FINANCIAL
STABILITY
BOARD

THE CHAIRMAN

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To G20 Finance Ministers and Central Bank Governors

Financial Reforms – Progress and Challenges

In Washington in 2008, the G20 committed to fundamental reform of the global financial system. The objectives were to correct the fault lines that led to the global crisis and to build safer, more resilient sources of finance to serve better the needs of the real economy. At that and subsequent summits, the G20 has called on the FSB to develop and coordinate a comprehensive framework of reforms. In recent years, there has been considerable progress on a wide range of fronts.

This letter reviews what remains to complete the job, and then outlines the characteristics of financial supervision and regulation needed to realise fully the benefits of an open, integrated global financial system. The continued support of G20 Ministers and Governors will be critical to ensure that we don't just fix past fault lines but build a system that can evolve with the global economy to support strong, sustainable and balanced growth across the G20. It makes two main points:

First, if we remain focused and ambitious, we can complete the remaining core elements of the reforms during the Australian G20 Presidency. That programme, agreed by G20 Leaders at the St. Petersburg Summit, has four elements:

- Building resilience of financial institutions
- Ending too-big-to-fail
- Transforming shadow banking to transparent and resilient market-based financing
- Making derivatives markets safer

Second, the G20's approach beyond the Brisbane Summit will determine the openness of the global financial system and consequently the strength and sustainability of global growth. To realise fully the benefits of an open system, the FSB recommends that the G20 commit to an approach characterised by:

- Global standards for the resolution of global systemically important institutions to ensure that failures of cross-border institutions will be handled fairly, predictably and smoothly;
- Deferring to each other's market regulatory regimes where they achieve equivalent outcomes;
- Peer reviews and impact assessments to ensure consistent implementation when we get standards right and refinement of standards when we get them wrong; and
- Enhanced co-operation to avoid domestic measures that fragment the global system.

PRIORITIES FOR COMPLETING REFORMS BY THE BRISBANE SUMMIT

Building more resilient financial institutions

Large internationally active banks are on course to meet the new Basel III capital requirements almost five years in advance of the deadline. A globally consistent definition of the leverage ratio was agreed in January 2014, for which disclosure requirements will take effect in January 2015.

By the Brisbane Summit:

- The Basel Committee will set out its plan to address excessive variability in risk-weighted asset calculations that, with the support of Ministers and Governors, can be actioned to improve consistency and comparability in bank capital ratios.
- The Basel Committee will finalise the proposed Net Stable Funding Ratio, which is designed to improve the resilience of bank funding and to complement the Liquidity Coverage Ratio that has already been agreed.

Ending too-big-to-fail

Global systemically important banks and insurers have been identified. They will be subject to resolution planning and resolvability assessments, higher capital requirements and more intense supervision. Methodologies for identifying non-bank, non-insurance global systemically important institutions have been issued for public consultation.

By the Brisbane Summit:

- A global standard for a minimum level of gone-concern loss-absorbing capacity that global systemically important banks should hold will be proposed by the FSB.
- Proposals will be developed by the FSB for contractual or statutory approaches for cross-border recognition of resolution actions, including bail-in and temporary stays on the close-out of financial contracts, and cross-default rights when a firm enters resolution.
- The International Association of Insurance Supervisors (IAIS) will finalise a basic capital requirement on which higher loss absorbency for global systemically important insurers will be built.

Transforming shadow banking

In November 2013 the FSB published its latest annual monitoring report on shadow banking. In December the BCBS published capital requirements for banks' equity investments in funds.

By the Brisbane summit:

- The FSB will complete its policy recommendations to reduce risks and increase transparency in repo and securities lending markets.
- The Basel Committee will complete policy recommendations that address the risks from banks' interactions with shadow banks.
- IOSCO will report on the implementation of agreed reforms to money market funds and the alignment of incentives in securitisation.
- The FSB will develop and start operating an information-sharing process to support its members' oversight and regulation of shadow banking entities.

Making derivatives markets safer

National implementation of agreed G20 objectives for OTC derivatives reform is overdue but substantial progress is being made. Critical implementation issues for the EU-US *Path Forward* approach to cross-border issues were resolved last week.

