

INTERNATIONAL FINANCIAL CO-OPERATION

The soundness of the international financial system and of international financial policies is vital to Australia. To this end, the RBA (together with other agencies, particularly the Commonwealth Treasury) takes part in a range of global and regional groups which foster debate and co-operation in these areas. The global groupings include the Financial Stability Forum (FSF), G20 and the IMF. Regional groupings include the Executives' Meeting of East Asia-Pacific central banks (EMEAP), the Four Markets Group and APEC. The RBA also participates regularly in several major G10 groups.

FINANCIAL STABILITY FORUM

One of the FSF's key roles is to examine the implications of international developments for the stability of the global financial system and, where necessary, co-ordinate initiatives to help deal with any perceived threats. The past year produced a number of challenges, with the combination of a global economic slow-down, the terrorist attacks in the United States, a spate of large corporate failures and the ongoing financial crisis in Argentina. Consequently a large part of the FSF's focus has been on these conjunctural issues.

One important area of work to emerge from discussions has been an assessment of the lessons for financial stability arising from the September 11 terrorist attacks. Work is being undertaken in a number of forums on this issue. The FSF will examine any possible follow-up at its next meeting in September 2002. At the request of the G7, the FSF also assessed global progress on combating terrorist financing. While noting efforts to date, the FSF felt that progress could be further enhanced by

improving co-operation between supervisory and law enforcement agencies. To this end it is collecting information on national protocols for inter-agency co-operation with a view to producing a model protocol. The FSF also examined issues raised by recent corporate failures and will hold a more substantive discussion in September.

An issue of particular relevance to Australia discussed by the FSF was a review of the state of the global reinsurance industry. The most immediate concerns followed on from the events of September 11 and the prospect that the associated losses would severely test the underwriting capacity of the sector. So far the industry has proved resilient, helped by rising premiums and a capacity to generate substantial amounts of new capital.

Australia has shared with the FSF some lessons emerging from the failure of HIH, currently the subject of a Royal Commission. At one level, the failure of HIH demonstrates that the demise of a general insurer can have important macroeconomic consequences if a particular line of underwriting business is highly concentrated. HIH held a dominant share of builders' warranty insurance in various States and its failure had an immediate impact on the construction industry as builders sought difficult-to-find and expensive replacement cover. The HIH failure also highlights shortcomings in standards of transparency and disclosure within the insurance industry and the scope for products that may involve very limited or no transfer of risk – commonly known as “financial” or “finite” reinsurance but sometimes (confusingly) marketed as “alternative risk transfer” solutions – to be used as a general source of finance by insurance companies.

The challenge for both insurance regulators and auditors is to differentiate between the various reinsurance products to make sure that there is no confusion about their implications – to ensure, in effect, that general insurers are given credit from a statutory solvency and balance sheet perspective only for those contracts that genuinely improve their risk profile.

The FSF has also made progress on its four main areas of ongoing work. In March it released an assessment of progress on the group's March 2000 recommendations on concerns raised by highly leveraged institutions (HLIs). This issue has been an important one for Asian countries given the disruptive role played by some large hedge funds during 1997 and 1998. The 2002 review found that, on balance, concerns that HLIs could pose a systemic risk to the international financial system are less than before. Funds under management by HLIs continue to grow, but both the number of large macro hedge funds and the degree of leverage used are significantly lower than in the late 1990s. The risk management practices of both HLIs and their counterparties have improved, as has the level and quality of HLI disclosures to counterparties. The report urges supervisory vigilance to ensure that these gains are not transitory. The main area where progress has been disappointing is in efforts to promote public disclosure – both voluntary and mandatory – which appears to have lost momentum given progress in other areas.

In March, the FSF reviewed the progress of offshore financial centres (OFCs) in strengthening their financial supervisory, regulatory, information-sharing and co-operation practices. This follows on from the FSF's move in May 2000 to identify OFCs for which it felt assessment by the IMF was a priority. Many of these countries have now undergone IMF assessments, or have undertaken to do so. Technical assistance to these countries has been stepped up. The FSF will continue to monitor progress.

Two other FSF initiatives have drawn to a close in the past year. The FSF's Follow-up Group on Incentives to Foster Implementation of Standards issued its final report in September. The group found that, while progress has been made in raising awareness of accepted financial standards and the IMF/World Bank processes for assessing them, there continues to be scope for market practitioners to take more account of countries' adherence to standards when making lending decisions. The Australian Treasury was represented on this group. September also saw the publication of a report offering *Guidance for Developing Effective Deposit Insurance Systems*. The FSF sees this as being particularly valuable for countries moving from an implicit or blanket guarantee of deposits to one of more explicit limited coverage.

