

To G20 Finance Ministers and Central Bank Governors

Financial Reforms – Completing the job and looking ahead

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. The G20 called on the FSB to develop and co-ordinate a comprehensive framework of reforms.

This letter reports on progress as we approach the Brisbane summit, which will mark the end of this phase of global financial reform. It makes four points.

First, during the Australian G20 presidency, work remains on track to substantially complete the job of fixing the fault lines that underlay the crisis. Most of the priorities agreed by Leaders at St Petersburg have now been completed.

Second, the support of Ministers and Governors is essential to meet the target of ending too big to fail for the Brisbane summit. It is essential that agreement is reached on proposals for a common standard for total loss absorbing capacity for globally systemic banks and on cross-border recognition of resolution actions regarding contractual stays. Without these measures, the prospect of indefinite public subsidies to the world's largest banks will continue, the system will lack market discipline and the credibility of the wider package of reforms will be compromised.

Third, we are building a system that combines common international standards, consistent implementation and where appropriate deferral to each other's approaches. To make that system as effective, efficient and consistent as possible, an approach must be embedded based on co-operation, peer review and outcomes-based approaches to resolving cross-border issues, and on tackling spill-overs where they occur. To assist that, the FSB will make proposals to change the structure of its representation and the inclusiveness of its working procedures, and will increase availability of information about its operations.

Fourth, as we move toward the conclusion of this phase of financial reform, the FSB will adjust focus, away from the design of standards to fix the fault lines that caused the crisis and towards new and constantly evolving risks and vulnerabilities. Many of these could arise from outside the core of the financial system. Sharing of data, analytics and policy choices will be vital to addressing those risks. The FSB is the platform for doing so. The support of Ministers and Governors is needed to build the new focus and where appropriate to develop common responses to promote global financial stability.

1) COMPLETING THE JOB OF FIXING THE FAULT LINES IN THE GLOBAL SYSTEM

We are on track to complete the priorities agreed by Leaders at the St Petersburg summit. In three areas, completion of our ambitious targets for the Brisbane summit is largely assured:

Building more resilient financial institutions

- Large internationally active banks remain 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.
- The Basel Committee is to set out its plan to address excessive variability in risk-weighted asset calculations and will finalise the proposed Net Stable Funding Ratio, which is designed to improve the resilience of bank funding.

Transforming shadow banking into resilient market-based financing

- Minimum haircut standards to address financial stability risks associated with securities financing transactions have been developed. A further public consultation will take place on the extension of the application of numerical haircut floors to transactions between non-banks.
- The Basel Committee has finalised its supervisory framework for large exposures and risk-sensitive capital requirements for banks' investments in equity of funds.
- The roadmap agreed by Leaders at St Petersburg to strengthen the oversight and regulation of shadow banking has continued to be implemented. National authorities have moved towards monitoring and reporting shadow banking activities.
- IOSCO will report progress on implementation of recommendations regarding money market funds and incentive alignment schemes for securitisation.

Making derivatives markets safer

- Standard setters have completed the capital standards for treatment of banks' central counterparty exposures and will publish standards for the recovery and resolution of core financial market infrastructures.
- The FSB will publish its eighth detailed progress report on implementation of derivatives reforms and the OTC Derivatives Regulators Group will report on how it has addressed, or intends to address, cross-border implementation issues.

2) ENDING TOO BIG TO FAIL FOR THE BRISBANE SUMMIT

As the G20 Leaders directed, it is essential that systemically important institutions can be resolved in the event of failure without the need for taxpayer support, while at the same time avoiding disruption to the wider financial system.

Notwithstanding the substantial progress made in the areas detailed above, the integrity of the wider package of reforms rests on reaching agreement on proposals that will end too big to fail. These proposals, on which material progress has been made, but agreement has not yet been reached, are:

- a common standard for total loss absorbing capacity for globally systemic banks, and
- cross-border recognition of resolution actions regarding contractual stays.