By the Brisbane Summit:

- The OTC Derivatives Regulators Group will provide in April 2014 a list of remaining cross-border implementation issues, and for the Brisbane Summit a report on how it has resolved or intends to resolve the identified cross-border issues together with a timetable for implementing the solutions.
- The FSB will publish in September 2014 a report on jurisdictions' established processes to enable them to defer to each other's rules in cross-border contexts where these achieve similar outcomes.
- Standards setters will complete the capital standards for treatment of banks' central counterparty exposures and issue finalised guidance on the recovery and resolution of financial market infrastructures.
- The FSB will report on how information from trade repositories can be aggregated and shared among authorities.

REALISING FULLY THE BENEFITS OF AN OPEN, INTEGRATED AND RESILIENT GLOBAL FINANCIAL SYSTEM

As we approach the completion of the major elements of reform, the G20 can begin to look further ahead to how, collectively, members will regulate and supervise the global system in a way to build mutual confidence and trust, and thereby realise fully the benefits of an open, integrated system.

Commitment from, and support of, Ministers and Governors is needed in four areas.

Global standards to address globally systemic institutions

A lack of mutual trust can lead to concerns about spill-overs from failing cross-border institutions and prompt jurisdictions to safeguard their markets unilaterally through actions such as ring-fencing, compulsory stand-alone subsidiarisation, or extra-territorial application of domestic rules. Such measures can be avoided only if Ministers and Governors commit to tackling spill-overs through applying global standards that build confidence in both the quality of cross-border supervision, and that failures of cross-border institutions will be handled fairly, predictably and smoothly.

Outcomes-based approaches to resolving cross-border issues

G20 Leaders agreed in St. Peterburg that jurisdictions and regulators should be able to defer to each other when justified by the quality of their respective regulations and enforcement regimes, in a non-discriminatory way, based on similar outcomes. This does not necessarily mean that different jurisdictions need to have identical market regulations, as long as the outcomes are similar. OTC derivatives markets are the test case for applying these principles; jurisdictions should commit that the cross-border issues identified by the OTC Derivatives Regulators Group should be resolved on this basis. To assist this process, we are asking regulators to share their processes and frameworks for making equivalence or comparability decisions. Experience in this area should support discussion in the G20 on how far flexible outcomes-based approaches to resolving cross-border market regulation issues can be relied upon more widely.

Peer reviews and impact assessments that catalyse action

Rigorous monitoring and peer review processes that assess and publicly report on whether countries are fully and effectively implementing reforms are not only crucial to building resilience and mutual confidence, but also a necessary basis for assessing whether the measures are having their intended effects. Ministers and Governors can reconfirm their commitment to address the issues identified in such reviews and assessments by correcting gaps and inconsistencies in implementation. Equally, we must be prepared to adjust policies where material unintended impacts are observed and to draw lessons from implementation to improve the regulatory framework where necessary. Impact assessments should be used to ensure that measures are having their intended effects to finance the real economy in a sustainable manner, including supporting the financing of long-term investment and the restarting of the securitisation market on a sound basis.

Enhanced co-operation and avoidance of fragmentary domestic measures

Strengthened cross-border cooperation and information sharing must complement the framework of more robust standards. This should extend to co-operation amongst authorities in the assessment of whether there are any spill-overs of national regulatory policy initiatives that could be harmful to the objective of an open, integrated system. The FSB will report to Ministers and Governors later this year on the spill-overs from national banking structural reforms, with the objective that these spill-overs are well understood and taken account of in their design. We will also propose to you in April the framework for authorities to share information on shadow banking entities and policy tools. In these, and in a variety of other areas, Ministers and Governors can support robust information and data sharing to further enhance cooperation, inform policy and build trust and confidence.

As we implement reforms, the global system will of course continue to face new risks. But the reforms and the strengthened global framework for cooperation mean that we will be in a better position to face those risks. Reforms have brought significant new capital into the core of the financial system and made firms, investors and regulators more alert to the risks that arise from excessive leverage, poor valuations, maturity mismatches and illusory liquidity. Our task ahead is to make sure we complete the job and then manage the system dynamically and effectively. That will require more transparency, greater consistency and demonstrated willingness to adjust in the face of new information.

Doing so will deliver the open and resilient financial system necessary to support strong, sustainable and balanced growth.

Yours sincerely,

Mark Carney