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**Article**

## The Financial Stability Forum ; reform of the international architecture

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## THE FINANCIAL STABILITY FORUM

BY SVEIN ANDRESEN\*

### Background to FSF's establishment

At the height of the turmoil in the international financial system in the summer and fall of 1998, much disenchantment was expressed about arrangements for international financial regulation and surveillance. At their meeting in Washington on 3 October 1998, the finance ministers and central bank governors of the G7 countries asked Mr Hans Tietmeyer, then President of the Deutsche Bundesbank, to consult appropriate bodies and recommend new structures that may be required. Mr Tietmeyer presented his report, *International Co-operation and Co-ordination in the Area of Financial Market Supervision and Surveillance*<sup>1</sup>, to the G7 Ministers and Governors in Bonn on 20 February 1999, who unanimously endorsed it.

The report identified three shortcomings in then-existing arrangements. First, strengthened arrangements were needed to help identify incipient vulnerabilities in the financial system and to formulate concerted policies to address them. Second, more effective procedures were required to develop and implement internationally agreed standards of best practice which could be applied consistently across financial institutions and countries. And third, new arrangements were needed to improve information exchange and co-ordination among the various authorities and bodies responsible for promoting and maintaining financial stability.

The report concluded that overcoming these shortcomings did not call for sweeping changes to the institutional architecture of international financial system. Instead, it proposed the establishment of a

Financial Stability Forum (FSF) in which the national authorities from the major financial centres, the international financial institutions, and the groupings of regulatory and central bank officials should come together to assess vulnerabilities affecting the international financial system; to identify and oversee action needed to address these vulnerabilities; and to improve co-ordination and information exchange among the authorities responsible for financial stability.

The FSF was convened on 14 April 1999 in Washington, with a membership comprising the deputy finance ministers and central bank governors and heads of financial supervision from the G7 countries; senior officials from the major international organisations (IMF, World Bank, OECD and BIS); and the chairmen of the international regulatory and supervisory groupings (the Basle Committee on Banking Supervision, the International Organisation of Securities Commissioners, the International Association of Insurance Supervisors) and of the G10 central bank Committees on Payment and Settlement Systems and on the Global Financial System. Mr. Andrew Crockett, General Manager of the BIS, was appointed Chairman of the FSF in his personal capacity for a term of three years. Support for the Forum is provided by a small secretariat located at the BIS in Basel.

### Activities of the Forum

The Forum has achieved good progress since its initiation. As directed by its mandate, it has created a process for sharing information on, and co-ordinating where appropriate, the work of its membership.<sup>2</sup> It has also created an informal process to pool and assess information available to its members on potential vulnerabilities affecting the international financial system. In a number of areas, this has led the Forum to form ad hoc working groups to address issues of particular concern, on which more below.

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<sup>1</sup> See the FSF's website: [www.fsforum.org/About/TietmPaper.pdf](http://www.fsforum.org/About/TietmPaper.pdf)

<sup>2</sup> See Reports on Ongoing and Recent Work Relevant to Sound Financial Systems, FSF ([www.fsforum.org/Reports/RepORW.pdf](http://www.fsforum.org/Reports/RepORW.pdf))

The Tietmeyer Report proposed the establishment of the Financial Stability Forum to overcome the short comings of the international financial system

In other areas, the Forum has given impetus to important work among its members. This has included, *inter alia*, the development by the IMF and the World Bank of guidelines on sound sovereign debt and liquidity management practices, and a review by the Joint Forum on the consistency of capital regulation across financial sectors. The Forum also encouraged the Basle Committee to examine the possible pro-cyclical effects arising from the revised bank capital adequacy regulations, and to develop guidance on the management of foreign exchange and liquidity exposures for use by banks in emerging market economies. Finally, the Forum has provided high level support for cross-sectoral work to improve the quality and consistency of public disclosures by all types of financial institutions.

When the Forum was established, it was intended that its membership should be broadened beyond the G7 countries. In the fall of 1999, the central bank governors of Australia, Hong Kong SAR, Netherlands, and Singapore joined the Forum. In addition, senior officials from Argentina, Brazil, Chile, China, Hungary, India, Malaysia, Mexico, the Philippines and South Africa have taken part in the Forum's working groups. Working groups have also consulted private sector participants and academics, and the Forum itself has organised a number of meetings with private sector and academic participation. All this has provided valuable additional perspectives to the Forum's work.

### Specific initiatives of the Forum

At its first meeting in April 1999, the Forum set down three working groups whose subjects bore closely on the turmoil of 1997 and 1998. The reports of these groups were endorsed by the Forum in March 2000, and distributed to the G7 and G20 Ministers and Governors as well as to the International Monetary and Financial Committee of the IMF.

One working group, on **Highly Leveraged Institutions (HLIs)**<sup>3</sup>, was asked to address the systemic threats raised by the near-collapse of LTCM in the fall of 1998, as well as concerns about the operations of HLIs in the financial markets of open economies.

<sup>3</sup> See Report of the Working Group on Highly Leveraged Institutions, FSF, April 2000 ([www.fsforum.org/Reports/RepHLLI.pdf](http://www.fsforum.org/Reports/RepHLLI.pdf))

The group issued a spectrum of recommendations, focusing on strengthened risk management practices at HLIs and their counterparties; enhanced regulatory oversight of credit providers to HLIs; changes in collateral management and documentation practices in wholesale markets; and improvements in public disclosure practices. The group also considered, but rejected for the time being, the direct regulation of currently unregulated HLIs, as well as the creation of a central credit registry for large financial institutions.

