FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

15 April 2013

To G20 Ministers and Central Bank Governors

Progress of Financial Reforms

We have sent for your upcoming meeting reports assessing progress in three key areas of reform to create a more resilient global financial system, one that is better able to support long-term economic and employment growth. They cover:

- Implementation of the Basel III capital and liquidity requirements, supporting the goal of *increasing the resilience of banks and banking systems*;
- Implementation of reforms to resolution regimes, supporting the goal of *ending "too big to fail";*
- Implementation of OTC derivatives reforms, supporting the goals of *reducing systemic risks and creating continuous core markets*.

Although important steps have been taken to strengthen the system, we are only part-way through a multi-year financial reform process, whose successful completion will require our continued cooperation and our sustained focus and effort. <u>It is especially important that, as we seek to reduce systemic risks from interconnectedness, we strive to maintain an integrated global financial system</u>.

<u>A resilient and global system will provide credit most efficiently and support strong, sustainable and balanced global growth</u>. We need to continue to re-build confidence in the long-term robustness of the global financial system and resist pressures to ring-fence national markets.

1. Implementation of Basel III – Increasing the resilience of banks

Good progress is being made in putting the Basel III agreement into force. Since October 2012, eight more FSB member jurisdictions have issued final Basel III-based capital regulations, bringing the total to fourteen.[1] The five remaining jurisdictions (comprising ten member countries) have published their draft regulations.[2] To reduce concerns about an

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[1] Of these 14, 11 have final Basel III capital rules in force: Australia, Canada, China, Hong Kong SAR, India, Japan, Mexico, Saudi Arabia, Singapore, South Africa and Switzerland. Three other jurisdictions – Argentina, Brazil and Russia – have issued final rules and will bring them into force by end 2013.

[2] The five are the EU (comprising member countries France, Germany, Italy, Netherlands, Spain and the UK), Indonesia, Korea, Turkey and the United States.

uneven playing field, these remaining jurisdictions should finalise rules soon and align their implementation with the agreed transition deadlines.

Banks capital levels are rising at a faster pace than set out in the Basel III phase-in arrangements. Over the year to June 2012, the average Common Equity Tier 1 (CET1) capital ratio of large internationally active banks rose from 7.1% to 8.5% of risk- weighted assets.[3] For those banks that do not yet meet the fully-phased in 2019 CET1 requirements, the capital shortfalls fell from roughly €450 billion to €200 billion, 45% less than at end-2011. The sum of profits after tax and prior to distributions for these same banks over that period was €380 billion; thus, for the systems as a whole, this gap can be easily closed through retained earnings during the transition period that runs to 2019.

In those jurisdictions that have made the most progress in rebuilding capital, the cost and availability of credit has generally been the most accommodative. Banks in the EU have more to do than those elsewhere to close the gap. This is one reason for the relative tightness of credit conditions in the single market.

To maintain a level playing field and prevent arbitrage, the Basel Committee on Banking Supervision (BCBS) is assessing both the consistency of national regulations with the Basel III agreement and the consistency of the outcomes on banks. With respect to assessments of the consistency of national regulations, Singapore received a compliant grade (the highest possible) in its review; assessments of Switzerland and China are underway.[4] With respect to outcomes, the BCBS has initiated work to address its finding of excessive variation of risk-weighted assets under the internal models-based approach (excessive variation undermines the comparability of reported bank capital ratios and could raise competitiveness issues over time). Three types of policy options are emerging: (i) improving public disclosure and regulatory data collection to aid the understanding of banks' calculations of RWAs; (ii) narrowing the modelling choices for banks; and (iii) further harmonising supervisory practices with regard to model approvals (to reduce the level of variation in RWAs). The BCBS expects to publish its next report in this area in early July.

With respect to the remaining outstanding components of the Basel III framework, the BCBS intends to finalise its work on the leverage ratio this year, and on the Net Stable Funding Ratio, the trading book, securitisation and large exposures in 2014.

2. Implementation of reforms to resolution regimes – Ending "too-big-to fail"

The financial crisis demonstrated the urgent need to improve resolution regimes to enable authorities to resolve failing financial institutions quickly without destabilising the financial system or exposing taxpayers to loss. Following the crisis, the FSB developed the *Key Attributes for Effective Resolution Regimes for Financial Institutions* as part of a set of agreed policy measures to address the moral hazard risks posed by systemically important financial

[3] The rise in capital ratios reflect a significant rise in capital levels (mainly retained earnings but also capital raisings) and a very modest decline in risk weighted assets over this period.

