Press release

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Financial Stability Forum endorses policy actions aimed at reducing global financial vulnerabilities

The Financial Stability Forum (FSF) held its third meeting this weekend in Singapore and exchanged views and shared perspectives on potential threats to the stability of the international financial system. The Forum endorsed a broad range of concrete policy actions to address concerns related to highly leveraged institutions, volatile capital flows, and offshore financial centres.

Established by the G7 in February last year, the Forum aims to promote international financial stability through enhanced information exchange and co-operation in financial supervision and surveillance. It comprises national authorities responsible for financial stability in significant international financial centres, international financial institutions, international supervisory and regulatory bodies, and central bank expert groupings. The Forum is chaired by Mr Andrew Crockett, General Manager of the Bank for International Settlements, in his personal capacity.

The Forum received reports from three working groups set up at its first meeting in April 1999, to address concerns related to ***highly leveraged institutions (HLIs), capital flows***, and ***offshore financial centres (OFCs)***, and endorsed their recommendations.

The working group on HLIs, chaired by Mr Howard Davies, Chairman of the UK Financial Services Authority, recommended a package of measures to address both systemic risk and market dynamics concerns arising from the activities of HLIs (especially hedge funds). The measures include strengthened risk management practices by HLI counterparties and HLIs, enhanced regulatory oversight of HLI credit providers, enhanced public disclosure by HLIs and other counterparties, guidelines on good practices for foreign exchange trading, and building a firmer market infrastructure. The group also considered, but did not recommend, at this stage, direct regulation of currently unregulated HLIs. The Forum emphasised that direct regulation would be re-considered if, upon review, the implementation of the report's recommendations were not adequately addressing the concerns identified.

The working group on capital flows, chaired by Mr Mario Draghi, Director General of the Italian Treasury, recommended that national authorities put in place a risk management framework for monitoring and assessing the risks faced by their economies as a result of large and volatile capital flows. Work is already under way in the IMF and World Bank to develop a set of guidelines for sound practice in sovereign debt and liquidity management. Participants in other sectors of the economy must take steps to enhance their own risk management procedures. The group pointed to important ways in which national authorities and international bodies should support this process, for example, by addressing gaps in available statistics, encouraging greater transparency, and eliminating laws and regulations that

inadvertently encourage imprudent behaviour. The Forum urged that the ongoing work to develop guidelines on sovereign debt and liquidity management be finished promptly.

The working group on OFCs, chaired by Mr John Palmer, Superintendent of Financial Institutions, Canada, concluded that enhanced implementation of international standards by OFCs, particularly as regards regulation and supervision, disclosure and information sharing, would help address concerns about some OFCs. The group's recommendations spell out a process for assessing OFCs' adherence to international standards, identify standards for priority implementation and assessment, and propose a menu of incentives that could be applied to enhance their adherence to international standards. The Forum stressed the urgency of making operational this framework.

The Chairman of the Forum will seek the support of national authorities and the G7, the G20, and the IMF's International Monetary and Financial Committee for the groups' recommendations.

At its meeting in Singapore, the FSF also:

- exchanged views on a number of features of international financial markets that could aggravate shocks if they were to occur or could make resolution of problems more difficult;

- discussed implementation of international standards to strengthen financial systems, based on a report prepared by a task force headed by Mr Andrew Sheng, Chairman of the Hong Kong Securities and Futures Commission, and emphasised the need for further efforts in this area. The Forum agreed that attention should focus on 12 key international standards, which will be highlighted in the *Compendium of Standards*—a common reference for internationally accepted standards relevant to sound and stable financial systems;

- reviewed progress by a study group on deposit insurance headed by Mr Jean Pierre Sabourin, President of the Canada Deposit Insurance Corporation, and asked the group to consult widely in the development of international guidance for deposit insurance arrangements;

- considered developments in the insurance industry, including reinsurance, and encouraged the International Association of Insurance Supervisors to carry forward the work underway in these areas; and

- considered a range of other international financial issues, including the proposed revision to the Basel Capital Accord, and the supervisory implications of the internet and electronic finance.

Note for editors

The executive summaries of the three working group reports are attached. The full reports will be made available on the FSF web site on 5 April.

Annex 1 lists the institutions and groups that attended the third meeting of the FSF on 25-26 March 2000 in Singapore.