THE GROUP OF TWENTY (G20)

The G20, established in 1999, comprises the seven largest developed economies together with key medium-sized developed and emerging economies, and provides a forum for discussions on policies promoting sustainable and equitable economic growth. Much of the G20's focus over the past year has been on gaining a better understanding of the benefits and costs of globalisation. The RBA devoted its annual economic conference to hosting, jointly with the Australian Treasury, a workshop in May 2002 which explored the interaction of globalisation, living standards and inequality. G20 member countries are also preparing individual case studies examining their experiences, both positive and negative, with market reform and globalisation; these are expected to be published in the coming year. Other issues under discussion by the G20 include the appropriate policies for sustaining international capital flows and the effectiveness of economic aid.

SOVEREIGN DEBT RESTRUCTURING

An issue which has generated a lot of discussion in recent years is that of private sector involvement in crisis prevention and resolution. Discussion about a mechanism for resolving sovereign debt crises is not new, going back at least to the Rey Report produced by the G10 in May 1996. That report canvassed the possibility of an international bankruptcy court and urged the widespread introduction of collective action clauses (CACs) in bonds. The Asian financial crisis intensified efforts in the late 1990s to reform the international financial architecture, with a heavy focus on ways to ensure private sector involvement in crisis prevention and resolution. This was an issue on which the RBA placed considerable importance, but relatively little was achieved in terms of improving international financial arrangements. The IMF agreed that, to support a restructuring of a country's finances, it would continue to lend to a member that was in arrears to its private creditors, and there was widespread agreement in the official sector (but little action) on the need to include CACs in bond contracts. The idea of an international bankruptcy court foundered on the belief that it would be too difficult to bind parties across a wide range of independent legal systems.

Interest in this topic was heightened in November 2001, when the IMF's First Deputy Managing Director, Anne Krueger, proposed a statutory mechanism for dealing with sovereign debt restructuring, based on domestic bankruptcy law and underpinned by a number of principles:

- protection from litigation by creditors once a temporary standstill on debt repayments is called;
- safeguarding creditors' interests, by requiring debtors to negotiate on restructuring during the standstill period and to implement appropriate

economic policies;

- application of majority voting by creditors on restructuring terms, which would be binding across all creditors, rather than separately to individual debt classes and lines; and
- encouragement for new private funding, possibly by granting preferred creditor status on new money.

The proposal envisaged a central role for the IMF, endorsing the initial standstill and subsequent rollovers based on assessments of debt sustainability and the member's economic policies, although later refinement by Krueger has reduced the scope of IMF involvement.

In response to the Krueger proposal, a number of alternatives have been proposed by others (including the US Treasury and private-sector groups) which focus on facilitating contractual agreements between debtors and creditors rather than on the statutory mechanism envisaged by Krueger. The G7 countries have endorsed a proposal to include in bond contracts contingency clauses which would contain several features:

- decisions of a collective super-majority of bond holders would be binding on the minority;
- procedures by which debtors and creditors come together, how creditors would be represented, and what data requirements must be met; and
- details on how the sovereign would initiate the restructure, including the use of a "cooling off" period (i.e. a standstill) between the date when the sovereign notifies creditors it wishes to restructure and the process beginning, during which time debt payments would be adjourned and bond holders prevented from litigating.

The ensuing debate has led to widespread agreement (including in the private sector) about the positive role that CACs could play in facilitating

restructurings, although some private-sector scepticism about the use of these clauses to augment powers for sovereigns to initiate standstills remains.

Overall, the debate has demonstrated that there is now acceptance of the need for improved processes to deal with unsustainable sovereign debt as an essential element in the prevention and resolution of financial crises. The RBA sees the active pursuit of contingency clauses embodying the principles above as a practical step forward towards improving the fair involvement of private-sector creditors in the resolution of international financial crises.

COMBATING MONEY LAUNDERING AND THE FINANCING OF TERRORISM

International financial co-operation has also aimed over the past year to improve measures to prevent financing of terrorism. This followed several years in which there were steps towards improving financial co-operation and the prevention of money laundering, including increased pressure on (and technical assistance from the IMF and others to) offshore financial centres to improve their domestic regulatory environments and their interaction with regulators in the major financial markets. The RBA has been involved in these earlier steps through its membership of the FSF, participation in the work of the Financial Action Task Force (FATF), and its support of the Asia-Pacific Group on Money Laundering.

