SM/02/331

October 24, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Financial Stability Forum—An Update of Activities—August–September 2002**

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

Questions may be referred to Mr. W. Alexander, ICM (ext. 35366), Mr. Baliño, MAE (ext. 38551), Mr. Schinasi, ICM (ext. 36613), and Mr. Sensenbrenner, MAE (ext. 39965).

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INTERNATIONAL MONETARY FUND

Financial Stability Forum: An Update of Activities—August–September 2002

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

(In consultation with the Policy Development and Review Department)

Approved by Gerd Häusler and Stefan Ingves

October 23, 2002

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EXECUTIVE SUMMARY

- The FSF held its eighth meeting on September 3-4, 2002, in Toronto. Forum members reviewed potential vulnerabilities in the international financial system; weaknesses in market foundations; transparency in the reinsurance industry; and progress in the compliance of offshore financial centers with international standards.
- The Chairman of the FSF, Mr. Andrew D. Crockett, sent a letter and a report to G-7 finance ministers and governors on September 20, 2002, reviewing the current downside risks and the weaknesses in market foundations from an international perspective. He also delivered a statement to the IMFC meeting on September 28, 2002, in which he reported on the FSF meeting in Toronto.
- The German authorities will host the next FSF meeting in Berlin on March 24-25, 2003.

I. Introduction

1. This note provides an update of the Financial Stability Forum (FSF) activities in August–September, 2002.[1]

II. FSF Meeting

2. The FSF held its eighth meeting on September 3-4, 2002, in Toronto, Canada. Mr. Häusler participated on behalf of the Fund. Forum members reviewed potential vulnerabilities in the international financial system; weaknesses in market foundations; transparency in the reinsurance industry; and progress in the compliance of offshore financial centers (OFCs) with international standards (Attachments I and II) .

3. **Potential vulnerabilities.** Forum members saw significant downside risks to the baseline of moderate growth in industrial countries, such as further declines in equity prices, continued erosion of investor confidence, a surge in oil prices, and a deterioration of the situation in South America. In **mature markets**, nonperforming loans, sluggish investment banking activities, falling equity prices, and increased litigation risks exerted financial pressures on banks. As a result of investment losses and underwriting claims, considerable strains also emerged in the primary and reinsurance sectors. Although these developments reflected adjustments from unsustainable buildups in the past few years, Forum members recognized that credible policy responses might be needed in the short run. Nevertheless, they stressed that policy responses should not undermine market discipline, distort incentives, or prevent the inevitable reduction of excess capacity in the financial system.

4. In **emerging markets**, the FSF called for consistent strategies across regions and creditor classes to minimize the risk of contagion. Violations of the rule of law and of contractual arrangements risked policy contagion and could hamper FDI inflows. Sound macro policies and appropriate private sector involvement were seen as a first line of defense in addressing policy problems. Debt sustainability and well-balanced currency exposures were considered essential. When debt is unsustainably large and confidence is eroded, national authorities should consider timely restructuring of external and domestic debt. Members were optimistic about capital flows to emerging Asia and Europe (with a few exceptions), but they feared that flows to Latin America might decline further.

5. **Weaknesses in market foundations.** The FSF stressed the importance of using the current window of opportunity to advance reforms and international harmonization ("coherence"). Greater international coherence might reduce market volatility and restore confidence. As a first step, international principles for corporate governance, accounting, auditing, and disclosure should be agreed upon. The FSF sees its role as drawing attention to gaps in international harmonization that adversely affect efficiency and stability in financial markets. Progress on these issues will be reviewed at the next FSF meeting in March 2003.

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[1] See SM/02/274, August 23, 2002, for the previous update.

6. **Transparency in the reinsurance sector.** The FSF supported work by the IAIS on a global framework for reinsurance supervision. It also called for more information on the global reinsurance market and individual reinsurance companies to assess risk taking and risk management, particularly on a consolidated group-wide basis. The FSF also stressed the need for cooperation from supervisors in offshore financial centers with large reinsurance activity.

7. **Offshore financial centers (OFCs).** The FSF welcomed efforts by the Fund to conclude all OFC assessments in 2003 and expects that all OFCs will publish the assessments, along with action plans to address gaps. Recognizing that harmonization of OFCs' regulatory frameworks with international standards is resource-intensive, the FSF called on its members to strengthen bilateral technical assistance for OFCs. The FSF will assess the effectiveness of its OFC initiative in 2003.

8. Concerning **highly leveraged institutions** (HLIs), it was agreed that BIS and Fund staff will periodically review available data on HLIs, although there were no immediate concerns about HLI activities. Field tests of the **large and complex financial institutions (LCFI) fact book** had revealed gaps in the information required in a crisis. Based on the final report on the field test, the Forum will discuss LCFI issues at its next meeting. FSF follow-up discussions also covered potential financial stability implications of **U.S. government-sponsored enterprises** and **anti-terrorist financing**.

III. LETTER AND REPORT TO G-7 FINANCE MINISTERS AND GOVERNORS

9. On September 20, 2002, the Chairman of the FSF, Mr. Andrew D. Crockett, sent a letter and a report to G-7 ministers and governors (Attachments III and IV). The letter reviews the current downside risks and notes that financial systems have less capacity to absorb future shocks and may be more susceptible to disruptions. The report focuses on weaknesses in market foundations from an international perspective and stresses the challenge of sustaining the momentum for reform. It summarizes recent measures to improve corporate governance, accounting, auditing practices, and disclosure standards, and to address conflicts of interest. It also discusses the appropriate balance between market self-correcting mechanisms and policy interventions to lock in improvements in best practices.

IV. STATEMENT TO THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE MEETING

10. On September 28, 2002, Mr. Crockett, as Chairman of the FSF, delivered a statement to the IMFC meeting, in which he reported on the FSF meeting in Toronto (Attachment V).

V. FUTURE ACTIVITIES

11. On October 11, 2002, an outreach meeting with Asian countries was held in Beijing; Mr. Tran participated on behalf of the Fund. Further outreach meetings in Europe and Latin America are planned for 2003. On October 21, 2002, a roundtable discussion on the policy implications of recent corporate failures took place in Basel. The German authorities will host the next FSF meeting in Berlin on March 24-25, 2003.

FINANCIAL STABILITY FORUM

AT] ACHMENT I

Press release

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Ref no: 17/2002E
4 September 2002

Financial Stability Forum reviews vulnerabilities and efforts to strengthen the international financial system

The Financial Stability Forum (FSF), chaired by Andrew Crockett, General Manager, Bank for International Settlements, met on 3-4 September in Toronto. Members focused on a review of potential vulnerabilities in the international financial system. Emphasis was also given to:

- addressing weaknesses in market foundations;
- improving transparency in the reinsurance industry; and
- reviewing progress in offshore financial centres to comply with international standards.

Vulnerabilities in the international financial system

The FSF reviewed sources of potential vulnerabilities in the international financial system. Growth prospects seem somewhat weaker now than at the previous FSF meeting in March and downside risks have increased. However, going forward, moderate growth in major industrial countries was still seen as the most likely scenario.

Risk premia have risen since March. Some special factors have affected individual financial institutions. One consequence to which members drew particular attention is that the process of bank consolidation and restructuring that is under way in some countries will be more important in these circumstances. The experience of the financial sector overall supports the benefits of the considerable investments in risk management that had previously been made.

Risk premia and access to international financial markets for some emerging market economies are other elements of concern. Members reviewed the risks posed by these developments and possible measures to mitigate them.

Members agreed that the current environment and the potential for increased risk aversion call for enhanced vigilance and supervisory cooperation.