For further information on the FSF, its membership, previous meetings, its groups, and the *Compendium of Standards*, please visit the FSF web site (*www.fsforum.org*).

Report of the Working Group on Highly Leveraged Institutions (HLIs)

Executive Summary

1. The Working Group was asked to assess the challenges posed by highly leveraged institutions (HLIs) to financial stability and to achieve consensus on the supervisory and regulatory actions which would minimise their destabilising potential. Its creation followed two main episodes. First, the near-collapse of Long Term Capital Management (LTCM), which raised concerns about the potential systemic risks posed by a HLI. Second, the spillover effects from the 1997/8 crises in Asia and Russia, when the authorities in some small and medium-sized open economies were concerned that HLIs had exerted a destabilising impact on their markets.

2. The Working Group's main focus has been on firms categorised by the Basel Committee on Banking Supervision (Basel Committee) and International Organisation of Securities Commissions (IOSCO) as large, unregulated and opaque institutions employing a high degree of leverage in financial markets – primarily 'hedge funds'. But regulated firms and their affiliates also played important roles in both episodes. In the case of LTCM, they provided the credit that allowed the accumulation of the fund's leverage. And, in the episodes affecting market dynamics in small and medium-sized open economies, the proprietary trading desks of banks and securities firms were active market participants alongside hedge funds.

3. The key issues arising from the LTCM episode are twofold. First, how best to address the systemic risks arising from the accumulation of high levels of leverage in financial markets. Second, how to reduce the potential market and economic impact of the sudden and disorderly collapse of an unregulated HLI. In the market conditions of late 1998, the disorderly liquidation of a hedge fund as large and as leveraged as LTCM could also have imposed substantial direct losses on its counterparties. Significant secondary losses could have been imposed on other firms, through the rapid liquidation and closing out of LTCM's positions and the collateral supporting its funding. The potential widespread disruption in financial markets and possible collapse of some major firms would have posed grave dangers to the stability of the financial system and the health of the global economy. The Report stresses the importance of leverage, particularly in the context of large players with complex market and credit exposures. Although leverage itself is neither strictly synonymous with risk nor straightforward to define, high leverage - and its interaction with other elements of risk – can nevertheless produce significant concerns from the perspective of the financial system as a whole.

4. The market dynamics issues relating to HLI activities in small and medium-sized open economies are: the potential for large and concentrated positions seriously to amplify market pressures, and the risk that market integrity may be compromised by aggressive trading practices. The Working Group examined the experiences of six economies in whose markets HLIs were active during 1998. Even in the absence of HLI activity, there would certainly have been considerable market pressure in these economies at the time because of vulnerabilities in their economic structures or financial systems or the size of external shocks they faced. In unsettled and fragile conditions, large and concentrated HLI positions have the potential materially to influence market dynamics. Although the

Working Group was concerned about some of the practices of HLIs identified in the six case studies, it was not able to reach a firm conclusion on their scale and the implications for market integrity.

5. These issues merit a concerted international policy response, involving actions by HLIs themselves, regulated firms, industry groups, supervisors and regulators, and national and international bodies. The Working Group recommends a package of responses, which it considers to be consistent, complementary and commensurate to the problems identified. A strong theme uniting most of these measures is the critical importance of promoting and sustaining adjustments in firm behaviour and enhancing market discipline. The first eight recommendations set forth below relate predominantly to systemic risk issues, while the last two have particular relevance to market dynamics issues.

⇨ ***Stronger counterparty risk management.*** Improved counterparty risk management is critical to addressing concerns about the accumulation of excessive leverage in the financial system. All financial institutions acting as counterparties to HLIs should review their counterparty risk management arrangements against the recommendations promulgated by the Basel Committee, IOSCO and Counterparty Risk Management Policy Group (CRMPG). These cover: firms' overall risk management framework; systems for counterparty credit assessment and on-going risk monitoring; exposure measurement methodologies; limit setting procedures; collateral, documentation and valuation policies and procedures; legal risks; and systems for reporting to senior management. Where those arrangements are inadequate, firms should not operate in highly risky and volatile instruments and markets, or with counterparties offering positions in such markets. Regulators and supervisors should reinforce this message.