[4] Assessments of national Basel III regulations for all jurisdictions home to G-SIBs will be completed by end-2013.

institutions (SIFIs). The *Key Attributes* set out the core elements of effective resolution regimes that apply to any financial institution that could be systemically significant if it were to fail.

We have completed a first in a series of iterative peer reviews of FSB jurisdictions' existing resolution regimes and any planned changes to those regimes using the *Key Attributes* as a benchmark. While legislative reforms have been undertaken by some FSB jurisdictions, implementation of the *Key Attributes for Effective Resolution Regimes* is still at an early stage. The key findings suggest that despite considerable progress much work remains to be done:

- In many countries, resolution authorities currently lack important powers needed to resolve systemic institutions, such as powers to write down and convert liabilities of a failing institution to equity ("bail-in") or to impose a temporary stay on the exercise of financial contracts.
- In terms of regime scope, most jurisdictions lack powers to take control of the parent company or affiliates of a failed financial institution, and do not have the authorities or powers to resolve systemic non-bank institutions, such as central counterparties and other financial market infrastructures (FMIs).
- Many jurisdictions currently have neither expedited procedures for giving effect to foreign resolution actions nor clear and dedicated statutory provisions for domestic authorities to share confidential information and cooperate for resolution purposes with foreign authorities. These limitations on cross-border cooperation and information sharing are significant impediments to resolution planning for G-SIBs.
- Finally, many jurisdictions lack a statutory resolution planning requirement or the power to require firms to make changes to their organisational and financial structures in order to improve their resolvability.

Legislation is needed in many jurisdictions to make resolution of G-SIBs feasible. With the EU home to 14 of the 28 G-SIBs, the adoption and implementation of an EU Recovery and Resolution Directive fully consistent with the *Key Attributes* will be a significant step in this direction.

As part of the FSB's G-SIFI framework, members have committed to develop for all G-SIFIs resolution strategies, operational resolution plans and firm-specific cross-border co-operation agreements (COAGs) that set out a process for cooperation and information sharing. Progress is being made in developing resolution strategies and plans for G-SIBs, with strategies coalescing around two stylized approaches on which further guidance will shortly be issued. But, as noted, these strategies cannot be made operational without national legislation providing both the resolution tools and the legal basis for much closer cross-border cooperation and information exchange to take place.

We therefore need to maintain momentum in introducing and completing legislation as well as on policy guidance. By the Summit:

- countries that are home or important hosts to G-SIBs should legislate or set out their timetables for legislating the implementation of the *Key Attributes*;
- key financial centres should legislate to have the powers to resolve central counterparties or set out their timetables for doing so;

- the FSB will issue guidance on resolution strategies, and consult on guidance for the resolution of financial market infrastructures, large insurance companies and the treatment of client assets in resolution.

The FSB will provide a comprehensive progress report to the Summit that will highlight the required next steps to end too-big-to-fail.

3. Implementation of OTC derivatives reforms - Creating continuous markets

The FSB published this week its 5th progress report on the implementation of OTC derivatives reforms. The key message is that, although considerable progress has been made, much remains to be done to complete the agreed reforms. In the near term, jurisdictions need to rapidly issue detailed rules to implement the G20 commitments to help remove regulatory uncertainty, while preserving sufficient flexibility within those rules to allow issues of cross-border consistency to be resolved.

Obtaining better data is crucial in order to assess the systemic risks relating to derivatives markets and the practical progress made to reform these markets, especially with respect to meeting the G20 objectives of comprehensive trade reporting, central clearing and trading on organised exchanges.

In the longer term, trade repositories will be the source of comprehensive data on derivatives markets, but we need to make sure that the relevant authorities have access to accurate and usable data. CPSS and IOSCO's recently published consultation paper on authorities' access to trade repository data provides useful guidance. It is clear that challenges remain. For instance, privacy restrictions in some jurisdictions that create barriers to reporting the information necessary for regulatory purposes need to be fully addressed. The FSB plans to organise a feasibility study of how to produce and share globally aggregated trade repository data that authorities need for monitoring systemic risks.