Addressing weaknesses in market foundations

The erosion of confidence in the wake of misleading financial statements and the recent series of large corporate failures has had serious and widespread repercussions on financial markets.

The FSF reviewed recent initiatives by market participants, national authorities and international standard-setters and organisations to restore market integrity and stability. Progress on these initiatives must be sustained – an area where the FSF can usefully provide encouragement. Given the international dimensions of the problems and their remedies, FSF members also underscored the importance of international and cross-sectoral consultations to ensure that these efforts are based on high level principles that are coherent across countries.[1]

- **Corporate governance.** Poor corporate governance has played a central role in many of the recent failures. National authorities should act to improve practices in this area. Members welcome the decision by OECD Ministers to bring forward to 2004 their comprehensive review of international *Principles of Corporate Governance* and urge that, to the extent possible, the revised principles embody specific guidance.

- **International accounting standards.** Accounting treatment of consolidated entities, revenue recognition and equity-based remuneration has been a key issue in the current undermining of confidence. The FSF calls upon national and international standard setters to accelerate their efforts at developing more comparable, accurate and transparent ways of accounting for these in financial statements; to improve international accounting standards; and to bring about greater international convergence on principles-based standards.

- **Auditing standards and practices.** Independent and high quality auditing is of fundamental importance to the integrity of markets. The international community is consulting on the most effective practices in this area. The FSF took note of initiatives for auditor oversight in train in a number of jurisdictions. The FSF welcomes the principles on auditor independence and audit profession oversight that are being formulated by the International Organisation of Securities Commissions (IOSCO) and looks forward to their early approval and publication. It also urges the International Federation of Accountants to intensify its work on improving *International Standards of Auditing*.

- **Disclosure.** Material information must be disclosed in a comprehensive, truthful, timely and clear manner. The FSF noted recent and pending reforms in the United States and other member countries. Members look forward to the early approval and publication of principles on disclosure and transparency being developed by IOSCO.

- **Credit rating agencies.** The analysis provided by credit rating agencies has a pervasive influence on financial markets. The FSF noted work under way by the U.S. Securities and Exchange Commission to review the policies and procedures of credit rating agencies. The FSF will discuss the conclusions of that review at its next meeting.

The FSF will report to the G-7 Finance Ministers and Governors later in September, underscoring the importance of implementation of sound market practices based on the principles that have been agreed. It will continue to monitor initiatives and, in part through its outreach activities, promote and help to coordinate reform efforts by national authorities and international standard setters in all these areas. It will focus attention on issues of coherence and opportunities to increase the efficiency, integrity and stability of financial markets. At its next meeting in March 2003, it will review again progress made and issues outstanding.

Improving transparency in the reinsurance industry

The FSF reviewed a number of concerns related to the reinsurance industry. It noted that the reinsurance industry had performed well in the face of recent shocks. However, the opaqueness of the reinsurance market and of public disclosures makes it difficult, if problems in the reinsurance industry were to arise, to assess the potential impact on the insurance sector as a whole and on financial stability more generally. It was also pointed out that some of these issues are also relevant to other parts of the insurance industry.

Members call for efforts at the national and the international level to produce data and reporting on the global reinsurance market. At the same time individual reinsurance and insurance firms should expand the frequency and enhance the quantitative and qualitative content of their public disclosures. These efforts should begin speedily. The FSF lends its full support to the work of the IAIS and others to improve industry disclosures and to develop an efficient global framework for reinsurance supervision, which could benefit reinsurers, primary insurers and policyholders, and therefore economies at large.

Offshore financial centres

The FSF re-emphasised the importance of progress by offshore financial centres (OFCs) in bringing their supervisory, regulatory, information sharing and cooperation practices up to international standards. The FSF welcomes the acceleration of the IMF's assessment program, and reiterates its expectation that all OFCs should have completed and published by 2003 assessments of their observance of international standards, along with action plans to address gaps.

In this context, members:

- welcome the recent publication by Aruba and Macau SAR of their IMF assessments (available at www.imf.org) and encourage those that have had assessments -- Andorra, Belize, Costa Rica, Lebanon, Marshall Islands, Monaco, Netherlands Antilles, Seychelles, Vanuatu -- to disclose the results when the assessment process is completed and to act speedily to implement its recommendations;[2]

- call on those that have requested assessments of observance of standards under the IMF's Module 2 or the FSAP -- Anguilla, Antigua and Barbuda, Bahrain, Barbados, The Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Guernsey, Isle of Man, Jersey, Liechtenstein, Labuan (Malaysia), Malta, Mauritius, Samoa, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, The Turks and Caicos -- to disclose publicly the results of these assessments when they have been completed, along with action plans to implement recommendations; and

- regret that some OFCs -- Nauru, Niue -- have not yet requested an IMF Module 2 assessment.

The FSF recognised that resource limitations can be a constraint in the implementation of standards and calls upon its members to strengthen the provision of technical assistance to promote further progress by OFCs.

The FSF will assess the overall effectiveness of its OFC initiative in 2003.

The FSF also:

- reviewed options for improving information on highly leveraged institutions and noted that the Joint Forum is pursuing work in this area;
- discussed lessons that have been drawn for contingency arrangements in the context of 11 September; and
- took note of national arrangements for information exchange to combat terrorist financing, and of progress made by FATF, the IMF and the World Bank to develop assessments of observance of standards for anti-money laundering and combating of terrorist financing.

The next meeting of the FSF will be held in Berlin on 24/25 March 2003.

Notes

1 In 2001, the FSF highlighted 12 widely agreed standards that underlie well functioning and stable financial markets. These standards cover broad areas such as macro-economic policy, market foundations and financial regulation and supervision. Four of these 12 essential standards - concerning corporate governance, accounting, auditing and securities regulation - are central to current reform efforts to increase investor confidence in equity markets: (see http://www.fsforum.org/standards).

2 Dublin (Ireland) participated in the pilot phase of the FSAP. Assessments conducted during the pilot phase cannot be published under IMF and World Bank policy.

For further information on the FSF, its membership and its activities, visit the FSF web site at ***www.fsforum.org***.

Attachment I

Institutions and Groups Attending the Meeting of the FSF
3-4 September 2002

Chairman

Mr Andrew D Crockett

National Authorities (26)

Australia

Reserve Bank of Australia

Canada

Department of Finance
Bank of Canada
Office of the Superintendant of Financial Institutions

France

Ministry of the Economy
Commission des Operations de Bourse
Banque de France

Germany

Ministry of Finance
Bundesanstalt für Finanzdienstleistungsaufs
Deutsche Bundesbank

Hong Kong SAR

Hong Kong Monetary Authority

Italy

Ministry of the Economy and Finance
Banca d'Italia
CONSOB

Japan

Ministry of Finance
Financial Services Agency
Bank of Japan

Netherlands

De Nederlandsche Bank

Singapore

Monetary Authority of Singapore

United Kingdom

Bank of England
Financial Services Authority
H M Treasury

United States

Department of the Treasury
Securities & Exchange Commissior
Board of Governors of the Federal Reserve System

National Association of Insurance Commissioners

International Financial Institutions (6)

International Monetary Fund (IMF), 2
World Bank, 2
Bank for International Settlements (BIS)
Organisation for Economic Co-operation and Development (OECD)

International Regulatory and Supervisory Groupings (7)

Basel Committee on Banking Supervision (BCBS), 2
International Accounting Standards Board (IASB)
International Association of Insurance Supervisors (IAIS), 2
International Organisation of Securities Commissions (IOSCO), 2

Committees of Central Bank Experts (2)

Committee on Payment and Settlement System (CPSS)

Committee on the Global Financial System (CGFS)

European Central Bank

FINANCIAL STABILITY FORUM

Eighth Meeting of the Financial Stability Forum

3-4 September 2002, Toronto, Canada

Summary[1]

26 September 2002

I. Vulnerabilities in the international financial system

Recent developments in the real economy have been disappointing, and problems have continued to accumulate for the global financial system. Uncertainty is unusually high, and further erosion of investor confidence might lead to persistent and intensified risk aversion across-the-board, causing a retrenchment from credit markets and risk-taking more generally. A key question is whether these developments, while partly triggered by the cleansing needed for a sounder equilibrium in the medium-term, raise systemic concerns in the short run, and what could be the policy implications.