Total loss-absorbing capacity requirement for global systemically-important banks (G-SIBs)

Leaders called on the FSB to develop proposals by the end of this year on the adequacy of global systemically important financial institutions' loss-absorbing capacity when they fail. Sufficient capacity to absorb losses, both before and in resolution, is vital for:

- home authorities to have the ability to resolve systemically important banks safely, while taking account of differences in national resolution regimes;
- host authorities to have confidence that systemically important banks can be resolved and therefore diminish any incentives to ring-fence bank assets domestically, and
- private markets to recognise that systemically important banks can be resolved without the use of public funds and therefore to remove the implicit public subsidy.

Substantial progress has been made in developing proposals to be delivered to the Brisbane Summit. At Cairns, the FSB will review the central element of the Brisbane package: a term sheet for a requirement for Total Loss Absorbing Capacity that would not be introduced before 2019 and would operate in parallel to the existing Basel capital requirements. The term sheet details:

- a range for the minimum pillar 1 requirement for the total amount of loss absorbing capacity a G-SIB must hold at all times;
- criteria that liabilities must meet in order to be considered loss-absorbing without disrupting the provision of critical functions or being subject to legal and compensation risk, and
- the distribution of loss absorbing capacity within G-SIB banking groups across home and hosted entities and the allocation of responsibilities between home and host authorities.

The term sheet reflects differences in national resolution regimes and banking system structures, including recognition that emerging market banking systems may not immediately meet the same standards as applied to advanced economies, and that credible, reliable and legally permissible commitments to provide resolution funding may count towards a limited fraction of the requirement.

FSB members will require the support of Ministers and Governors to agree these proposals to go forward to the Brisbane summit. The proposals will then be issued for consultation and quantitative impact study and will be finalised in 2015.

Cross-border resolution actions

For the resolution of cross-border banks to be credible, resolution actions undertaken in one jurisdiction must be able to be recognised by other jurisdictions in which the resolved institution operates. This includes the need for cross-border recognition of stays or temporary suspensions on termination rights in financial contracts (e.g. derivatives) when a firm enters resolution, and of the write-down or conversion of debt issued under foreign law through a bail-in power.

Through engagement with the financial industry, the FSB is working to establish contractual mechanisms to allow for the cross-border application of a stay on termination rights in financial contracts and the write-down or conversion of debt issued under foreign law.

Progress has been made by FSB members working alongside ISDA (the International Swaps and Derivatives Association) but finalisation for the Brisbane summit is not assured. It will require the commitment of Ministers and Governors to deliver, on schedule, the objectives of:

- A new derivative contractual Master Agreement and its adoption by systemically important banks;

- Commitments from national authorities to put in place regulatory requirements for the use of the revised Master Agreement, and
- Commitments from national authorities to establish clear statutory mechanisms to support the recognition of resolution actions on a cross-border basis.

Measures to end too-big-to-fail in institutions other than G-SIBs

Progress has continued to be made in ending the too big to fail problem across other types of financial institution. By the Brisbane Summit and end-2014 respectively:

- the International Association of Insurance Supervisors will present a Basic Capital Requirement on which higher loss absorbency for globally systemic insurers will be built, and
- the FSB, working with IOSCO, will refine methodologies for identifying global systemic firms that are neither banks nor insurance companies, taking account of comments received during the initial public consultation earlier this year.

3) REALISING FULLY THE BENEFITS OF AN OPEN, INTEGRATED GLOBAL SYSTEM

Subject to the important work that remains to be completed for the G20 summit, the FSB can now 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 global financial system.

An overall approach

To make that system as effective, efficient and consistent as possible, the commitment of Ministers and Governors is needed to embed co-operation, peer review and outcomes-based approaches to resolving cross-border issues, and to tackle spill-overs where they occur.

To assist the development of that approach, the FSB will make proposals to the Brisbane summit on the structure of its representation and inclusiveness of its working procedures, and will increase availability of information about its operations. Following a survey of FSB members, proposals are being developed that will:

- respond to the increasing integration of emerging markets in the global economy;
- ensure that our work is informed by the best expertise in national jurisdictions, and
- maintain the FSB's effectiveness as a decision-making body.