⇨ ***Stronger risk management by hedge funds.*** Some hedge funds have prepared sound practices for risk management, internal controls, disclosure/transparency and documentation and have promoted increased informal dialogue with market authorities. That is encouraging. It is crucial that such practices permeate throughout the hedge fund community.

⇨ ***Enhanced regulatory oversight of HLI credit providers.*** Enhanced regulatory and supervisory oversight of credit providers is needed to ensure that sound practices are pursued and recent improvements in practices are locked in. Supervisors and regulators in all countries should take appropriate steps to determine the extent of institutions' compliance with the Sound Practices promulgated by the Basel Committee and IOSCO (in conjunction with the recommendations of the CRMPG) and take action where they identify deficiencies. That may involve: greater intensity of supervisory and regulatory oversight of regulated institutions which fall short of sound practices; requiring regulated institutions to provide periodic affirmations of their compliance with sound practices; greater use of the supervisory review process following 'Pillar II' of the Basel proposals[1] and restricting the ability of firms to carry on business with HLIs where they consider that firm's counterparty risk management practices to be deficient.

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[1] "A New Capital Adequacy Framework". Consultative paper by the Basel Committee (June 1999).

⇨ ***Greater risk sensitivity in bank capital adequacy regulation.*** The Working Group supports the objective of the Basel Committee consultative document to revise the Capital Accord. This should increase the degree of risk sensitivity in bank capital adequacy regulations.

⇨ **Sustaining industry progress.** There are important areas of counterparty risk management where further work is required, both at the industry level and in individual firms. These include refining measurements of potential future exposure, developing better stress testing, the development of liquidity risk measures, collateral management techniques and use of external valuation. The Working Group has encouraged the formation of a small group consisting of representatives of the Basel Committee and IOSCO to assess industry progress in these areas.

⇨ ***Building a firmer market infrastructure.*** The Working Group strongly commends further steps to improve documentation harmonisation across different products, collateral practices and valuation practices. National authorities should work to ensure that their bankruptcy laws allow certainty to market participants that positions can be closed and collateral realised in such an eventuality.

⇨ ***Enhanced public disclosure by HLIs.*** The Working Group firmly supports the objective of enhancing public disclosure by HLIs and endorses US efforts to achieve this through both regulation and legislation. It calls on all jurisdictions to consider the adequacy of their own disclosure requirements and introduce, where necessary, appropriate changes to legislation or regulations to ensure that major funds located in their jurisdictions are subject to complementary disclosure requirements. This recommendation should also apply to offshore centres, particularly those which currently host large unregulated hedge funds.

⇨ ***Enhanced public disclosure practices generally.*** The Multidisciplinary Working Group on Enhanced Disclosure endorsed by the Financial Stability Forum (FSF) provides an important opportunity for movement towards improved and more comparable risk-based public disclosure among all types of financial institutions, including hedge funds. The Working Group urges firms taking part in the study to take full advantage of the opportunity to engage in a forward-looking and practical discussion of how disclosure practices should be improved.

⇨ ***Enhanced national surveillance of financial market activity.*** Authorities should consider strengthening market surveillance at the national level with a view to identifying rising leverage and concerns relating to market dynamics and, where necessary, taking appropriate preventive measures. There are also improvements to market transparency which might be of value to market participants and the official sector alike. Particular areas that could be explored include enhancing existing foreign exchange and over the counter (OTC) derivatives markets data, for example by broadening currency breakdowns.

⇨ ***Good practice guidelines for foreign exchange trading.*** Leading foreign exchange market participants should review and, as necessary, revise existing market codes and guidelines and take the responsibility of articulating model guidelines of good trading practices in the light of concerns expressed about trading behaviour in foreign exchange and related markets. These could serve as a starting point for local adaptation in individual emerging market economies.

6. The Working Group also considered, but did not recommend, a further range of potential policy options including an international credit register specifically directed at HLIs and direct regulation of currently unregulated HLIs. However, it notes that reconsideration of these proposals may be appropriate in the future. While it is difficult to be precise about the circumstances that might lead to this, the failure to carry through properly the recommended measures within this Report is likely to prompt such a reconsideration.

