

To G20 Leaders

Progress of Financial Regulatory Reforms

The Seoul Summit will mark the delivery of two central elements of the reform programme launched in Washington to create a sounder financial system and reduce systemic risk globally: a materially strengthened global framework for bank capital and liquidity, and a comprehensive policy framework to address the moral hazard risks associated with institutions that are too big (or complex) to fail.

The reform programme launched at the Washington Summit was necessarily ambitious and the timetable demanding. Propelled by your support and determination, and reflecting an unprecedented intensity of international co-operation, the core policy reforms have been delivered on time.

Full and internationally consistent implementation of the agreed reforms will be essential if they are to have the impact on global financial stability that you intend. The process of implementation is well underway at national and regional levels, as detailed in the reports submitted to you. But much still lies ahead of us and your continued strong support will be needed to see through the changes in laws and regulations required.

Bank capital and liquidity standards

The new capital and liquidity standards developed by the Basel Committee on Banking Supervision will reduce the likelihood and severity of future financial crises and create a less procyclical banking system that is better able to support long-term economic growth. They have been designed to substantially raise the quality, quantity and international consistency of bank capital and liquidity; constrain the build up of leverage and maturity mismatches; and introduce capital buffers above the minimum requirements that can be drawn upon in bad times.

The FSB and the Basel Committee, in close collaboration with the BIS and IMF, have assessed the macroeconomic impact of the transition to the new Basel III standards. The resulting transition arrangements have been designed to ensure that implementation does not harm the economic recovery. National implementation of the risk-based capital requirements will begin on 1 January 2013. Member countries will translate the capital rules into national laws and regulations before that date. From that point forward, the capital requirements rise each year, with the transition to the newly agreed levels fully completed on 1 January 2019.

Addressing the moral hazard risk associated with SIFIs

Systemically important financial institutions (SIFIs) are firms whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. Too often, because we have lacked the tools and the capacity to co-ordinate resolution across borders, we have answered the threatened failure of such firms by bailing them out using taxpayer funds.

We have agreed a policy framework, work processes and timelines for addressing the systemic and moral hazard risks associated with SIFIs.

The framework calls for action in five areas:

- First, and foremost, improvements to resolution regimes to ensure that any financial institutions can be resolved without disruptions to the financial system and without taxpayer support.
- Second, a requirement that SIFIs and initially in particular global SIFIs (G-SIFIs) have additional loss absorption capacity beyond the Basel III standards to reflect the greater risks that these institutions pose to the global financial system.
- Third, more intensive supervisory oversight for financial institutions which may pose systemic risk.
- Fourth, stronger robustness standards for core financial infrastructure to reduce contagion risks from the failure of individual institutions.
- Fifth, peer review by an FSB Peer Review Council of the effectiveness and consistency of national policy measures for G-SIFIs, beginning by end-2012.

With your endorsement, we will implement this framework. It will require legal reforms in many of our countries to make feasible the resolution of any financial institution without taxpayer exposure to loss while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in their order of seniority.

In improving our resolution regimes, we will need to achieve the legal preconditions and degree of legal harmonisation that permit rapid and efficient resolution of the global operations of a SIFI. This will require clear mandates and capacity in law for national resolution authorities to cooperate and to share the information needed for effective recovery and resolution, and the elimination of provisions in national laws that hamper fair cross-border resolution.

G-SIFIs will be subject to a sustained process of mandatory recovery and resolution planning that will assess their resolvability under applicable resolution regimes. Where resolvability is not assured, authorities should have the powers, exercisable under clear criteria, to require financial institutions to make the changes to their legal and operational structure that ensure their resolvability.

Supervisory Intensity and Effectiveness

As you stressed at the Toronto Summit, improved rules – such as Basel III and those described above for addressing SIFIs – on their own are not enough. Every country must have a supervisory system that is up to the task of ensuring that the new regulations are backed up by effective risk assessments and enforcement. Moreover, supervisors must have the powers to be able to detect problems proactively and intervene early to reduce the impact of potential stresses on individual firms and therefore on the financial system as a whole.

The actions and implementation processes we have proposed, which have been developed in consultation with the IMF, focus on the following elements necessary to deliver more effective and intense supervision:

- Ensuring that supervisors have unambiguous mandates, sufficient independence and appropriate resources;
- Providing supervisors with the full suite of powers necessary for effective early intervention;
- Improving supervisory standards to reflect the complexity of financial institutions and the system as a whole; and
- Increasing the frequency of assessments of supervisory regimes.