Baseline macroeconomic and financial scenario

Although it was agreed that the baseline scenario of moderate growth in major industrial countries was still the most likely outcome, many members expressed concern about materialisation of downside risks and/or intensification of risk aversion. In the view of some, uncertainty was the predominant feature of the current juncture, given that so far there is no clear indication that the correction process has come to an end and the possibility of further downward revisions of growth and profit expectations could not be ruled out.

The US delegation saw no evidence that the decline in financial markets and increase in risk premia had visible effects on the outlook for the US economy. A mild recovery would be a natural consequence of the mild recession. The US economy is forecast to grow by 3 to 3.5% in 2003, based on productivity growth of 2 to 2.5% and an increase in labour force of 1%.

The European members said that the European economy should accelerate to a 2.5% growth by end-2002. Factors accounting for slow growth in Europe, especially in Germany, were discussed. In Japan, moderate growth, largely supported by exports to Asia as well as incipient recovery in industrial production, could continue, following a 2% growth in the second quarter of 2002.

Although such an outlook was accepted as most likely, it was felt by many members that downside risks had increased since the Forum's last meeting in March. For instance, slower growth in the United States, a further fall of stock markets, further erosion of investor confidence by new corporate scandals, a rise in oil prices, and deterioration of the Latin American situation were cited as downside risks that could change the expected growth path in some or all economies. The build-up of household debt in some countries might pose a risk as well, though the debt-servicing burden of that debt has been reduced by lower interest rates. Although there were off-setting factors relevant to respective economies, such as fiscal and monetary policy responses, robust consumer spending supported by buoyant housing markets, the strong capital base of many banks after enhancements during the 1990s, and progress in structural reforms, a majority of members thought that downside risks appeared more pronounced, which might affect the central scenario.

[1] A set of action points arising from the meeting, which were circulated to FSF members on 6 September is attached along with the meeting press release.

In addition, uncertainties arising from these downside risks as well as from a possible conflict in the Middle East or further acts of terror may have led to a greater risk aversion among investors. It was pointed out that risk aversion would be difficult to reverse in the short term.

Impact on financial institutions

Members noted that risk premia in debt markets and credit spreads for financial institutions had moved up in general, and quite significantly for some well known financial institutions in response to the downside risks identified in the baseline scenario and earlier shocks still working their way through the system. Although the cushion of comfort now is thinner than at the March 2002 meeting, the overall experience of the financial sector so far supports the benefits of the considerable investments hitherto in risk management. At the same time, it was noted that more risks were shifted to retail investors, e.g. through investment funds, and that the full effect of such moves was still unclear.

Supervisors diagnosed rising pressure on banks from non-performing loans, from declining profits in investment banking activities, from volatile and falling equity markets, and increased litigation risks. Pressures are most pronounced in banking systems that are suffering from a combination of low profitability and rising provisions and are undergoing a consolidation and restructuring process. At the same time, consolidation may now be even more important and may provide new opportunities. Supervisors are also monitoring closely exposures to the TMT sector, Latin American borrowers and US corporates (in the case of European banks), as well as the legal and operational risk embedded in credit risk transfer transactions.

Some members reported that in their markets strains from insured losses following September 11 and recent floods, falling equity markets, defaults on corporate bonds and/or low nominal interest rates were also being felt in the primary and reinsurance markets. In some cases, costly re-capitalisation will be unavoidable. In some markets, solutions may also have to be found for the life-insurers that face difficulty in meeting contractual or statutory obligations, due to losses on their equity and bond portfolios or insufficient interest income (negative margin problem). Some pension funds and corporate defined-benefit pension plans are in similar distress, most likely resulting in reduced benefits or in rising contributions that will weigh on corporate profits.

Policy options should downside risks materialise or risk aversion intensify

In their assessment of possible policy responses to loss of confidence, increased uncertainty and heightened risk aversion, members recognised that it could become important to take convincing policy measures, as appropriate, in the short run, even if current developments reflected an inevitable cyclical adjustment from the unsustainably high growth path of previous years. Members recognised that in 1998 a timely adjustment of macroeconomic policies had played an important role in containing market deterioration. At the time, supervisory guidance had also been instrumental in averting overreaction by individual institutions. Financial institutions were encouraged to lend and to rake on risk, which is their fundamental purpose and in their broad self-interest. However, members emphasised that such policies need to avoid undermining market discipline and distorting incentives. Members also noted that policy responses to loss of confidence should not prevent the inevitable shrinking of excess capacity built up previously. To regain profitability, supply side overhangs in financial systems and banking markets have to be corrected. While maintaining the stability of the financial system at large, individual institutions should still be allowed to exit the market if they fail to perform.

Situation in emerging markets

Members assessed the situation of emerging market borrowers. They discussed the risk of contagion and policy options available to mitigate the risk to global financial stability posed by recent developments. They called for consistent and comprehensive strategies across regions and creditor classes. Drawing a lesson from the crisis in Argentina, members insisted that violations of the rule of law and respect of contractual agreements cannot be tolerated if the risk of "political" contagion and the potential damage to vital FDI inflows are to be avoided.

More emphasis needs to be put on debt sustainability and on limiting currency mis-match problems in emerging market financial systems. The development of domestic currency debt markets holds the potential to overcome some of the difficulties in a medium to long-term scenario.

In discussing the likely pattern of capital flows, members were optimistic that flows to emerging Asia and Europe would hold up rather well, with the possible exception of Turkey and the Philippines. By contrast they feared that flows to Latin American borrowers would be further reduced.

In addressing the policy options members made clear that a first line of defence would include sound domestic macro economic policies and appropriate private sector involvement to ensure the prompt and full service of internal and external debt. Overall indebtedness should be kept at sustainable levels. In cases where these policy options do not suffice to overcome a temporary lack of confidence, additional help might be available from the IMF and others. Where the debt load is unsustainable and confidence cannot be restored, national authorities should consider the timely restructuring of external and internal debt.

II. Addressing weaknesses in market foundations

Members were invited by the Chair to focus on the following questions: What has been achieved to date? What more needs to be done? Where is international coherence most important? How can the Forum provide impetus for continued progress?

IOSCO representatives gave a progress report on the three drafting groups it has tasked with devising high-level principles to guide national supervisors and regulators in the areas of audit profession oversight, audit independence and transparency and disclosure. These three sets of principles will be submitted to the IOSCO Technical Committee in early October, and, once approved, widely disseminated across member countries. The IASB reported on its extensive work program to improve accounting standards in contentious areas (e.g. SPEs, related party transactions, leasing, stock options, revenue recognition, pension accounting), its major project to bring about convergence between U.S. GAAP and IAS (working with FASB) and to keep moving from rules-to principles-based standards. The OECD reviewed its efforts to revise and improve its *Principles of Corporate Governance* and, finally, the United States and other jurisdictions reported on their many initiatives to improve corporate governance, accounting/auditing standards and disclosure practices.