7. In many of the above areas, considerable work has already been done, or is under way, by private and public sector organisations. In particular, the reports of the Basel Committee's Working Group on HLIs[2], the US President's Working Group (PWG)[3], the International Swaps and Derivatives Association (ISDA) 1999 Collateral Review[4], the CRMPG[5], the IOSCO Hedge Fund Task Force[6] and a group of five large hedge fund managers[7] (together with a separate report by Tiger LLC) contain useful analysis and recommendations on issues relating to HLIs.

8. Taking forward the full range of these initiatives, and in particular ensuring that the changes required to strengthen market discipline are sustained, will require considerable effort. It is critical that these measures are carried forward with high priority by all the agents identified in this Report. This work becomes more pressing given the pace of financial market development, the degree of financial market inter-relationships and the complexity inherent in many new products.

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2 Banks Interactions with Highly Leveraged Institutions and the accompanying Sound Practices for Banks Interactions with Highly Leveraged Institutions (both January 1999). See also the follow up report on the Implementation of the Committee's Sound Practice Guidelines relating to Banks' Interactions with Highly Leveraged Institutions (January 2000).

3 Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (April 1999).

4 ISDA 1999 Collateral Review.

5 Improving Counterparty Risk Management Practices (June 1999).

6 Hedge Funds and Other Highly Leveraged Institutions (November 1999).

7 Sound Practices for Hedge Fund Managers (February 2000).

Report of the Working Group on Capital Flows (CFs)

Executive Summary

1. Industrial and emerging market economies alike share a common interest in building a strong and safe system for global flows of capital. To the extent that they take place in well-functioning, competitive markets and respond to proper price signals, capital flows contribute to an efficient, cross-country allocation of resources and risk. A healthy capacity to mobilise external capital is critical to financing a growing and successful world.
2. However, these benefits do not come without risks and potential costs, especially in the case of short-term flows. If the risk exposures associated with capital flows are not properly managed, the consequences for creditors and debtors and for global financial stability more generally can be severe. Realising the full benefits of capital flows will require adopting policies that control the risks associated with them.
3. In particular, abrupt portfolio adjustments can involve sudden cessation or reversals of flows and sharp changes in asset prices. Recent history provides ample evidence that countries with fixed exchange rates and large amounts of short-term debt are prone to disruptive volatility of this sort, which can have systemic consequences. Indeed, one of the central lessons of the crises in emerging market economies over the past few years is the importance of prudent management of liquidity and other risks.
4. In some instances, the risk of crisis seems to have been increased by factors that, intentionally or inadvertently, bias the pattern of capital flows toward concentrations of shorter-term maturities, which entail roll-over risk and thus can be more easily reversed. For example, regulations limiting long-term external borrowing by residents of emerging market economies or encouraging short-term lending by international banks can have this effect. Such potential biases should be identified, and prompt consideration should be given to their elimination in light of the added volatility they might cause.
5. However, efforts of this kind to reduce volatility -- while worthy and recommended -- need to be complemented by a prudential, risk management framework for the analysis of capital flows. Such a framework, based on stocks of assets and liabilities, should acknowledge the existence of risks and seek to find better ways to monitor and manage them. The present paper is based on such a framework.
6. In this report, the Working Group on Capital Flows makes a number of recommendations to deal with issues related to capital flows and their associated risks. The Working Group is pleased to note that some of the Group's recommendations already are being acted upon.

Risk monitoring at the national level

- The Working Group recommends that national authorities should have, as a clear goal, a risk management strategy that involves a system for monitoring and assessing the risks and liquidity of the economy as a whole, including at a sectoral level. Such an assessment is critical at times of crisis, but it is better to have the information needed to help avoid a crisis.

- Risk monitoring at the national level could be assisted by compiling a balance sheet, for the economy as a whole and for key sectors, designed to identify significant exposures to liquidity, exchange rates, and other risks. The authorities should employ simple vulnerability indicators and more sophisticated stress tests and scenario analyses in assessing the potential impact on liquidity and balance sheet strength of different types of shocks to the real or financial economy.
- National authorities, as well as international bodies, ought to assess the possible adverse consequences of their policies in terms of creating biases toward short-term capital flows or otherwise encouraging a build-up of unwarranted external exposures, and should take prompt corrective measures.

