FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

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To G20 Finance Ministers and Central Bank Governors

Achieving the G20's objective of strong, sustainable and balanced growth requires open markets, durable international capital flows, resilient financial institutions, robust sources of market-based finance and an end to too-big-to-fail.

By fixing the fault lines that caused the crisis and promoting financial stability more broadly, the G20 and FSB are making good progress in achieving these goals. Large banks are now considerably stronger, more liquid, less complex and more focused. All the necessary tools to end too-big-to-fail have been agreed. A series of measures are eliminating toxic forms of shadow banking, and more generally transforming shadow banking into resilient market-based finance. Durable market infrastructure is simplifying the previously complex – and dangerous – web of exposures in derivative markets. And authorities are now both more vigilant to emerging vulnerabilities and more consistent in preventing regulatory arbitrage.

The benefits of these efforts are beginning to be realised. The global financial system is moving from fragility to resilience. Credit is now growing in all major economies, while the cost of financing has remained low. Sources of finance are increasingly diversified between banks and markets. And the system is demonstrating an ability to dampen shocks rather than amplify them.

Despite this transformation, there are nascent risks that, if left unchecked, could threaten the progress made, fragmenting financial markets, and, ultimately, undermining the G20's objective for strong, sustainable and balanced growth.

A decade after the start of the crisis, an element of reform fatigue is understandable. But giving into it would mean that essential standards are neither completed nor fully implemented. This could erode our willingness to rely on each other's systems and institutions and, in the process, fragment pools of funding and liquidity, create inefficiencies and frictions, reduce competition and diminish cross-border capital flows. The net result will be less and more expensive financing for households and businesses, and very likely lower growth and higher risks in our economies.

Given these risks of fragmentation, G20 Finance Ministers and Governors may wish to consider how best to reinforce international regulatory cooperation. In this regard, the FSB can play an essential role, including through a more intense focus on the implementation and effects of reforms.

That means implementation must not only be effective, it must also be dynamic. That is, we must learn by doing and make adjustments, as necessary, to optimise our efforts, without comprising on the level of resilience the reforms are intended to achieve. In this spirit, the FSB is increasingly assessing the effectiveness of the G20 financial reforms, their interactions and combined effects. This includes any unintended consequences for emerging market and developing economies.

To embed this approach, the FSB is now developing a structured framework for these evaluations. The framework, which will be delivered to the G20 Summit in Hamburg, will support more comprehensive impact analysis and will help inform future decisions on any possible adjustments to the reforms.

With your support, the FSB has succeeded by emphasising collaboration, consensus and openness. Its strength lies in its members who bring authority, expertise and shared objectives. They have developed approaches to reduce risks to financial stability while supporting sustainable cross-border investment. Their efforts are creating a more level playing field for international firms and reducing opportunities for regulatory arbitrage. Effective global standards are being supplemented by mechanisms for deference to each other's national regimes and measures to promote supervisory collaboration.

As you know, the FSB is not a treaty-based organisation. These decisions are ultimately matters for national authorities who, acting out of enlightened self-interest and in recognition of the benefits of a resilient and open global financial system, guide and discipline the reform process.

The FSB priorities under the German Presidency are:

1. Transforming shadow banking into resilient market-based finance and addressing structural vulnerabilities in asset management;
2. Making derivatives markets safer by progressing the post-crisis reforms to over-the-counter (OTC) derivative markets and delivering coordinated guidance on central counterparty (CCP) resilience, recovery and resolution;
3. Supporting full and consistent implementation of post-crisis reforms, while developing a structured framework for post-implementation evaluation of the effects of reforms; and
4. Addressing new and emerging vulnerabilities, including misconduct risks, as well as those stemming from the decline in correspondent banking and from climate-related financial risks.

1. TRANSFORMING SHADOW BANKING INTO RESILIENT MARKET-BASED FINANCE

The financial crisis revealed how risks, which had built up outside the core banking system and without effective regulation, could have devastating effects on the real economy. Off-balance-sheet vehicles allowed enormous leverage to be masked, monoline insurers supported a system of unsustainable debts, and banks became overly reliant on fragile short-term funding from money market funds. As the complex chains in shadow banking unravelled, a spiral of asset fire sales and liquidity strikes followed, threatening the entire financial system and withdrawing access to credit from millions of households and businesses.