The ensuing discussion highlighted the

- importance of seizing the current <u>window of opportunity</u> to pursue implementation of needed reforms and bring about greater international coherence, based on high-level principles, in these areas. Members noted the risk of losing momentum, as the economy improves and public attention shifts elsewhere, and stressed that regulators have a responsibility to sustain the momentum of market-driven self-correction by locking-in best practices. Public support from G-7 Finance Ministers and Governors would also help maintain momentum.
- role that greater international coherence in certain aspects of reform efforts can play in reducing volatility, counteracting the current tendency of the market to focus on downside risks at the expense of the upside and, more generally, restoring confidence. At the same time, members recognise that national authorities are best able to act quickly and that regulators should not allow the codification of standards to stand in the way of the adoption of best practices arising from market self-correction. It was acknowledged that coherence will matter more in some areas than others.
- desirability of agreement between countries around high-level principles in the areas of corporate governance, auditing, accounting and disclosure, as a first step towards greater coherence.

- central importance, among the 12 key standards highlighted by the FSF, of standards for market infrastructure, especially corporate governance, accounting, and auditing, as a building bloc for sound financial systems. The recent problems in industrial countries should not be allowed to deflect efforts to improve practices in these areas in emerging market economies and developing economies. The OECD was encouraged to provide more specific guidance to national authorities and companies in its *Principles*.
- timeliness of the comprehensive study of rating agency behaviour requested from the SEC in the Sarbanes-Oxley legislation. The SEC is required to submit this study to Congress before January 26, 2003 and FSF members will have the opportunity to review its findings at their March 2003 meeting

Members also welcomed the announcement by the US SEC representative that sensitivity about the extra-territoriality issue stemming from the Sarbanes-Oxley Act was well recognised and would be looked at by the newly-created Public Oversight Board.

There was general agreement on the useful role to be played by the FSF in:

- Maintaining an up-to-date inventory of initiatives taken by market participants, domestic and international authorities to address weaknesses in market foundations;
- Focusing attention on gaps, obstacles or areas of important divergence in reform efforts and initiatives, and/or drawing attention to issues of international coherence when these entail opportunities to increase the efficiency and stability of financial markets;
- Providing impetus and support for these ongoing efforts;
- Helping to share and disseminate best practices and lessons learnt, including any improvements made to the relevant international standards and codes in the FSF *Compendium of 12 Key Standards*.

The next steps are for the Chair to prepare a report for G-7 Finance Ministers and Governors for the end of September. The FSF should make maximum use of regional outreach meetings to share best practices and lessons learnt with other jurisdictions. Members will review progress again at their March 2003 meeting in Berlin.

III. Improving transparency in the reinsurance industry

Members discussed various issues related to reinsurance, including the state of the industry after September 11 and systemic concerns that had been raised on previous occasions. Members expressed their strong encouragement and support for the ongoing work of the IAIS to develop an efficient global framework for reinsurance supervision. Issues such as collateral requirements for reinsurance contracts could best be dealt with in this context. They also welcomed the IASB's effort to develop principles for insurance and reinsurance accounting.

However, although there are no suspicions as of now that major reinsurance companies face difficulties, members felt that more information on the global reinsurance market, individual reinsurers and the rating process is needed to allow outsiders to form a clearer view on the risk taking and management and systemic concerns that might arise from the reinsurance industry. Notwithstanding more elaborate disclosure requirements in some jurisdictions, all types of insurance companies should enhance disclosure of the risks they are running, preferably on a consolidated group-wide basis as well as on a legal-entity basis. Such disclosure should not only encompass traditional insurance risk but also highlight the exposures arising from credit risk transfers and investment activities.

Members agreed that a special effort needs to be undertaken to improve the transparency of the global reinsurance market and enhance the public disclosures of reinsurance companies and insurance companies more generally. Members felt that the IAIS was best placed to take the lead in this work. They were of the view that improvements ought to be well within reach, given the reinsurance industry's concentration among a relatively small number of globally active firms. It was agreed that

Chairman would write to the IAIS Chair and key insurance supervisors, asking them to actively support an initiative within the IAIS towards improved transparency and disclosure to progress speedily. It was also agreed that it is important for the supervisors in major OFCs with large reinsurance activity, such as Bermuda, to participate in the effort at the IAIS. The IAIS will be asked to provide a progress report for the Forum's March 2003 meeting.

As for the international exchange of information between supervisors, it was noted that such exchange should be facilitated by the recently agreed 'OECD Decision on the Exchange of Information on Reinsurers.

IV. Progress in addressing earlier concerns

US Government sponsored entities

The Chair introduced this item as a follow-up to members' March 2002 discussion, when they had inquired about the potential stability implications, beyond the U.S. market, of the very large market share of these two government-sponsored enterprises. Members had before them a note prepared by the Federal Reserve setting out the limits on Fannie and Freddie's risk-taking, the supervisory regime they are subject to, their efforts to increase transparency and disclosure, and their hedging activities.

Members generally felt that this addressed their earlier concerns and it was agreed that there was no need to return to the issue, unless new information warranted it. The Forum also felt that Fannie and Freddie should pursue their efforts to improve transparency and disclosure, in the spirit of the "trust and verify" approach to regulation.

Fact books on Large and complex financial institutions

The Forum heard brief statements of members representing some of the authorities participating in the field tests of the LCFI fact book template. In general tests were thought of being highly relevant and useful, revealing important details and gaps in information required in a crisis and drawing attention to the difficult interaction of different national insolvency regimes and other procedures. Based on the final evaluation report of the field test exercise a thorough discussion of LCFI issues will take place at the Forum's March 2003 meeting.

Highly Leveraged Institutions (HLIs)

It was explained that the BIS and the IMF staff would periodically review data on HLIs that is commercially, and anecdotally, available. Although there is no immediate concern about HLIs' activity, especially their leverage levels, such periodic review could provide early warning of increases in leverage. It was agreed that the Forum should encourage the work of the Joint Forum on recommendations for enhanced disclosure (follow-up work of the Fisher Report).

Offshore Financial Centres (OFCs)

Members supported the description in the press release. It was reported by the IMF, which was making efforts to conclude all OFC assessments as planned in 2003, that assessments to date had found the scarcity of capable supervisors in the OFCs to be the greatest problem, calling for more technical assistance. Members encouraged more informal exchange of experience among supervisors regarding communications with offshore centres. One member noted, with regard to Switzerland, that there could still be difficulties in information exchange among developed financial centres.

Assessment of contingency arrangements post 9/11

Members took note of the extensive work by various U.S. regulators summarized in a 22 August draft white paper on *Sound Practices to Strengthen the Resilience of the U.S. Financial System* (posted on the web site of the U.S. Securities and Exchange Commission). The paper makes many recommendations for core clearing and settlement organisations and financial institutions that play significant roles in critical markets. In addition, an issues paper by the Joint Forum on potential supervisory implications of 11 September was presented, which also encouraged their members to make similar contingency arrangements. Insurance supervisors noted, however, that insurers do not face the same "real-time, business continuity" challenges that banks and payments-clearing organisations do (insurance claims typically are settled many years after an event).

Anti-Terrorist Financing

It was agreed that the secretariat's note should be shared by non-members through the G-20 and the FSF regional meetings. Important work at FATF such as on the transmission mechanism other than financial institutions (e.g. charity and cultural bodies) and on the methodology for ROSC assessments was progressing. The multilateral MOU initiative at IOSCO had also been completed. It was agreed by members that the Forum need not continue its own initiative in this area.

