THE CHAIRMAN

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To G20 Leaders

A decade after the start of the global financial crisis, G20 reforms are building a safer, simpler and fairer financial system.

The largest banks are considerably stronger, more liquid and more focused. They are now subject to greater market discipline as a consequence of globally-agreed standards to end too-big-to-fail. A series of measures are eliminating toxic forms of shadow banking and transforming the remaining into resilient market-based finance. Reforms to over-the-counter (OTC) derivative markets are replacing a complex and dangerous web of exposures with a more transparent and robust system that better serves the real economy. And authorities are now both more vigilant to emerging vulnerabilities and more consistent in preventing regulatory arbitrage.

The real economy is beginning to realise the benefits of your sustained efforts. 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.

G20 countries now have a strategic opportunity to build on this foundation to create an open, global financial system. Doing so would further support the cross-border investment needed for strong, sustainable and balanced growth across the G20.

This letter reports on the progress made and highlights the main issues which require the attention of the G20 Leaders by answering three questions.

What's Been Achieved?

G20 reforms have now addressed the fault lines that caused the global financial crisis.

The largest banks are required to have as much as ten times more of the highest quality capital than before the crisis and are subject to greater market discipline as a consequence of globally-agreed standards to resolve too-big-to-fail entities.

A decade ago, many large banks were woefully undercapitalised, with complex business models that relied on the goodwill of markets and, ultimately, taxpayers.

A decade on, the largest banks have raised more than $1.5 trillion of capital, and all major internationally active banks meet minimum risk-based capital and leverage ratio requirements well in advance of the deadline. Changes in funding models, in large part due to new global liquidity standards, are also making banks more robust to shocks, again well in advance of the agreed timetable.

To bring back the discipline of the market and to end the reliance on public funds, the FSB has led work to end too-big-to-fail. FSB members are making good progress implementing agreed standards that will help enable orderly and effective resolution of failing banks. These standards are being augmented by guidance published for this Summit on global banks' internal total loss absorbing capacity to support cross-border loss allocations in resolution. The FSB has also issued guidance aimed at ensuring that where banks in resolution are being restored to solvency they can maintain the arrangements they need to continue their critical functions.

Despite this progress, there is no room for complacency as substantial work remains to build effective cross-border resolution regimes and to operationalise resolution plans for cross-border firms.

A series of measures are eliminating toxic forms of shadow banking and transforming the remaining into resilient market-based finance.

A decade ago, enormous risks were built up outside the core banking system and away from effective supervision with devastating impact on the real economy. In 2013 the G20 agreed the Shadow Banking Roadmap, to implement its comprehensive framework to strengthen oversight and regulation of shadow banking.

A decade on, as a result of these measures, the financial stability risks from the toxic forms of shadow banking at the heart of the crisis no longer represent a global stability risk. The remaining activities are now subject to policy measures which reduce their risks and reinforce their benefits, allowing for more diverse and resilient forms of market-based finance.

The FSB's assessment for this Summit confirms the extent of the transformation of shadow banking into resilient market-based finance. It concludes that the agreed policies, once fully and effectively implemented, will be adequate to address existing risks. Furthermore, since shadow banking activities will inevitably evolve over time, FSB member authorities will strengthen ongoing surveillance, data sharing and analysis. This disciplined process will support ongoing risk assessments and guide any future regulatory response.

Reforms to OTC derivative markets are replacing a complex and dangerous web of exposures with a more transparent and robust system that better serves the real economy.

A decade ago, OTC derivatives trades were largely unregulated, unreported and bilaterally cleared. When the crisis began, uncertainty about exposures contributed to the panic. At the 2009 Pittsburgh Summit, G20 Leaders initiated a fundamental overhaul of OTC derivative markets to reduce systemic risk, improve transparency and prevent market abuse.

The FSB is delivering to this Summit a review of these reforms. It concludes that, a decade on, meaningful progress has been made towards mitigating systemic risk as a result of progress in trade reporting, central clearing frameworks, and new capital and margin requirements. For example, the amount of collateral covering OTC derivative counterparty exposures of global banks has risen by over $800 billion, and the coverage of exposures by collateral has risen from about one third to nearly two thirds. Taken together with better risk management practices, these comprehensive measures have further reduced risk in derivatives markets.

The use of central counterparties (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, and they make the massive derivatives markets themselves more robust. The resilience of the CCPs has been significantly strengthened in recent years. To reinforce these measures, for this Summit, the FSB has issued guidance on CCP resolution, and CPMI-IOSCO has provided detailed guidance on CCP resilience and recovery. Following the Summit, the FSB will begin work to consider whether there is a need for additional financial resources to resolve safely CCPs, the findings of which will be delivered to the 2018 G20 Summit.

