financing relative to previous cycles;
- Improved risk management systems and supervision;
- Greater diversification of risk within institutions brought about through consolidation; and
- Improved allocation of risk through the use of new risk transfer mechanisms.

It was noted, however, that the picture for banks in Asia was more mixed given a greater concentration in real estate lending, an uneven pace of consolidation and evidence of increasing non-performing loans in some countries. Moreover, some cautionary notes were expressed with respect to the general picture:

- While banks' overall capital had held up well, there may have been some deterioration in its quality because of the growing use of new instruments.
- New risk transfer mechanisms remained to be fully tested and would depend on the health of underlying counterparties, which are largely insurance companies.
- It was noted that banks still have a great capacity to manage their earnings, and bank performance needed to be monitored carefully.

4. The impact of the Argentine Crisis

Participants noted that the direct contagion effects of the Argentine crisis continued to be limited (largely to neighboring Uruguay). Some possible slower acting forms of contagion were highlighted relating to unforeseen losses in a disorderly restructuring of Argentine debt or to changes in international bank lending practices more broadly. However, it was noted that it could be difficult to separate these effects from the consequences of home grown factors, e.g., weak domestic fundamentals and increased political risk. Brazil was raised as a case in point. It was noted that with a sizable amount of government debt indexed to the USD exchange rate, uncertainty about the upcoming presidential election is adding to market concerns. Political risk was also seen to be prevalent in Columbia, Ecuador and Venezuela. Several participants considered that the outlook for the Latin American region as a whole was worsening, and it was suggested that the FSF Chairman give special consideration to this when reporting to the G7 at its Fall meeting.

Participants noted that major international banks have not yet made final decisions on the future of their Argentine operations. The legal situation surrounding the freeze of bank deposits, the "corralito", and possible compensation for losses by the government change almost every day. Thus far, international banks had shown considerable commitment to Argentina and EMEs more generally, but they could not be expected merely to stand by when the enforceability of contracts breaks down, the rule of law is abused/violated and national banks receive preferential treatment. Despite the negative impact on their share prices, international banks did not appear to be exiting at this time, and it was suggested that they may await the definitive resolution of the deposit freeze. Nevertheless, the disruptive measures taken by Argentina had heightened banks' overall sensitivity to political risk in EMEs and could trigger a revaluation of bank participation and a rethinking of lending strategies. Some concern was expressed that a class-action suit recent filed with in New York on the behalf of bondholders (representing about USD 20bn) could accelerate such a course of events, although this concern did not appear to be fully shared by others.

A number of participants underscored that while IMF support to Uruguay was fully justified, the IMF should not financially assist Argentina for the time being based on its current policy measures. It was particularly important at this time to avoid any impression that abrasive behavior is rewarded in the end.

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In summing up, the Chairman noted that on balance participants found the outlook for financial stability reassuring. Nevertheless, FSF members needed to remain vigilant and continue to monitor possible vulnerabilities. He opined that such a teleconference provided a useful opportunity for members to exchange views and suggested that regular interim teleconferences on vulnerabilities be held in between FSF plenary meetings.