V. Update on ongoing work by Forum members

Attention was drawn to the letter from the Chairman of the G-10 contact group that was working on a cross-country analysis of insolvency arrangements for financial institutions. A final report would be sent to Forum members at a later date.

VI. Date and Venue of Next FSF Meetings

The next meeting of the Forum will be hosted by the German authorities on ***24 -25 March 2003*** in Berlin. Members are asked to keep these dates clear.

VII. Other

A regional outreach meeting with ***Asian*** countries will be held on 11 October in Beijing, preceded by a dinner the evening before. Members are encouraged to participate. Further outreach meetings in ***Europe*** and ***Latin America*** will follow in the course of 2003. Members are also invited to participate in the seminar on corporate failures to be held in Basel on 21 October 2002.

FINANCIAL STABILITY FORUM
CH-4002 BASEL, SWITZERLAND

THE CHAIRMAN

20 September 2002

To G-7 Ministers and Governors

I am writing to report on some of the main points to emerge from the most recent meeting of the Financial Stability Forum (FSF) in Toronto on 3-4 September 2002. Although my report is based on views expressed by FSF members, the particular conclusions I draw are my own.

My report focuses on two topics of immediate policy relevance: potential vulnerabilities arising from the current economic and financial conjuncture, and the reforms necessary to re-establish investor confidence in the wake of recent corporate failures.

Financial Vulnerabilities

Some comfort may be taken from the fact that the central macro-economic scenario remains one of a recovery that gradually gathers pace in major industrial economies. Moreover, despite the fact that problems have accumulated in the global financial system, financial markets have continued to function and to support economic activity. Now, however, downside risks are substantially greater, and comfort margins significantly lower than when I reported to you in April. Uncertainty remains unusually high and concerns are growing that intensified risk aversion could cause a retrenchment from credit markets and risk-taking more generally. Large banking groups and institutional investors have significantly curtailed their exposure to emerging market economies in response to losses on their international activities (a situation unlikely to change until confidence in these economies can be restored). Globally, financial systems have less capacity to absorb future shocks and there are now more weak links in the chain. The insurance sector, in particular, is a focus of increased concern.

The upshot is that the financial system upon which we rely to facilitate adjustment may now be more susceptible to disruption. Indeed, a credit retrenchment holds the risk of accelerating in a disorderly way the unwinding of the imbalances carried over from the boom of the 90s.

FSF members will therefore monitor very closely how financial markets and institutions perform over the coming months and stand ready to confer or even meet at short notice, should changes in the situation warrant it.

Should significant downside risks materialise, or risk aversion greatly intensify, financial authorities will need to react swiftly. In their assessment of possible policy responses, some FSF members recalled that, in 1998, expanded liquidity provision by central banks had played an important role in containing market deterioration.

Regulators and supervisors should also consider action, within the confines of their prudential responsibilities, to prevent overreaction by individual institutions. They can do so by reminding financial institutions of their collective self-interest in liquid and well-functioning markets and in adequate credit supply to borrowers.

Of course, authorities will need to weigh carefully the risk that any policy response could undermine confidence by blunting market discipline, distorting incentives and hindering the necessary unwinding of excess capacity and supply-side overhangs.

Addressing Weaknesses in Market Foundations

The recent spate of corporate failures and accounting irregularities has had a damaging effect on investor confidence in global markets. This could still threaten the recovery, further test the financial sector's resilience and eventually pose financial stability problems. I draw three conclusions from the FSF's recent deliberations on this issue. A fuller report, as requested by Ministers and Governors last April, is attached with this letter.

First, national and international authorities face an unprecedented window of opportunity to strengthen market foundations, with lasting benefits for efficiency and stability. This opportunity must be seized before public attention shifts elsewhere. The central challenges for decision-makers will be to maintain the momentum in ongoing reform to underpin the self-correcting forces of markets, while managing the tension between public expectations of immediate results and the careful work required to build better foundations for the longer term.

Second, a determined effort should be made to use ongoing reforms to improve the coherence of market frameworks across countries. Work to improve corporate governance, strengthen oversight of the audit profession, improve public disclosures, and achieve convergence of U.S. and International Accounting Standards make up, in effect, a convergent agenda for reform across the major financial centres. There are real and lasting benefits to be reaped from greater comparability of financial reports: these include lower capital costs and a better allocation of capital across sectors and countries.

In this respect, Ministers could help by lending their support to:

- the work of domestic standard-setters and the International Accounting Standards Board (IASB) to raise, and increase the convergence of, accounting standards world-wide around principles-based standards;
- IOSCO's forthcoming guidance on audit independence, audit profession oversight and disclosure and transparency, to be released in the fall;
- the OECD's efforts to review and make more demanding its *Principles of Corporate Governance.*

These improvements will in time have consequences for the 12 standards and codes designated by the FSF as essential to well functioning financial markets and the FSF will help ensure that they are implemented more widely.

Third, there is a need for co-ordination of reform efforts across countries and, in some cases, sectors. The FSF, given its composition, is well placed to foster such co-ordination, and to provide ongoing impetus to the initiatives under way. At the Toronto meeting, members agreed that the FSF would monitor progress, identify gaps and obstacles to reform, and focus attention on opportunities to increase the efficiency, integrity and stability of financial markets. The Forum will also make active use of its regional outreach activities to promote and help coordinate reforms beyond the main financial centres. Support from Ministers and Governors for this work is desirable.

A D Crockett

Attachment

c.c. Members of the FSF

FINANCIAL STABILITY FORUM

Addressing Weaknesses in Market Foundations - an International Perspective

A Report to G-7 Finance Ministers and Governors[1]

20 September 2002

1. The Challenges: sustaining the momentum for reform and seeking greater coherence

The accumulation of breakdowns in truthful accounting and in the chain of internal and external "checks and balances" on publicly listed companies is undermining investor trust in financial market foundations. The sensitivity of investors to negative corporate news has reached high levels and spread beyond the high-tech sector into national and international markets, exacerbating the financial and psychological impact of the bursting of the high-tech bubble. This sensitivity manifests itself in sustained risk aversion and a tendency for investors to focus excessively on downside risks. Indeed, symptoms of a crisis of confidence are present, even if it may be difficult to disentangle precisely what, in the current market re-pricing, is due to normal market corrections after a bubble, generalised suspicion over financial reporting and corporate governance or even doubts over the robustness of official baseline macroeconomic scenarios.

Financial stability problems may develop should weak financial markets threaten the recovery and further test the financial sector's resilience. Beyond the direct impact of the erosion of financial wealth, doubts about the reliability of corporate earnings are affecting lenders' and investors' appetite for risk, resulting in an increase in the cost of, or reduced access to, capital for corporations. Putting in place a set of structural reforms that will address the loss of investor confidence in a convincing way is therefore a key objective in all major financial centres.

Elected officials face clamours for quick fixes, on the notion that reforms of market foundations should somehow restore asset values. This is not a realistic objective, nor are expectations that the full effect of reforms will be immediately felt. The first challenge for national authorities is to manage this tension between immediate public expectations and the careful and sustained work required to put in place a sounder framework of market foundations that will be effective for the long term. The second challenge is to seize an unprecedented window of opportunity for reform to increase coherence between the market frameworks of different countries, with real pay-offs in terms of financial system efficiency and stability.

2. Initiatives to date: much has been done, but there is more to do

The attached table provides an overview of the weaknesses being addressed in the wake of recent corporate failures. The overall story it tells is one of inadequate **standards** in corporate governance, accounting, audit and disclosure, defective **practices** in these areas, in part as a result of weak **enforcement** of existing standards.