Risk management by the public sector

- Recent experience has highlighted the need for governments to limit the build-up of liquidity exposures and other risks that make their economies especially vulnerable to external shocks. To this end, sound risk management by the public sector warrants high priority. It is a prerequisite for risk management by other sectors, because individual entities within the private sector typically are faced with enormous problems when inadequate sovereign risk management generates vulnerability to a liquidity crisis. To help national authorities understand and implement more systematic risk management procedures, the Working Group recommended that operational guidelines, or sound practices, should be formulated for liquidity management and asset/liability management more broadly. The Working Group set out a checklist of issues which, in the Group's view, such guidelines should cover.
- At the initiative of the Working Group, the desirability of guidelines was discussed at a meeting of the Financial Stability Forum in Paris in September. Following that discussion, the IMF and World Bank were asked to lead an effort to develop guidelines for sound practice in sovereign debt and liquidity management drawing on national experts, including some members of the Working Group. Such an effort is under way, responding importantly to the request by the Forum but also to the expressed interest of others and the institutions' own work agenda. The effort involves three closely inter-related elements, which should provide considerable help to national authorities. Building on this effort, work should proceed to distil a set of debt management guidelines. The Working Group urges national authorities to take advantage of the insights gained from that effort to build their capacity for risk management and to implement sound risk management policies.
- In terms of policies for the management of official foreign currency reserves, the Group emphasised the following factors:
    - Other things being equal, more official reserves will be needed (a) when a country is operating a fixed exchange rate regime; (b) the lower its standing in and routine access to international capital markets; and (c) the shorter the maturity of the public sector's external or foreign currency liabilities.
    - While prudent liquidity management by banks themselves and effective regulatory oversight must be the primary defences against foreign currency liquidity problems in the banking sector, the public sector may need to take account of such risks in its own reserves policy since it might otherwise find itself unable to supply needed foreign currency liquidity to the banking sector to contain an incipient crisis.
    - Policy on official reserves and foreign currency liability management might also need to place some weight on the position of the non-bank private sector, but the

primary mechanism for effective risk control in this area should be improved transparency.

- The Working Group emphasised also the need to develop domestic bond markets. The development of a domestic bond market can help a government to avoid concentrating its borrowing in short maturities or in foreign currencies, instead creating a diversified portfolio strategy with more dispersed maturities.
- The international institutions should help countries to identify elements of public sector risk management that deserve attention and to monitor and encourage progress in implementing those elements. Technical assistance should be provided, where warranted, by international institutions and national authorities.

Risk management by the banking sector

- The Working Group distinguished between banks in countries receiving capital inflows – in particular, in the emerging market economies – and the international banks that extend cross-border credit. Both have a responsibility to avoid any build-up of exposures that generates systemic vulnerabilities.
- The Group welcomed the recent publication of the Basel Committee's revised guidelines on managing liquidity risk and in particular the distinction made between domestic and foreign currencies; their application to emerging market economies should be given a high profile and made a high priority by national authorities. Further guidance from the Basel Committee on how to measure and manage foreign exchange exposures is desirable, as well. Until supervisory capacity is adequate, a set of more explicit regulations designed to limit liquidity and foreign exchange risks might be considered. The Group urges the Basel Committee's Core Principles Liaison Group and its Risk Management Group to address issues related to currency and maturity mismatches in emerging market economies.
- More work also could be done by the Basel Committee to address the linkages amongst liquidity risk, foreign exchange risk, and credit risk.
- With respect to credit risk, not all countries have the supervisory capacity to implement in full or immediately the new capital adequacy framework being developed by the Basel Committee. Countries that do not should be encouraged to enhance their supervisory procedures and should be supported in their efforts. The Group urges that the Basel Committee's Core Principles Liaison Group set out recommendations as to how a new capital accord should apply to emerging market economies.
- The Group welcomes likely changes by the Basel Committee in the system for determining risk weights for sovereign and private credits and in the risk weights that currently favour short-term interbank claims.
- National authorities should aim at obtaining sufficient information not only to assess the risk exposures to foreign currency funding of individual banks, but also to monitor, through analysis of aggregated information, the overall exposure of the banking system to the risks of foreign currency funding.

Risk management by non-bank financial institutions and non-financial institutions

- The Working Group urges IOSCO and IAIS to continue to promote prudent behaviour on the part of securities firms and insurance companies, respectively,

especially insofar as the issues raised in this report with respect to banks apply also to securities firms and insurance companies.