We have set ambitious timelines for national authorities and standard setters to follow up on the recommended actions. FSB thematic peer reviews and IMF/World Bank FSAP assessments will monitor national implementation.

OTC derivatives reforms

At the Toronto Summit, you called for acceleration of the implementation of the G20 commitments for reform of the OTC derivatives market. In response, international standard setters and national authorities working through the FSB have agreed approaches to implement these reforms in an internationally consistent and non-discriminatory way. The report submitted to you sets out recommendations for addressing the G20 commitments concerning standardisation, central clearing, organised platform trading, and reporting to trade repositories.

This report is only the first step toward consistent implementation of the G20 commitments, and highlights the amount of work that remains going forward. Authorities will need to coordinate closely to minimise the potential for regulatory arbitrage. The FSB will review regular reports on progress in implementing the necessary reforms as from March 2011.

Principles for reducing reliance on CRA ratings

In Toronto, you asked us to develop Principles for reducing reliance on external ratings in rules and regulations. The goal is to reduce the cliff effects and herding associated with CRA ratings changes. These arise in large measure because we – as authorities – have “hard wired” CRA ratings into rules and regulations, which produces a mechanistic market response to

rating changes. Accordingly, the principles call on standard setters and national regulatory authorities to assess references to CRA ratings in laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness. The principles address the use of ratings in prudential standards; policies of investment managers and institutional investors; central bank operations; private sector margin arrangements; and disclosures by issuers of securities. Change in this area will not and cannot happen overnight, since alternative creditworthiness standards need to be developed. But the direction in which we want to move is clear.

Reform programme going forward

Under your leadership, the G20 have delivered on an ambitious financial reform agenda. This has been essential to maintain public and political support for an open and integrated global financial system.

The FSB will monitor and regularly report on the progress of consistent international implementation of these reforms. In doing so, we will draw on the FSB peer review process, and where needed, along with our international member bodies, set up subject specific monitoring processes. We evaluated the implementation by all members of compensation standards in early 2010 and will do so again in 2011. Other key areas will be implementation of the new capital and liquidity rules, and the national implementation of G-SIFI policy measures.

Thematic peer reviews of risk disclosures and of mortgage underwriting practices are underway, and preparations are being made for reviews of deposit insurance standards. We will have an iterative process of reviews of resolution regimes. These reviews will be complemented by country reviews that follow up on recommendations from IMF-World Bank FSAP assessments. A review of Mexico's financial sector policies was completed in September 2010; reviews of Italy and Spain are underway; and reviews of Australia, Canada and Switzerland are scheduled for 2011.

We will carefully assess the macroeconomic and financial system responses that the implementation of regulatory reforms will inevitably trigger. With regulatory requirements on the banking system tightening, we need to counter a likely resurgence of shadow banking activity. Assessing the need to apply regulatory safeguards to shadow banking will be a key priority of the FSB's reform agenda going forward. In addition, the FSB will, in cooperation with all the relevant bodies, focus attention on the further development of macro-prudential policy frameworks, on emerging markets' financial stability issues, as well as on commodity derivatives markets and market integrity.

The FSB recognises the importance of consulting widely and engaging a broader range of countries in its work. This includes the need to take account of the perspectives of emerging market countries – not only of those which are FSB members but of others as well. We have submitted to you a proposal for the establishment of a regional consultative group structure that will expand and formalise outreach beyond our membership. The first meetings of this new structure will take place in 2011.

The steps you took at the London and Pittsburgh Summits to expand the membership and strengthen the mandate of the FSB have contributed to the coordination and speed of the regulatory and supervisory response to the crisis. It is essential that we maintain and build on these achievements. Indeed, a central lesson of this crisis is that financial and supervisory authorities and regulatory bodies will need to act more speedily and coherently than in the past, within a system-wide, macro-prudential perspective, to fend off emerging stability threats. This will require ongoing collective diagnosis of evolving risks and regulatory weaknesses, strong co-ordination of regulatory and supervisory agendas, and political accountability for defining and implementing mitigating actions. So that the FSB can fulfil its mandate and keep pace with growing demands, further steps are needed to strengthen its capacity, the resources that support it and its governance arrangements.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Mario Draghi', with a stylized, cursive script.

Mario Draghi