Corporate governance standards have been found wanting, particularly in areas of board independence, audit and remuneration committee independence and in the accountability

[1] This report is an updated and abbreviated version of the report prepared by the FSF Secretariat and presented to the FSF meeting of 3-4 September 2002 in Toronto. While the report, it is believed, would be broadly endorsed by the Forum, individual Forum members have not been consulted on the way in which points are made.

regimes for CEOs and CFOs. Conflicts of interest have extended beyond corporate boardrooms and their committees, affecting the behaviour of financial analysts, rating agencies, financial institutions of different types, institutional investors and various other "gatekeepers" of market integrity.

The U. S. Administration, through a ten-point action plan, and the recently enacted *Sarbanes-Oxley Act of 2002*, together with the SEC, NYSE, and NASDAQ, have launched a major push to strengthen the independence of boards and their various committees, as well as to increase the personal responsibility of CEOs for truthful financial reporting in their companies. The EU is undertaking a thorough review of its corporate governance regimes with the help of a High Level Group of Company Law Experts (HLG), and the OECD is surveying developments in corporate governance among its members to identify lessons to be learned, as well as implications for the OECD *Principles of Corporate Governance*. Finally, steps are being taken to address conflict of interest affecting analysts, investment banks, rating agencies.

Specific **accounting** standards have also been found wanting. For instance, standards on the consolidation of Special Purpose Vehicles (SPVs) are either not demanding or not clear enough; and the same holds for standards dealing with revenue recognition, which typically accounts for two thirds of re-estimations of net income. There is much discussion of whether equity-based remuneration schemes in the form of options should be expensed as costs to be deducted from net income. The International Accounting Standards Board (IASB) has already signalled its intention to adopt a new standard requiring that stock options be costed and deducted from net income in financial statements and, among many other things, is working on revenue recognition and business combinations.

Beyond specific accounting issues, there are **overarching** issues about the respective merits of rule-based versus principles-based approaches to accounting and the need for international convergence of accounting standards. FASB and the SEC are publicly committed to moving the U.S. from the current rule-based to a more principles-based approach. And the European Union is committed to adopting by 2005 International Accounting Standards (IAS) for all companies listed in Europe. Other countries - Australia, New Zealand, Singapore and Hong Kong - have decided to adopt IAS as well, some of them earlier. The IASB has a full scale accounting convergence project underway with FASB.

Auditing practice standards have been found deficient as well as inadequately enforced. Several jurisdictions have concluded that self-regulation is an inadequate form of oversight over the auditing profession. The U.S. and Canada have both recently created independent public boards to oversee their audit professions. The UK is reviewing its audit oversight mechanisms, as are other countries. And, at the international level, IOSCO has two drafting groups developing, for early October, some guidelines for domestic authorities on auditor independence and auditor oversight.

Both **disclosure** standards and practices have been revealed as inadequate with respect to comprehensiveness (e.g. off balance sheet transactions), timeliness (between reporting period events) and transparency of valuation practices. In the U.S., the SEC and the *Sarbanes-Oxley Act of 2002* have already taken steps to tighten disclosure norms. IOSCO and the Joint Forum have task forces working on transparency and disclosure guidelines, and the EU along with many domestic authorities are reviewing their disclosure standards.

Conflicts of interest have also been revealed in corporate governance at financial institutions. A number of countries have announced new codes of behaviour to shore up the independence of financial analysts, particularly when they work for institutions active in underwriting, investment and research.

Finally, there is much effort to strengthen the **enforcement** of standards. Market forces and the checks and balances of corporate governance are the first line of defence in enforcing discipline on companies. But enforcement must also take more direct forms: auditing, market oversight by independent analysts and credit rating agencies; market oversight by regulators and supervisors; external pressure of well informed investors; rules, legislation, and, ultimately, legal recourse and public sanctions.

Recent corporate failures have revealed shortcomings in all of these disciplining mechanisms, which, taken together, are mutually reinforcing: Deficient corporate management practices can compromise audit committee and remuneration committee independence; lack of audit independence undermines audit quality; poor audits and poor disclosure prevent effective market oversight and supervision. A lack of enforcement weakens practices all around.

Reforms to address these various shortcomings have already been announced by many parties and jurisdictions, more are coming, and on issues where the best policy response is unclear, work is underway.

3. Getting the right balance between market self-corrections and public interventions

Much competitive self-correction is already happening in the areas of corporate governance, auditing and accounting practices and voluntary disclosure. Since the Enron bankruptcy, many large companies have voluntarily committed to reviewing and disclosing off-balance sheet entities and transactions; deducting equity-based remuneration schemes as costs in their income statement; increasing the separation between audit and consulting services provided by accounting firms; and publishing corporate codes of ethics.

Not only are corporations volunteering commitments to improve their practices, but large investors are banding together in groupings like the International Corporate Governance Network to leverage reforms on the part of the companies whose stock they hold. Such pressure by the more "visible" hand of the market is potentially powerful.

As long as market-driven self-correction amounts to a "race to the top" (i.e. towards best practices) rather than a "race to the bottom", it is desirable and should be encouraged. And if market corrections obviate the need for further regulation and public intervention, that is welcome.

But, there are limits to market based self-correction, particularly with regard to audit quality, disclosure standards, and conflicts of interest arising in corporate governance. A key objective of public policy is to help "lock in" improvements in best practices, e.g. by codifying them, so that they:

- eventually spread to all public companies
- spread faster than would otherwise be the case
- become the norm, the floor, rather than the ceiling for other market participants
- do not give rise to widening discrepancies in standards of behavior

"Locking-in" is important for preventing undesirable forms of regulatory arbitrage (the competitive search for weaker regulatory regimes). Moreover, market corrections are typically highly cyclical: booms are phases of increasing complacency, followed by busts, retrenchment and overreaction.

There is today a window of opportunity to implement needed reforms. This should be seized, given that public attention and market resolve may well weaken as the economy improves and the spotlight moves to other issues. <u>A key challenge is how to maintain the resolve to keep improving market foundations</u>. Ministerial support and urging can help regulators play their role in reducing over-reactions at both extremes of the business cycle. Getting this balance right, between over- and under-reaction, will require on-going dialogue between national and international authorities

4. A window of opportunity for greater coherence between national reform efforts

The current crisis of confidence offers a unique window of opportunity for different countries to carry out broadly consistent reform agendas that will improve the efficiency, integration and stability of capital markets, and hence investor confidence. Initiatives to date make up -- in effect -- a converging agenda among FSF members for strengthening market foundations. Indeed, while current U.S. reforms respond to recent high-profile corporate and financial reporting failures, similar initiatives have been launched in a number of other countries for not dissimilar reasons. In particular, the aim of the European Union and of a number of other countries to ensure that, by 2005, listed companies report their accounts using IAS standards is giving impetus to work to strengthen accounting and auditing arrangements. Multilateral movement towards more demanding accounting/auditing/enforcement standards across countries would facilitate cross-border comparisons, reduce uncertainty resulting from non-comparable information, leading to more efficient financial flows, and ultimately reducing the cost of capital, while improving its allocation across sectors and companies. And coalescing around "best practices" will bring stability benefits as well.

"Coherence" does not require identical standards or practices across countries; it refers to the more limited objectives of ensuring that (1) high-level goals and principles are consistent across countries, (2) the same broad outcomes are being sought, and (3) market incentives are properly aligned, to produce efficient outcomes. Within these broad parameters, coherence leaves it to national authorities to decide on the approaches, means and mechanisms best adapted to their national circumstances.