- National authorities should promote good corporate governance practices on the part of individual firms. Government agencies should avoid policies that distort corporate sector liability choices and, in particular, that bias corporations to engage in short-term borrowing.

Transparency

- Good information is fundamental to risk management. Disclosure by participants in financial markets is, in turn, a key element in making good information available.
- National authorities should adopt a high level of transparency about their own risk and liquidity management strategies and operations, and about official, including regulatory, policies governing private sector risk and liquidity management.
- Agencies with a responsibility for financial stability should aim to publish an annual assessment of liquidity conditions in the economy as a whole, and in important sectors of the economy, in particular the banking sector and other parts of the financial sector. This should help market participants and credit-rating agencies to make more informed assessments about the liquidity of a country, as well as increase the incentives for prudent debt and liquidity management.
- National authorities should promote, if necessary via corporate law, the adoption and implementation of accounting standards that require companies to disclose, in their audited report and accounts, the composition of their liabilities and financial assets, including by maturity and currency.

Data requirements

- In addition to better disclosure of the financial positions and risk management policies of market participants, better data on aggregate external financial positions are needed if investors and borrowers are to understand more fully and take better account of the risks inherent in international capital flows.
- To provide impetus to the process of improving the availability and quality of data, the Group proposed a conference in which policy makers involved in financial issues, officials in the statistical reporting function, and representatives of the private sector could meet to clarify the importance of enhanced reporting of external flows and positions and to explore the priorities. The IMF, in co-operation with the Working Group, hosted such a conference on 23-24 February in Washington.
- Much progress has been made in recent years in upgrading the quality, coverage, and timeliness of data on external flows and positions. Nevertheless, many gaps in available data have not been filled. Moreover, new gaps arise as new financial instruments become available that escape the reporting net or transform the risks associated with existing instruments in ways that are not captured in the data.
- The Working Group pointed to some gaps that it deems to be especially important, offered encouragement to efforts already under way to fill some of them, and urged new efforts to help fill others. In particular, the Group identified the following gaps with respect to statistics on external debt: data by residual maturity rather than original maturity; by face value as well as market value; with a distinction by currency as well as residency; information on embedded put options in bond

contracts; and amortisation schedules (including interest payments). National authorities should give high priority to upgrading their external debt statistics.

- The Group also urges relevant bodies to consider gaps with respect to creditor side and market data: a cross-sectional breakdown in the Locational Banking Statistics that would enable a combined breakdown both by sector and maturity, rather than just one or the other; reporting by offshore centres; private placements of debt securities held by the non-bank sector; data that might be available from global custodians; and non-resident purchases of domestically issued bond and money market instruments.
- The Working Group also identified a number of areas where efforts are warranted in the national context to enhance the dissemination of data that are needed to assess the risks and liquidity of an economy.

Report of the Working Group on Offshore Financial Centres (OFCs)

Executive Summary

1. The FSF Working Group on Offshore Financial Centres (OFCs) was convened to consider the significance of OFCs in relation to financial stability in all its aspects. This report lays out the Group's findings, the key issues that have been identified with respect to OFCs, and its recommendations.
2. In conducting its work and developing its recommendations, the Group has drawn on OFC-related work undertaken by international financial institutions, standard-setting bodies and national authorities, the available analytic work on OFCs, and has considered recent episodes of financial crises and the role of OFCs. It has met with major internationally active financial institutions, industry associations, professional financial advisors, regulators and supervisors[8], and OFC representatives, both individually and as a group. In addition, the Group has conducted a formal survey on OFCs of supervisors from both onshore and offshore jurisdictions. A description of the survey, a summary of its results, and the survey's recipients and OFC non-respondents are included in the report.
3. OFCs, to date, do not appear to have been a major causal factor in the creation of systemic financial problems. But OFCs have featured in some crises, and as national financial systems grow more interdependent, future problems in OFCs could have consequences for other financial centres. The significant growth in assets and liabilities of institutions based in OFCs and the inter-bank nature of the offshore market, together with suspected growth in the off-balance sheet activities of OFC-based institutions (about which inadequate data exist), increase the risk of contagion.
4. Problematic OFCs (i.e., OFCs that are unable or refuse to adhere to international supervisory standards, resulting in weak supervisory practices or little or no co-operation and transparency) allow financial market participants to engage in regulatory arbitrage and constitute weak links in the supervision of an increasingly integrated financial system. The "loopholes" presented by some OFCs hinder efforts to improve the global supervisory financial system through the implementation of international standards more broadly, frustrating collective efforts to reduce overall exposures to global financial instability, and creating a potential systemic threat to the financial system.
5. Not all OFCs are the same. Some are well supervised and prepared to share information with other centres, and co-operate with international initiatives to improve supervisory practices. But the Survey carried out by the Working Group indicated that there are serious concerns by onshore supervisors about the quality of supervision in, and degree of co-operation provided by, some OFCs.