In 2011, the FSB set out a comprehensive framework to strengthen oversight and regulation of shadow banking. Since then, as endorsed in G20 Leaders' Shadow Banking Roadmap in 2013, the FSB has systematically mapped the shadow banking system and developed new mechanisms to monitor and address risks.

The FSB's latest assessment shows that this comprehensive policy response is moving these activities out of the shadows and into the light of resilient market-based finance. The toxic forms of shadow banking at the heart of the crisis – with their large funding mismatches, high leverage and opaque, off-balance-sheet arrangements – have declined to a point where they no longer represent a global stability risk. And the other, more constructive, forms of shadow banking that were once sources of vulnerability, including money market funds and repo markets, are now subject to effective policy measures that reduce their risks and reinforce their benefits.

In tandem with these efforts, the importance of asset management has grown rapidly. Collective investment vehicles with run risk now account for almost two-thirds of identified shadow banking up from less than one-third prior to the crisis. The growth of asset management is positive overall. It is creating new sources of funding and investment, promoting international capital flows, reducing reliance on bank funding and bringing welcome diversity to the financial system. At the same time, however, asset management's vastly increased importance reinforces the need to minimise the risk of sudden stops in times of stress.

In January 2017, delivering on its commitment to the G20 Leaders in Hangzhou, the FSB finalised its recommendations to address structural vulnerabilities and reduce liquidity mismatches associated with asset management. These recommendations will be operationalised by IOSCO with work on liquidity mismatches in open-ended funds to be completed by end-2017 and development of consistent leverage measures by end-2018.

In completing the work under the Shadow Banking Roadmap, the FSB has not identified new shadow banking risks that currently require additional regulatory action at global level. However, given that new forms of shadow banking activities are certain to develop in the future, FSB member authorities must maintain and continue to invest in an effective and ongoing programme of surveillance, data sharing and analysis so as to support judgements on any required regulatory response in the future.

Finance Ministers and Central Bank Governors are asked to endorse the FSB's January 2017 policy recommendations to address the risks around asset management activities, completing the job of transforming shadow banking into more resilient market-based finance.

- **By the Hamburg Summit**, the FSB will report our assessment of the evolution of shadow banking activities since the financial crisis and related financial stability risks, and whether the policies and monitoring put in place since then are adequate to address these risks.
- **By the Hamburg Summit,** the FSB will report on progress in operationalising the asset management recommendations.

2. MAKING DERIVATIVES MARKETS SAFER

The Pittsburgh Summit in 2009 initiated a fundamental overhaul of OTC derivatives markets to reduce systemic risk, improve transparency and prevent market abuse. Since then, there has been substantial progress in some areas, with a significant increase in the central clearing of OTC derivatives, and somewhat slower progress in the introduction of margining requirements for non-centrally cleared derivatives, and requirements for reporting derivatives transactions to trade repositories. It is vital that authorities remain focused on completing the job of addressing the major systemic risks associated with OTC derivatives.

Challenges remain to realise fully the benefits of these reforms. In particular, there is ongoing work to remove legal barriers to reporting and to establish Unique Transaction Identifiers and Product Identifiers to improve data quality. Further efforts are also needed to expand the use of deference to each other's regulatory regimes in relation to cross-border activity.

Although the reforms to derivatives markets are not yet complete, they have already begun to reduce systemic risks by replacing the complex, opaque and fragile web of ties between banks with simple, transparent and robust links between resilient CCPs and their member banks. Given the progress made, now is the time to review the implementation and effects thus far of these reforms to assess the prospects for simpler, safer and more transparent derivative markets.

- **By the Hamburg Summit,** the FSB will report its findings from the comprehensive review of reforms to OTC derivatives markets.

The use of CCPs to clear standardised OTC derivatives transactions is central to the G20's efforts to reduce systemic risks. CCPs reduce the risk of contagion to the banking sector from the failure of individual institutions, as well as by making the massive derivatives markets themselves more robust. The extent to which this reform reduces overall systemic risks, however, depends on the resilience and resolvability of the CCPs themselves.