Corporate governance regimes are embedded in the unique history, institutional heritage and economic/cultural mores of each country. There are, however, high-level common principles and objectives valid for all countries (e.g. board independence, audit independence, avoidance of conflict of interest, accurate and truthful disclosure). These are set out in the *OECD Principles of Corporate Governance*, one of the 12 standards and codes deemed essential by the Financial Stability Forum for well-functioning financial markets. The OECD, in reviewing by 2004 its existing *Principles*, could usefully make them more explicit and demanding in the guidance they offer.

Coherence in **accounting standards** has become much more pressing, as a result of capital market integration. The intention of many countries to adopt IAS in the near term, together with the major convergence project between FASB and the IASB around more principles-based standards should help accelerate international convergence. But this will bring new challenges. Countries that move from rule- to principles-based accounting standards should expect to invest much in tighter corporate governance, auditing standards and audit profession oversight and enforcement in general. Principles create fewer incentives to adjust transactions to fit the rules, but leave more discretion to managers and auditors in deciding how to record transactions and report results. Principles will result in accountants and auditors sometimes making mistakes in good faith, which should not result in disproportionate penalties. Moving from rules to principles will thus place stronger demands on sound market foundations and control mechanisms.

At present, **auditing practice standards** differ considerably from country to country. Audit firms are required by law to abide by national standards of the country in which they operate and the common umbrella provided by the letterhead of global accounting firms conceals large variations in the audit quality of different branches and offices. Notwithstanding the existence of international audit practice standards, there have remained considerable institutional obstacles to convergence on these standards. These issues should be revisited in light of recent market developments.

Oversight of the auditing profession also leaves much scope for international consultation and coordination. There is significant international divergence in the oversight and enforcement of auditing practice standards. Indeed, many countries have no oversight agencies for their auditing sectors. An FEE (*Fédération européenne des experts comptables*) survey observes that this is the case for half of EU member countries. Other jurisdictions continue to rely on self-governance by the audit profession. However, several jurisdictions have recently come to the view that self-regulation is less effective than oversight and enforcement by independent bodies. The FSF attaches much importance to the guidelines on audit independence and oversight of auditors, which IOSCO is committed to releasing and disseminating in October 2002.

An aspect that bears on the means and methods by which higher audit quality can be achieved in individual jurisdictions is the increasing concentration of the "first tier" of **global accounting firms** (the former "big five" now reduced to the "big four"). It is too early to understand fully the potential effects of this concentration on audit quality, for example on the ability to practice auditor rotation and discipline the auditing profession. If future court judgments, for instance, were to force the exit of another global accounting firm, the resulting increase in concentration would have a major bearing on all countries. For this reason, the international community may have an interest in seeing develop a second tier of reputable and quality accounting firms able to step into the breach.

The increasing concentration of the world accounting industry is a truly global issue, where both the diagnosis and possible policy responses go beyond national boundaries. There is scope for an international dialogue on these issues.

Finally, global markets do require greater harmonisation of **disclosure standards**. While market pressures, notably through institutional investors, and multiple listings, are helping bring this about, national regulators and international standard setters such as IOSCO (which will issue new guidelines in October) have a key role to play in areas where pressures for better disclosure are weak or absent.

5. The FSF will facilitate international coordination and maintain momentum for reforms

There is much work underway among supervisors and regulators, finance ministries, international authorities, standard setters and expert committees. The FSF, which comprises all these bodies, is well placed to provide impetus and to coordinate this work. To this end, Forum members resolved at their recent meeting in Toronto that the FSF would:

- Maintain an up-to-date inventory of initiatives taken by market participants, domestic and international authorities to address weaknesses in market foundations;
- Focus attention on gaps, obstacles or areas of important divergence in reform efforts and initiatives, and/or drawing attention to issues of cross-country coherence, when these entail opportunities to increase the efficiency and stability of financial markets;
- Provide impetus and support for ongoing reforms more widely, beyond the major financial centres, notably through its regional outreach activities

- Help to share and disseminate best practices and lessons learnt, including any improvements made to the relevant international standards and codes in the FSF *Compendium of 12 Key Standards*
- Review progress made at its next meeting in March 2003 in Berlin and, should the macro-economic of financial situation warrant it, stand ready to convene a special meeting on short notice before then

FINANCIAL STABILITY FORUM

ANNEX

Reforms in Market Foundations

CORPORATE GOVERNANCE

- Corporate governance codes in general
- Incentives of CEOs to uphold high standards of conduct and business ethics
- Use of equity-based remuneration as managerial incentives
- Relationship of CEO and Board of Directors
- Role and composition of audit committees
- Treatment of whistle-blowers

ACCOUNTING STANDARDS

- Responsiveness of accounting standards to market changes and the needs of investors
- Rules versus principles in accounting standards
- Coherence of national and international accounting standards
- Consolidation of SPVs and other off-balance sheet entities
- De-recognition of assets and liabilities
- Revenue recognition
- Accounting for derivatives
- Accounting for management and employee stock option rewards
- Accounting for pension contributions and obligations

AUDITING QUALITY: STANDARDS & PRACTICES

- Codes of practice and auditor independence
- Oversight of audit profession/enforcement/discipline
- Effects of audit industry consolidation
- International coherence in audit quality standards and enforcement practices

DISCLOSURE AND MARKET OVERSIGHT

- Comprehensiveness of disclosure
- Timeliness of disclosure
- Transparency of valuation assumptions
- Use of pro forma results
- Plain language reporting
- Independence of investment analysts
- Quality of risk assessment and due diligence by financial counterparties
- Quality of rating agencies' work/timeliness of rating decisions
- Disclosure of rating triggers

ANNEX

SOME KEY INITIATIVES TO DATE

SARBANES-OXLEY ACT OF 2002

- Creates an independent Public Company Accounting Oversight Board to enforce professional standards, ethics and competence for the accounting profession
- Strengthens the independence of firms that audit public companies by having the SEC prohibit the provision of consulting services to audit clients, when these services create conflicts of interest
- Requires CEOs and CFOs to vouch personally for the veracity of their financial statements and provides much stiffer penalties for fraud
- Strengthens disclosure requirements for public companies, notably in the areas of off-balance sheet transactions and insider trading
- Protects the independence and objectivity of securities analysts by directing the SEC to review rules ensuring their independence
- Directs the SEC to undertake comprehensive reviews of corporate governance, the separation of audit and non-audit work, and the role of credit rating agencies and investment banks (this latter study to be undertaken by the GAO)
- Increases the resources available to the SEC

EUROPEAN UNION (EU)

- The EU recently completed a *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States.*
  - This study is being considered by a High Level Group (HLG) of Company Law Experts, chaired by Professor Jaap Winter
  - The HLG is also examining policy priorities on corporate governance issues and will report by July 2002.
  - European Commission to assess promptly whether the HLG's recommendations adequately meet concerns brought to light by Enron bankruptcy
- Speedy adoption, this year, of the Proposed Regulations requiring the use of IAS by EU listed companies by 2005
- Continuation of the dialogue with US authorities to encourage their acceptance of IAS financial statements prepared by listed EU companies for listing within the US (without reconciliation to US GAAP from 2005 onwards)
- EU support for global convergence through the IAS process on important accounting issues such as the treatment of financial instruments, share-based payments and off-balance sheet financing schemes
- Before Summer 2002, publication by the Commission of a second consultative document on *Regular Reporting* (e.g. quarterly reporting, on-going disclosure obligations)

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)

- Has advanced from 2005 to 2004 its comprehensive review of the OECD *Principles of Corporate Governance*

INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS (IOSCO)

- Three working groups are preparing draft guidelines dealing with:
  - audit independence
  - oversight of the auditing profession
  - disclosure and transparency
- Draft guidelines to be approved, published and disseminated after meeting of IOSCO Technical Committee in early October

INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

- Committed to having comprehensive International Accounting Standards (IAS) in place for target date of 2005, by which all companies listed in Europe must present accounts using IAS
- "Our goal is to identify the best standards around the world and establish a body of standards that build on the best...we call that convergence to the highest level"
- Has launched priority projects on:
  - business combinations (e.g. consolidation)
  - de-recognition
  - revenue recognition
  - derivatives
  - stock options
  - pension accounting
- Is working with FASB on a full-scale convergence project between U.S. GAAP and International Accounting Standards (including pension accounting)

Statement by Andrew Crockett

Chairman of the Financial Stability Forum

International Monetary and Financial Committee Meeting

28 September 2002

Washington, D.C.