[8] The term 'supervision' is generally understood to apply to government oversight of the banking and insurance industry, while the similar term for the securities industry is 'regulator'. However, for ease of reference, in the Report, the terms 'supervisor' and 'supervision' are understood to include 'regulator' and 'regulation'.

6. Weakness in supervision and lack of co-operation by some OFCs together lead to two types of problems, which can be inter-related, in the oversight of the international financial system: ***prudential concerns,*** relating to the scope for effective supervision of internationally active financial intermediaries; and ***market integrity concerns***, relating to the effectiveness of international enforcement efforts in respect of illicit activity and abusive market behaviour.

7. The Group has highlighted a number of key specific ***prudential and market integrity concerns in relation to OFCs, including***:

    - Cross-border co-operation on information exchange, timely access to information, and the ability to verify information with OFCs are all critical to conduct effective supervision, as well as to engender the international co-operation necessary to enhance financial stability and fight financial fraud.
    - The quality of the underlying supervision in an OFC is also of key importance. The impact of weak supervision can be amplified in cases where consolidated supervision is ineffectively exercised by the home supervisor of a financial institution with operations in an OFC.
    - The lack of due diligence with which financial institutions can be formed in many OFCs can facilitate inappropriate structures, or inappropriate ownership, that can impede effective supervision.
    - The lack of availability of timely information on beneficial ownership of corporate vehicles (companies, trusts, partnerships and other vehicles with limited liability) established in some OFCs can thwart efforts directed against illegal business activities.
    - The lack of comprehensive and timely data on OFCs' financial activity impedes effective monitoring and analysis of capital movements.

    In the course of its work, the Group has also identified some ***general prudential issues*** affecting onshore and offshore jurisdictions alike. Among these are:

    - International standards for insurance activities may not be sufficient, in particular concerning regulatory capital requirements.
    - There are no internationally accepted standards for reinsurance.

8. ***Enhanced acceptance and implementation of international standards by OFCs would address many of the concerns raised about some OFCs.*** International standards of regulation and supervision, disclosure and information sharing have been developed, which address issues of the kind associated with some OFCs from both a prudential and market integrity perspective.

9. The Group's recommendations can be summarised as follows:

Recommendation 1: ***An assessment process for OFCs' adherence to international standards***

The Group recommends that an assessment process (as described in the Report) for assessing OFCs' implementation of relevant international standards be put in place.

Recommendation 2: ***Responsibility for an assessment process***

The Group recommends that the FSF request the IMF take responsibility for developing, organising and carrying out an assessment process for OFCs.

The Group considers that the FSF should facilitate the efforts of the IMF (with the World Bank as appropriate) as the IMF organises assessments of the implementation of standards by OFCs. This would include providing moral suasion to encourage OFCs to participate in the assessment process, calling on FSF members to make available appropriate resources to the IMF to help it carry out the assessment process and to OFCs to assist them in improving their supervisory systems, and encouraging major financial centres to promote a wider acceptance of international standards.

Recommendation 3: ***Priority OFC jurisdictions for assessment***

The Group recommends that priority for assessment be placed on those OFCs where procedures for supervision and co-operation are in place but where there is substantial room for improvement. Priority could also be given to those jurisdictions with the most significant financial activity.

Recommendation 4: ***Standards for priority implementation and assessment by OFCs***

The Group recommends that the international standards relating to cross-border co-operation and information sharing, essential supervisory powers and practices, and customer identification and record keeping, be assigned priority in implementing and assessing OFCs' adherence to standards in the more immediate term. The specific standards (which should not be seen as exhaustive) identified by the Group are listed in an annex to the report, although adherence to all relevant international standards should be the ultimate goal.