For the Summit, the FSB will deliver:

- a further progress report, including an assessment of the readiness of market participants
- a report from regulators on how they have resolved outstanding cross-border issues, including gaps, overlaps and inconsistencies in regulation
- a report containing countries' confirmation that they have put trade repository regulations in place and their committed timetables for completing legislation and regulations on central clearing, trading on organised platforms and margining requirements
- publication of final or close-to-final international policy standards for capital and margining
- preliminary findings from a macroeconomic study on the impact of OTC derivatives reforms.

Going forward, the FSB will create a multi-year plan for further monitoring of implementation, including whether reforms are meeting the underlying G20 goals of improving transparency, mitigating systemic risk and protecting against market abuse.

4. Transforming shadow banking

We have reviewed the results of the public consultations on the shadow banking policy recommendations issued in November last year. Commentators supported addressing shadow banking risks based on economic functions and activities performed rather than on legal entity types. They also called for close co-ordination of the various regulatory initiatives underway and for impact assessments of the principal policy measures, especially in relation to haircuts in repo and securities lending markets.

Policy development towards enhancing the recommendations continues to advance. To reduce risks to the banking system, the Basel Committee has released for consultation a proposed framework for measuring and controlling large bank exposures, including bank's exposures to bank-like activities conducted by non-banks. With regard to repo and securities lending markets, policy development is focused on improving market transparency and minimum standards for methodologies used in calculating haircuts, with continuing consideration of numerical haircut floors for core transactions. A quantitative impact study is being set in train to calibrate and assess the impact of the proposals.

A package of policy recommendations for all five workstreams will be made to the Summit. This will include the next stage of an ongoing monitoring and policy process, as the shadow banking sector continues to evolve.

5. Reforming Financial Benchmark Setting

The cases of market manipulation and false reporting of LIBOR and of other similar benchmark rates, together with the post-crisis collapse in liquidity in interbank unsecured deposit markets, have undermined confidence in the reliability and robustness of existing interbank (quotation-based) benchmark rates. The official sector has an essential role to play in ensuring that widely-used benchmarks are held to appropriate standards of governance, transparency and reliability. The measures proposed by national regulators, IOSCO and central banks to restore the governance and oversight processes of benchmark rates need to be implemented with high priority and urgency. We will report to you in July on the process to ensure this implementation takes place.

As is well understood, however, without liquidity in unsecured interbank markets, the price discovery process in these markets will remain limited or non-existent for certain rates. Moreover, the current willingness of banks to participate in rate-setting panels cannot be taken for granted, in view of the perceived increase in regulatory, litigation and reputational risks arising from recent cases. The current uncertainty over the continued viability of a number of widely-used reference rates represents a potentially serious systemic vulnerability.

Given this emerging risk, there is also an urgent need to identify and validate suitable alternatives to existing financial benchmarks, anchored in observable market transactions, that could command widespread private and official sector support, and to address the issues that would arise in transitioning to these alternatives. We are discussing in the FSB how the official sector can initiate and support this process in conjunction with market participants, and will report on progress made at your July meeting.

6. Credit rating agencies

The FSB developed a roadmap to accelerate the implementation of its Principles for eliminating mechanistic reliance on credit rating agency ratings, which includes a peer review of jurisdictions' actions to implement the Principles. We will provide a progress report to the Summit. Meanwhile, IOSCO has reported to you at this meeting on its review of its Code of Conduct for CRAs, with the aim of increasing transparency and reducing barriers to competition. The FSB and IOSCO workstreams are separate but complementary exercises to reduce the systemic risk that credit rating agencies pose.

7. Long-term investment finance

The FSB is contributing to the important G20 Study Group work on long-term investment finance, through continued monitoring of the possible effects of regulatory reforms. Our contribution will include a particular focus on regulations affecting institutional investors, as they are large holders of long-term assets. As part of this work, the FSB will conduct outreach to ensure that any material issues are identified.

8. Implementation monitoring

The FSB remains committed to transparent reporting of progress in the development and implementation of policy reforms. To this end we will, as usual, provide a comprehensive progress report to the Summit, including a summary scorecard of the state of progress in global policy development and implementation, supported by clear country-by-country, policy-by-policy detailed information on that progress.

I trust this letter clarifies the considerable progress being made, the challenges that remain and the paramount need for your continued engagement in order to maintain an open, resilient global financial system that serves the G20's broader economic and social goals.

Yours sincerely,

Mark Carney