CCPs are already tightly regulated and directly overseen by authorities, and their resilience has been significantly strengthened since the crisis. To reinforce these measures, CPMI-IOSCO and the FSB are on-track to deliver further, detailed guidance for CCP resilience, recovery and resolvability at the Hamburg Summit. Following the Summit, the FSB will begin work to consider whether there is a need for additional financial resources to safely resolve CCPs, the findings of which will be delivered to the 2018 G20 Summit.

- **By the Hamburg Summit,** the FSB will publish final guidance on CCP resolution and CPMI-IOSCO will publish final guidance on resilience and recovery.

3. EFFECTIVE AND DYNAMIC IMPLEMENTATION OF THE POST-CRISIS REFORMS

The work on shadow banking and OTC derivatives are examples of how FSB members are assessing and refining the reforms to ensure that they best achieve their objectives. Other current implementation priorities include finalising the Basel III bank capital standard and some important mechanics of implementing the Total Loss-Absorbing Capacity (TLAC) standard. These measures are essential to deliver the G20 objectives to build a more resilient financial sector and to end too-big-to-fail.

The FSB's TLAC standard is designed to ensure that global systemically important banks can be resolved in an orderly manner. Key elements are providing home and host authorities with confidence regarding the resolution of cross-border banks, and minimising incentives to ring-fence assets domestically which would fragment the financial system. The FSB has consulted on a set of guiding principles to assist in the implementation of internal TLAC, to ensure that reliable mechanisms are in place to downstream resources within groups.

- **By the Hamburg Summit,** the FSB will finalise guidance on internal TLAC.

The Basel Committee has made further progress towards the finalisation of the Basel III reforms, which include revisions to the risk-weighted asset framework, the leverage ratio framework and the output floor. Our collective agreement on the remaining elements of Basel III is essential. Completing this standard will protect the gains in global resilience, restore full confidence to the bank capital framework, give certainty to international banks, and help avoid measures that could balkanise international banking.

With the overall policy framework now largely in place and implementation well underway, the FSB is increasingly focused on assessing whether the reforms are achieving their intended outcomes. The FSB's third Annual Report to G20 leaders in Hamburg will report on progress in implementation and set out more in-depth analysis on the overall effects of reforms, informed by a call for evidence and workshops held earlier this year.

The FSB will also deliver to the G20 Summit a structured framework for evaluating the post-implementation effects of the G20 financial regulatory reforms. This framework will be subject to public consultation. It will be used to guide analyses of whether G20 reforms are achieving their intended outcomes, identify any regulatory gaps, remaining or emerging risks, or potential material unintended consequences. The development of and consultation on this framework shows the FSB's policy review process places the highest priority on effective evaluation and transparency.

One aspect of reforms which has already been a focus of further analysis is their potential effect on market liquidity. A report by the Committee on the Global Financial System on the resilience of global repo markets will be delivered to G20 Finance Ministers and Central Bank Governors at their April meeting.

- **By the Hamburg Summit,** the FSB will publish its third Annual Report on implementation and effects of G20 financial regulatory reforms, and the framework for post-implementation policy evaluation of the effects of those reforms.

4. ADRESSING NEW AND EMERGING VULNERABILITIES

Misconduct risks

Numerous instances of misconduct in the financial industry in recent years have damaged confidence in financial institutions and undermined trust in markets. The implications of misconduct can be far-reaching, limiting the potential of finance to serve real economies and to foster global economic growth.

In response to a request from G20 Leaders, the FSB is implementing an action plan to address these issues through a range of preventative measures, focusing on (i) improvements to financial institutions' governance and compensation structures to reduce misconduct risk; (ii) improvement to global standards of conduct in the fixed income, commodities and currency markets, including through codes of conduct and through related regulatory and enforcement tools in wholesale markets; and (iii) reforms to major financial benchmark arrangements to reduce the risks of their manipulation. The work recognises that, while fines and sanctions deter misconduct, preventative measures, including those which increase individual accountability, can also play important roles.

The FSB is currently conducting a stocktake of efforts by national authorities, international bodies, standard-setters and firms to strengthen governance frameworks in this area, and agreed last month to conduct further work on information gaps and due diligence in the employment of individuals with a history of misconduct; responsibility mapping; and the role of corporate culture.