The Group considers that assessments should also take into account the capacity of supervisors and law enforcement authorities to obtain, on a timely basis, information about the beneficial ownership of corporate vehicles registered in their jurisdiction and the ability to share that information with foreign authorities.

Recommendation 5: ***Incentives to enhance OFCs' adherence to international standards***

The Group recommends that a menu of incentives—market, disclosure-type, membership, provision of assistance, supervisory, and other incentives identified in the Report—be considered for application by the appropriate bodies or groupings in relation to an OFC's adherence to the relevant international standards.

The Group also recommends that the FSF discuss the IMF's conclusions arising from the proposed assessment process, and foster efforts, including by supervisors of major financial centres, that would be most effective if undertaken collectively in the application of incentives to enhance OFCs' adherence to relevant international standards.

Recommendation 6: ***Actions for onshore jurisdictions***

The Group encourages onshore jurisdictions to engage in more effective consolidated supervision in the banking and insurance sectors, recognising the important responsibilities of home country supervisors, so that the ability of offshore activities to escape oversight is reduced. Similarly, the Group encourages securities supervisors to enhance their oversight of securities firms to improve their understanding of relevant offshore activities.

Recommendation 7: ***Insurance standards development***

The Group encourages the IAIS in its work to develop best practices for reinsurance and its supervision, as well as with respect to developing specific supervisory standards on solvency and consolidated supervision for all insurance activities.

Recommendation 8: ***Assessment methodologies for standards***

The Group encourages those bodies that have not already done so to develop methodologies for assessing observance with their respective standards, or to complete their efforts, as soon as possible, in consultation with the IMF and World Bank and others.

Recommendation 9: ***Corporate vehicles and beneficial ownership***

The Group recommends that appropriate international fora be asked to explore the issue of developing mechanisms to prevent the misuse of corporate vehicles. These mechanisms should assure that supervisors and law enforcement authorities are able to obtain, on a timely basis, information on beneficial ownership of corporate vehicles and the sharing of that information with foreign authorities.

Recommendation 10: ***Data reporting by OFCs***

The Group strongly encourages OFCs with significant financial activities to report financial data to the BIS for its quarterly publication on International Banking Statistics with the requested breakdown (distinguishing between debt securities and other claims), and on a timely basis. The Group notes that such action could be considered as an indicator of an OFC's willingness to co-operate within the international financial system. As necessary, OFCs should seek the available technical assistance from national authorities and international financial institutions to improve their statistical practices and capacity.

Recommendation 11: ***Co-ordination of OFC-related initiatives***

The Group recommends that the published version of this Report be formally transmitted by the FSF to the various international groups that are concerned with the activities of OFCs. In addition, the Group recommends the development of a mechanism to assist the international community in keeping abreast of progress on OFC-related initiatives.

10. To facilitate the review of progress in implementing these recommendations, the Group suggests that a brief report be prepared by the FSF Secretariat for the Fall 2001 meeting of the Forum.

Annex 1

Institutions and Groups attending the meeting of the FSF on 25-26 March 2000

Chairman

Mr Andrew D Crockett

National Authorities (25)

Australia
The Reserve Bank of Australia

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

France
Ministry of the Economy
Commission Bancaire
Banque de France

Germany
Ministry of Finance
Bundesaufsichtsamt für das Kreditwesen
Deutsche Bundesbank

Hong Kong SAR
Hong Kong Monetary Authority

Italy
Ministry of the Treasury
Banca d'Italia
CONSOB

Japan
Ministry of Finance
Financial Supervisory Agency
The 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 Commission
Board of Governors of the Federal Reserve System

International Financial Institutions (6)

International Monetary Fund (2)
The World Bank (2)
Bank for International Settlements
Organisation for Economic Co-operation and Development

International Regulatory and Supervisory Groupings (6)

Basel Committee on Banking Supervision (2)
International Organisation of Securities Commissions (2)
International Association of Insurance Supervisors (2)

Committees of Central Bank Experts (2)

Committee on Payment and Settlement System
Committee on the Global Financial System