This work was given a new focus on combating the financing of terrorism following September 11. Later that month, the United Nations adopted Resolution 1373, which obliged member states to freeze accounts of those individuals and organisations which had been identified as terrorists (and named as such in the Resolution). Australia's actions in response to this were in two parts. First, to permit an immediate response, action was taken under the Reserve Bank Act to implement a freeze on any such

accounts and a ban on foreign exchange transactions with the entities named. These sanctions were imposed on 3 October 2001, through the *Banking (Foreign Exchange) Regulations*, and extended to further entities on 17 October and 9 November.

The second action introduced was the *Charter of the United Nations (Anti-Terrorism) Regulations*, which took effect on 21 December 2001. These Regulations specified sanctions on all entities identified by the United States Administration and the United Nations as terrorists, but with wider coverage than the earlier measures taken by the RBA, which they effectively superseded. The list of entities sanctioned was updated further on 20 March and 17 April 2002.

In Australia, operational responsibility for the enforcement of the sanctions (under both sets of Regulations) was and is borne by AUSTRAC and the Australian Federal Police.

Further work on combating the financing of terrorism is expected to be based on the set of Special Recommendations put forward in October 2001 by the FATF, which will in future be used by the IMF as a benchmark in its financial sector assessments. Like other FATF members, Australia has completed a self-assessment of its compliance with the Special Recommendations and is committed to their full implementation.

OTHER GLOBAL GROUPS

In addition to its involvement with the FSF and the G20, the RBA also participates in various groups associated with the BIS and the G10. These include the Committee on the Global Financial System (CGFS), the Markets Committee, and the Committee on Payments and Settlement Systems (CPSS).

Issues considered during the year by the CGFS and Markets Committee included the changing structure of foreign exchange and derivatives markets (based on the publication during the year of the BIS triennial

survey of activity in these markets) and policies to strengthen the resilience of financial markets following major disruptions, such as the events of September 11.

In the CPSS, attention was focussed on the forthcoming introduction of CLS to foreign exchange markets. Central bank oversight of the operations of CLS Bank, which is the vehicle through which the settlements are processed, is being co-ordinated through the CPSS. As the Australian dollar is one of the seven currencies that will be settled in CLS Bank, the RBA is represented on the CPSS group reviewing the project and liaising with CLS Bank on operational and policy issues. (The issues raised by CLS for the RBA's domestic operations were discussed in the chapter on "Operations in Financial Markets".)

The CPSS has also continued its interest in retail payments. The RBA is represented on a working group, which has already published two reports, on policy issues for central banks in the regulation of retail payment systems.

REGIONAL GROUPS AND TECHNICAL ASSISTANCE

Central banks in the East Asian region, including the RBA, have established close links over the past decade or so both bilaterally and through multilateral arrangements such as the Executives' Meeting of East Asia-Pacific central banks (EMEAP). The focus of EMEAP has been on fostering operational co-operation and providing for a dialogue on regulatory and supervisory policies; a key issue in the past year has been the potential impact of the Basel II capital rules on regional economies. EMEAP also sponsors meetings with the US Federal Reserve, European Central Bank and the G10 Markets Committee to discuss developments in global and regional foreign exchange markets.

The RBA is also a member of the Asian Consultative Council, established in 2000 by the BIS. The Council

provides advice to the BIS Board on central banking issues of importance in the region, and on the services provided in the region by the BIS, including the operations of the BIS Representative Office for Asia and the Pacific located in Hong Kong. The Governor, Ian Macfarlane, has chaired the Council since its inception.

In addition to these formal links, the RBA maintains a large number of bilateral and informal relationships with regional central banks. Some of these take the form of financial assistance provided in conjunction with the Australian Government. When Australia participated in the IMF-led financing package for Thailand in 1997, at the onset of the Asian financial crisis, this was in the form of a foreign exchange swap facility between the RBA and the Bank of Thailand. Drawings of US\$862 million were made under this facility up to mid 1999, and repayments began in early 2001. By the end of June 2002, US\$520 million had been repaid.

Most of the RBA's bilateral linkages take the form of technical assistance to other regional central banks. One staff member has worked full-time on providing assistance to the Bank of Papua New Guinea, mainly in the areas of financial market operations and the design of a new registry system for PNG Government securities. Others have provided shorter-term assistance to central banks in East Timor, Fiji, Iran, the Solomon Islands and Thailand and participated in providing training courses in the region for SEACEN and other organisations.