What Remains to be Done?

The FSB's third Annual Report to G20 Leaders shows continued steady progress in implementing reforms and provides evidence that greater resilience is being achieved without impeding the supply of credit to the real economy. It also highlights areas which merit further attention.

The main unfinished business is to operationalise a few key reforms and to pursue full, timely and consistent implementation of the entire package of measures across the G20.

Basel III must be completed urgently and then implemented faithfully.

The Basel Committee has agreed many of the final elements of the Basel III package, which will include revisions to the risk-weighted asset framework and the finalisation of the international leverage ratio standard. It now needs to finish the job.

G20 Leaders may wish to insist on the timely completion of Basel III in order to lock in the benefits of a resilient international banking system, equipped with the regulatory certainty to lend and invest, supported by a level playing field of consistent international standards.

The increased importance of asset management reinforces the need to minimise the risk of sudden stops in times of stress. This requires making agreed policies operational.

Over the past decade, asset management has grown from $50 trillion of assets (in 2008, equivalent to 30% of total financial system assets) to over $75 trillion (in 2015 or 40% of total financial system assets). Investment funds now account for over two thirds of market-based finance, up from around one third immediately before the crisis.

This is a fundamentally positive development. Asset management provides new sources of funding and investment, promotes international capital flows, and reduces reliance on bank funding. However, within the asset management sector, open-ended funds with "run risks" have grown particularly rapidly. In January 2017, responding to the encouragement of G20 Leaders in Hangzhou, the FSB finalised recommendations to address the structural vulnerabilities associated with asset management that could give rise to financial stability risks.

Measures to operationalise these recommendations, particularly to address liquidity mismatches in open-ended funds, are now underway. IOSCO and FSB will assess if these recommendations have been implemented effectively, and the FSB will report back to the G20 on whether they are having their desired effect.

Further work is urgently required to realise fully the benefits of trade reporting and so complete the improvements to the transparency of OTC derivatives markets.

National legal barriers in some jurisdictions are preventing regulators' access to trade reporting data in line with CPMI-IOSCO guidance. This is impeding authorities' oversight of OTC derivatives markets, and creates the possibility that vital information about looming risks is reported but not accessible. In order to meet their commitments by next year's deadline, G20 Leaders should encourage their jurisdictions to step up efforts to remove remaining legal barriers to trade reporting and to sharing of the data among authorities.

A series of initiatives have the potential to help address the underlying causes of misconduct by bolstering individual accountability and better aligning incentives and reward. But more needs to be done to break over-reliance on ex post fines.

Global banks' misconduct fines and litigation costs have reached over $320 billion since the crisis. Fines are essential to punish wrong doing and have an important deterrent effect, but it is insufficient and inefficient to rely solely on ex post penalties of institutions and their shareholders. The resources paid in fines, had they been retained as capital, could have supported up to $5 trillion in lending to households and businesses.

The FSB's misconduct work plan delivered to this Summit outlines measures to restore public trust in the financial sector, including through a greater emphasis on individual accountability. In particular, the report details: improvements to financial institutions' governance and compensation structures to reduce misconduct risk; global standards of conduct in the fixed income, commodities and currency markets, and reforms to major financial benchmark arrangements to reduce the risks of their manipulation.

In the next phase the FSB is prioritising to explore ways to increase individual accountability of senior managers; to prevent individuals with records of misconduct from moving between firms; and to promote governance frameworks that address cultural risk factors that drive misconduct. The continued support of G20 Leaders for these initiatives is needed to create incentives for better conduct in the financial services sector and better outcomes for the real economy.

What's Next?

Just avoiding the repeat of past failures is not a recipe for success. The financial system evolved since 2007, and the G20's response must adapt accordingly. The FSB will continue to scan the horizon to identify, assess and address new and emerging risks to financial stability.

FinTech and cyber risk: New financial technologies are developing rapidly, bringing both opportunities and risks. The FSB's report to the G20 Summit on the supervisory and regulatory issues raised by FinTech concludes that while potential risks to financial stability are generally well-captured by existing regulatory frameworks, it will be important to monitor closely the evolution of the financial system, service providers and dependencies between them as FinTech developments progress.