Since its last report to the IMFC on 20 April 2002, the Financial Stability Forum (FSF) has focused on three priority areas: the evolution of economic and financial **vulnerabilities** affecting the world economy, concerns about risks in the **reinsurance** sector and national and international initiatives to **strengthen market foundations** in the wake of recent corporate failures.

Vulnerabilities in the international financial system

At its recent meeting in Toronto on 3-4 September, the FSF thoroughly reviewed risks and vulnerabilities affecting the international financial system. The Forum noted that the central macro-economic scenario remains one of a recovery that gradually gathers pace in major industrial economies. And while problems have continued to accumulate for the global financial system, financial markets have on the whole continued to function and to support economic activity. The experience of the financial sector overall supports the benefits of the considerable investments that have been made in risk management systems and in strengthening capital cushions in recent years.

At the same time, downside risks are now substantially greater than they were six months ago. Uncertainty remains high and intensified risk aversion could cause a retrenchment from credit markets and risk-taking more generally. Losses sustained in domestic and international activities are causing financial institutions and institutional investors to reduce exposures to emerging market economies perceived to face debt sustainability and currency mismatch problems. The insurance sector is a focus of increased concern in the light of recent financial market weakness and negative margin problems. Globally, financial systems have less capacity to absorb future shocks and there are now more weak links in the chain.

Against this background, the Forum emphasised that 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 may need to act, as appropriate, to contain market deterioration. However, policy responses should not prevent the necessary shedding of excess capacity built up in previous years.

Addressing Weaknesses in Market Foundations

The FSF has reviewed the many initiatives underway in this area by market participants, national authorities and international standard-setters and welcomed the speed and determination with which the weaknesses are being addressed. The Forum emphasised the importance of seizing the current window of opportunity to pursue reforms to sustain and lock-in market-driven self-correction. Given the international dimension of the problems and their remedies, FSF members also underscored the importance of international and cross-sectoral coherence in reforms.

The FSF noted that poor **corporate governance** had played a central role in many of the recent failures, and called upon national authorities to act to improve practices in this area.

Members welcomed the decision by OECD Ministers to bring forward to 2004 their comprehensive review of international *Principles of Corporate Governance* and urged that, to the extent possible, the revised principles embody more specific guidance than previously.

Weaknesses in the **accounting treatment** of consolidated entities, revenue recognition and equity-based remuneration have also been a key issue in the current undermining of confidence. The FSF called upon national standard setters and the International Accounting Standards Board to accelerate their work to develop more comparable, accurate and transparent ways of accounting for these in financial statements; to improve international accounting standards; and to bring about greater international convergence on principles-based standards.

The Forum stressed that **auditing standards and practices** need improvement. Independent and high quality auditing is of fundamental importance to the integrity of markets. The FSF took note of initiatives for auditor oversight in train in a number of jurisdictions. The international community is consulting on the most effective practices in this area. In this regard, the FSF welcomed the principles on auditor independence and audit profession oversight that are being formulated by the International Organisation of Securities Commissions (IOSCO) and looked forward to their early approval and publication. It also urged the International Federation of Accountants (IFAC) to intensify its work to improve *International Standards of Auditing.*

Recent corporate reporting problems have also underscored the need for reforms to ensure that material information is disclosed in a comprehensive, truthful, timely and clear manner. The FSF welcomed recent and pending reforms in the United States and other member countries, and looked forward to the early approval and publication of **principles on disclosure** and transparency being developed by IOSCO.

The above work will result in revisions to some of the 12 key Standards and Codes that the FSF and IMF have identified as particularly important for strengthening financial systems. The ROSCs and FSAP programs of the IMF and the World Bank will be vital means of ensuring that these improvements are spread widely.

The FSF also discussed the role of **credit rating agencies.** In an environment of more marketable debt, the analysis provided by credit rating agencies has an increasingly pervasive influence on financial markets. The FSF welcomed the work under way by the U.S. Securities and Exchange Commission to review the policies and procedures of credit rating agencies and will discuss the conclusions of that review at its next meeting.

In the period ahead, the FSF will 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 March 2003 meeting.

Improving Transparency in the Reinsurance Industry

The FSF has reviewed a number of concerns related to the reinsurance industry. The reinsurance industry plays an indispensable role in the provision of insurance coverage, and has become increasingly engaged in the underwriting and distribution of financial risk. While the reinsurance industry had performed well in the face of recent shocks, the opaqueness of the reinsurance market and of reinsurers' public disclosures makes it difficult to assess the potential impact of problems in the industry, should they arise, on the insurance sector as a whole and on financial stability more generally. Some of these issues are also relevant to other parts of the insurance industry.

The FSF has therefore encouraged the regulators in the key jurisdictions in which large parts of the global industry is based to lead efforts nationally and within the International Association of Insurance Supervisors (IAIS) to produce data and reporting on the global reinsurance market. The Forum also called for improvements in the frequency and quantitative and qualitative content of public disclosures by individual reinsurers and insurance companies. These efforts should begin speedily. The FSF lent its full support to the work of the IAIS and national supervisors and others to improve industry disclosures and to develop an efficient global framework for reinsurance supervision, which could benefit reinsurers, primary insurers and policyholders, and therefore economies at large.

Offshore Financial Centres

At its recent meeting, the FSF also re-emphasised the need for continued efforts by many offshore financial centres (OFCs) to bring their supervisory, regulatory, information sharing and cooperation practices up to international standards. The FSF welcomed the acceleration of the IMF's assessment program, and noted that all OFCs should now be able to complete and publish by 2003 assessments of their observance of international standards, along with action plans to address gaps. The FSF welcomed the recent publication by Aruba and Macau SAR of their IMF assessments (available at www.imf.org) and encouraged others that have had assessments[1] to disclose the results and action plans when the assessment process is completed and to act speedily to implement recommendations.

The FSF also encouraged the jurisdictions[2] that have requested assessments of observance of standards under the IMF's Module 2 or the FSAP to disclose publicly the results of these assessments when they have been completed, along with action plans to implement recommendations; and regretted that some OFCs -- Nauru, Niue -- had not yet requested an IMF Module 2 assessment.

The FSF noted that resource limitations can be a constraint in the implementation of standards and called upon its members to strengthen the provision of technical assistance to promote further progress by OFCs.

The FSF will assess the overall effectiveness of its OFC initiative in 2003.

1 Andorra, Belize, Costa Rica, Lebanon, Marshall Islands, Monaco, Netherlands Antilles, Seychelles, Vanuatu

2 Anguilla, Antigua and Barbuda, Bahrain, Barbados, The Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Guernsey, Isle of Man, Jersey, Liechtenstein, Labuan (Malaysia), Malta, Mauritius, Samoa, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, The Turks and Caicos.