A second working group, on **Capital Flows**<sup>4</sup>, developed a framework for monitoring and addressing the risks faced by economies as a result of large and volatile capital flows. Elements of this framework include sound practices in sovereign debt and liquidity management, guidance for the management of liquidity and foreign exchange exposures at financial institutions, the elimination of any laws and regulations encouraging volatile capital flows and imprudent behavior, and the closure of gaps in available national and international statistics. Work to give these recommendations practical effect is now underway in the international financial institutions and relevant international groupings.

And a third working group, on **Offshore Financial Centers (OFCs)**<sup>5</sup>, set out a process for enhancing OFCs compliance with international standards for supervision and information exchange, including thorough assessments to be undertaken by the IMF. It identified a set of standards for priority implementation and proposed a menu of incentives that could be applied to enhance OFCs adherence to standards. The group also classified OFCs based on a survey it conducted of onshore and offshore supervisors and regulators. The Forum agreed to publish this classification to identify OFCs that should be assessed by the IMF with priority.<sup>6</sup> While its publication raised some controversy, it has proven highly effective in prompting change in OFCs, and the most significant OFCs have now applied for an IMF assessment of their supervisory arrangements.

A key focus of the Forum's work has been the **development and implementation of International**

<sup>4</sup> See Report of the Working Group on Capital Flows, FSF, April 2000 ([www.fsforum.org/Reports/RepCF.pdf](http://www.fsforum.org/Reports/RepCF.pdf))

<sup>5</sup> See Report of the Working Group on Offshore Financial Centres, FSF, April 2000 ([www.fsforum.org/Reports/RepOFC.pdf](http://www.fsforum.org/Reports/RepOFC.pdf))

<sup>6</sup> See press release on Grouping of Offshore Financial Centres (OFCs) to Assist in Setting Priorities for Assessment, FSF, May 2000 ([www.fsforum.org/press](http://www.fsforum.org/press))

The Forum's three working groups have initiated a spectrum of recommendations to enhance financial stability

**Standards** of sound practices in financial systems. An early initiative was the creation and dissemination through the Forum's website of a *Compendium of International Standards* relevant to sound financial systems.<sup>7</sup> And in the fall of 1999, the Forum formed a broadly-based Task Force to draw up a strategy to foster standards implementation and to strengthen co-operation among the many parties involved in this effort, including the various standard-setting bodies, the international financial institutions undertaking assessments of standards, and a range of national authorities. The Forum endorsed and published the report<sup>8</sup> of the Task Force in March 2000. Among its recommendations was the designation of 12 key international standards for priority implementation, which have since been endorsed by the G20 and other broad international fora.

A follow-up group is presently exploring **incentives to foster the implementation of standards**. Although countries have a self-interest in strengthening their financial systems, standards implementation competes with other domestic priorities. However, in view of the spill-over effects of financial crises, the international community has a legitimate interest in such efforts being accelerated. One aspect being examined is how to make financial markets take better account of countries' progress in implementing standards in their risk pricing and allocation decisions. Another issue is what measures supervisory and regulatory authorities could apply to encourage standards implementation in foreign jurisdictions.<sup>9</sup>

Of course, strengthening financial systems requires resources for technical assistance and capacity building on the ground. To this end, the Forum has disseminated on its website, along with the World Bank, the IMF and BIS, a **Financial Supervision Training Directory**<sup>10</sup> that provides a global database of training opportunities for financial supervisors.

The second meeting of the Forum, in the fall of 1999, requested a report on **developments and possible vulnerabilities in the insurance/re-insurance industry** – sectors of the financial industry that

have come to greater prominence as financial market integration has proceeded. The report, which was presented to the Forum in March 2000, identified a need for progress in the regulation of solvency requirements, accounting and disclosure practices in the insurance industry; improvements and greater uniformity in supervision of re-insurance activities; and an examination of regulatory arbitrage between insurance and other financial industries. These are now being pursued by the International Association of Insurance Supervisors.

The Forum has also considered the scope for strengthening **Deposit Insurance Arrangements**. A working group has been established to develop practical guidance on deposit insurance issues for countries considering the adoption of a deposit insurance system or the strengthening of existing systems.<sup>11</sup>

#### What the Forum is looking at now

Overseeing the implementation of the above initiatives is itself a significant agenda to which the Forum attaches great importance. In addition, the Forum is currently looking into factors affecting liquidity in financial markets, and the issues that would arise should some of the very large and complex financial institutions now present in the financial landscape encounter serious difficulties. It is also exploring the feasibility of developing international guidance on dealing with weak banks and systemic banking problems. This is an area in which one-size-fits-all solutions are not workable, but where past experience points to a number of pitfalls which national authorities would want to avoid. Finally, the Forum is examining the scope for greater coordination of the regulatory and supervisory responses to the development of e-finance. As in the case of its past work, the Forum's unique composition of finance ministries and central banks, sectoral regulators and supervisors, and the international financial institutions and groupings, should help ensure that relevant perspectives are brought to bear on these issues.

<sup>7</sup> See [www.fsforum.org/Standards/Home](http://www.fsforum.org/Standards/Home)

<sup>8</sup> See Report of the Task Force on Implementation of Standards, FSF, April 2000 ([www.fsforum.org/Reports/RepIoS.pdf](http://www.fsforum.org/Reports/RepIoS.pdf)).

<sup>9</sup> See Report of the Follow-Up Group on Incentives to Foster Implementation of Standards, FSF, September 2000 ([www.fsforum.org/Reports/RepInFoIS.pdf](http://www.fsforum.org/Reports/RepInFoIS.pdf)).

<sup>10</sup> See [www.fsforum.org/Training/Home](http://www.fsforum.org/Training/Home).

<sup>11</sup> See International Guidance on Deposit Insurance: A Consultative Process, FSF September 2000 ([www.fsforum.org/Reports/RepIGDI.pdf](http://www.fsforum.org/Reports/RepIGDI.pdf)).

The development and implementation of international standards of sound practices has been a major focus of the FSF