Cyber risks were highlighted as major concerns as the steady digitisation of services provides more entry points for cyber-attacks. As reported in the progress report on cyber security delivered to you, the FSB is conducting a stocktake of its members' supervisory practices, guidance and regulation of cyber security, with a view to promoting effective practices across the G20.

Correspondent banking and remittances: So-called "de-risking" in correspondent banking relationships has threatened the ability of some emerging market and developing economies to access the international financial system, and it risks driving flows underground. The report for this Summit on the FSB's Action Plan includes the following measures: publication of an analysis of trends in correspondent banking; clarification by FATF and Basel Committee of regulatory expectations through updated guidance to industry and supervisors; enhanced information-sharing and coordination of technical assistance and capacity-building; and promotion of due diligence tools for industry. In response to a recent G20 request, the FSB will convene a high level roundtable to establish whether there are unwarranted barriers preventing remittance providers from accessing banking services that should be addressed by financial authorities.

Task Force on Climate-related Financial Disclosures (TCFD): Access to better quality information on climate-related financial risks that companies face is essential to enable investors and lenders to take account of those risks. Without the necessary information, market adjustments to climate-related developments could be abrupt and potentially destabilising. In response to a G20 request, the industry-led TCFD was established by the FSB to develop voluntary, consistent, disclosures for use by companies in providing risk information to investors, lenders and insurance underwriters. The final report, published by the TCFD in June 2017, benefitted from extensive public consultation and outreach and has been endorsed by TCFD member companies with market capitalisations of around $3.5 trillion and financial institutions responsible for assets of $25 trillion. The Task Force will continue working over the next year to promote and monitor adoption of its recommendations.

Dynamic implementation is critical to ensure the reform programme is efficient, coherent and effective.

Reforms must not be static. Markets adapt and innovate, policies age, opportunities for arbitrage arise, and unintended consequences become apparent. The FSB's new approach to dynamic and effective implementation will help ensure that the new regulatory framework keeps pace with a changing financial system in as efficient a manner as possible.

The new Policy Evaluation Framework delivered to the Summit provides a transparent vehicle to achieve such efficient resilience. Evaluations using this structured framework in coming years will assess whether G20 financial reforms are achieving their intended outcomes and identify any regulatory gaps, overlaps or emerging risks. Where material unintended consequences are identified, it will inform future decisions about possible policy adjustments to optimise our efforts without compromising on the objectives of reforms. We expect the first application of this framework to assess whether interactions of reforms – in particular, relevant derivatives reforms and the leverage ratio – are appropriately incentivising central clearing of OTC derivatives.

Conclusion: A Strategic Choice for the G20

At the London G20 Summit in 2009, Leaders agreed "to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards that a global financial system requires." That goal is now within reach.

The FSB has built a framework of high standards. Implementation is progressing well. Cross-border arrangements for the supervision and the crisis management of systemic institutions and infrastructure are now up and running. There is a new, rigorous system of implementation monitoring and progress is being transparently reported by the FSB, IMF and World Bank. As a result, the playing field for cross-border activities is being levelled, and opportunities for regulatory arbitrage are being reduced.

In parallel, the FSB's new approach to dynamic and effective implementation should help ensure that the regulatory framework keeps pace with the changing financial system in as efficient a manner as possible.

Despite this immense progress, there are nascent risks that, if left unchecked, could undermine the G20's objective for strong, sustainable and balanced growth. In particular, giving into reform fatigue could erode the willingness of G20 members 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 and investment flows. The net result would be less and more expensive financing for households and businesses, and very likely lower growth and higher risks across the G20.

There is, however, another path that involves working together through reinforced, voluntary, international regulatory cooperation grounded in agreed international standards. Leaders can capitalise on the progress made over the past decade by:

- Encouraging full and consistent implementation of standards to support a level playing field and reduce regulatory arbitrage opportunities; supported by rigorous member-led peer review and accountability mechanisms;
- Revising legal frameworks to facilitate cooperation (e.g. sharing information amongst authorities on resolution and removing legal barriers to reporting OTC derivatives to trade repositories and to authorities access to that data);
- Considering how the progress made in agreeing and implementing common standards and enhancing cooperation and coordination can be best leveraged to preserve an integrated and open system; and
- Improving FSB processes, effectiveness and transparency, including through the framework for post-implementation evaluation of the effects of reforms.

The progress over the past decade and culminating with the German Presidency has created a robust platform for a truly resilient, open and international financial system. If the G20 embraces the strategic choice to seize opportunities to enhance international cooperation in the financial sector, then the G20's goal of strong, sustainable and balanced growth could be within reach.

Yours sincerely,

Mark Carney