- **By the Hamburg Summit,** the FSB will (i) deliver to G20 Leaders a report drawing together actions taken and recommendations made to address misconduct risk across the various elements of the action plan; and (ii) publish a consultation paper on the use of compensation tools to address misconduct.

Correspondent banking and remittances

For some emerging market and developing economies, the persistent threat of financial abandonment due to the de-risking in correspondent banking relationships could curtail their access to the international financial system and drive financial flows underground. This has potentially serious consequences for growth, financial inclusion, as well as the stability and integrity of the financial system.

An FSB Coordination Group was established last March to implement the FSB's four-point action plan to assess and address this decline by:

(i) further examining the dimensions and implications of the issue;

(ii) clarifying regulatory expectations to give additional certainty and confidence to those engaged in correspondent banking;

(iii) domestic capacity building for jurisdictions that are home to affected respondent banks;

(iv) strengthening tools for customer due diligence by correspondent banks

Progress has been made against each of these priorities. In the coming months, the FSB will sustain momentum in our collective efforts to stem the trend of de-risking. The FSB will also work with the Financial Action Task Force and Global Partnership for Financial Inclusion to consider whether there are unwarranted barriers preventing remittance providers from accessing banking services that financial authorities should address.

- **By the Hamburg Summit,** the FSB will report on further progress and next steps under its correspondent banking action plan.

Task Force on Climate-related Financial Disclosures

Access to better quality information on climate-related financial risks is essential to enable market participants to better understand and manage these risks. Without the necessary information, market adjustments to climate change could be incomplete, late and potentially destabilising. The private sector, industry-led Task Force on Climate-related Financial Disclosures, under the leadership of Michael Bloomberg, was established by the FSB in response to the G20's request to develop voluntary, consistent, climate-related financial disclosures for use by companies in providing information to investors, lenders, and insurance underwriters.

In December, the Task Force issued its report for consultation, setting out specific disclosure recommendations. This is a solution by the market for the market. The Task Force will publish its final report in June 2017, and, then continue working until at least September 2018 to promote and monitor adoption of the Task Force's recommendations by companies and to evaluate the extent to which the recommended disclosures are meeting the interests of users.

- **By the Hamburg Summit,** the FSB will deliver the Task Force's final report to G20 Leaders.

Implications of financial technology innovations

A series of financial technology ("Fintech") innovations have the potential to transform elements of the financial system. Financial authorities must ensure that they are prepared to respond to any financial stability risks that may emerge, without stifling innovation. Laying the groundwork for Fintech's safe and sustainable development will help support the G20 Presidency's priorities on shaping digitalisation.

To those ends, the FSB is evaluating potential financial stability implications (both opportunities and risks) of emerging Fintech innovations, drawing on the expertise of standard setters as well as a stocktake of national authorities' regulatory approaches to domestic Fintech activity. Given the cross-border reach of Fintech, an international approach to assessing and responding to vulnerabilities related to the expansion of Fintech and increasing flows of information will be important.

- **By the Hamburg Summit,** the FSB will publish its report on the financial stability implications of Fintech, identifying regulatory and supervisory issues that merit authorities' attention from a financial stability perspective.

CONCLUSION

The collaborative, consensus-based approach, which is the hallmark of the way the FSB works, is delivering highly effective international cooperation and building a more cohesive, resilient and international financial system.

Given the substantial progress in reforming the financial sector, now is the right time to take stock. The development for the Hamburg Summit of a new structured framework for evaluating policies underscores the FSB’s commitment not just to full, timely and consistent implementation, but also to dynamic evaluation of effects and effectiveness of our reforms. Based on such rigorous analysis, the FSB will propose targeted adjustments to measures, if required.

A decade on from the start of the crisis, the G20 has made substantial progress in building a financial system that is more resilient and better able to fund households and business in sustainable way. As the global recovery gains strength, now is not the time to risk these hard-won gains.

With your support, the FSB must complete the journey from fragility to resilience. That means ensuring that shadow banking is fully transformed into resilient market-based finance, that durable market infrastructure is in place, that the possibilities of financial technology are harnessed in a sustainable way, and that emerging vulnerabilities are addressed in a timely and consistent manner. In these ways, the FSB will make a lasting contribution to the G20 objective of strong, sustainable and balanced growth.

Yours sincerely

Mark Carney