Co-operation and commitment to tackle spill-overs

A lack of mutual trust leads to concerns about spill-overs from failing cross-border institutions and can prompt jurisdictions to safeguard their markets unilaterally through such actions as ring-fencing, compulsory stand-alone subsidiarisation, or extra-territorial application of domestic rules.

These measures can be avoided only if Ministers and Governors commit to tackling spill-overs by applying global standards that build confidence in both the quality of cross-border supervision and the fair, predictable and smooth handling of failures of cross-border institutions.

Common global standards for globally systemic institutions must therefore be accompanied by commitments, supported by Ministers and Governors, to co-operation:

- through the Resolvability Assessment Process for each of the current 29 G-SIBs, and

- by empowering national authorities to work with counterparts in other countries, including by recognising foreign resolution actions.

We must also recognise that circumstances differ across jurisdictions, including in their stage of development and integration into the global economy. So it is not the case that all policies should be identical across all jurisdictions. For example, individual jurisdictions have planned or implemented tailored domestic banking reforms beyond international minimum standards. These measures can strengthen the resilience of domestic institutions and help to address the too big to fail problem. In that regard, they can support the building of a resilient global system and engender mutual trust.

However, tailored national measures have the potential to also impact on institutions and markets in other countries. To make the system as effective and consistent as possible, the support of Ministers and Governors is needed for strengthened cross-border information sharing to allow assessment of whether there are any adverse spill-overs of national regulatory policy initiatives. In 2015, this support will be needed, in particular, for the planned FSB peer review on national implementation of the high-level policy framework for shadow banking entities.

Peer review

Rigorous and transparent monitoring and peer reviews that assess whether countries are effectively implementing reforms are necessary for building resilience and mutual confidence. They also help to identify whether the measures are having their intended effects.

Ministers and Governors can reconfirm their commitment to address the issues identified in such reviews by correcting gaps and inconsistencies in implementation. Equally, we must be prepared to adjust policies where any material unintended impacts have been identified and to draw lessons from implementation to improve the regulatory framework where necessary.

Outcomes-based approaches to resolving cross-border issues

G20 Leaders agreed last year that jurisdictions and regulators should be able to defer to each other in the cross-border application of derivatives regulations. They could do so when justified by the quality of their respective regulations and enforcement regimes, assessed in a non-discriminatory way, based on similar outcomes.

Regulators of the majority of cross-border trading in derivatives continue to make progress in this area, which will help alleviate the reduction in market liquidity.

The continued support of Ministers and Governors is needed to further this work and to allow the more widespread adoption of flexible outcomes-based approaches to resolving cross-border market regulation issues.

4) ADJUSTING FOCUS TOWARDS NEW AND CONSTANTLY EVOLVING RISKS

As the fault lines that caused the crisis are addressed and an approach to regulation of the global system is embedded, the FSB will adjust focus, away from the post-crisis design of new standards for the core financial institutions and towards new and constantly evolving risks and vulnerabilities in the global financial system.

Many of these new risks could arise from outside the core of the system. The evolving nature of these risks means we need a flexible, adaptive approach. Sharing of data, analytics and policy

choices will be vital to allow national authorities to understand and react to new risks in a timely way.

The FSB, through the work of its Standing Committees for Assessment of Vulnerabilities and Supervisory and Regulatory Co-operation, provides a platform for authorities to assess market developments and respond when needed. This work will become increasingly important as authorities consider the macro-prudential risks associated with activity taking place outside traditional banking institutions, and the development of tools to address the risks associated with those activities.

The FSB is also taking actions to promote information sharing on shadow banking and on derivatives markets to ensure data can be efficiently and effectively used to monitor risks to global financial stability. The FSB has:

- agreed next steps in developing approaches to aggregating and sharing derivatives data amongst authorities, and
- instituted an information sharing process to support implementation of the policy framework for oversight and regulation of shadow banking entities.

The support of Ministers and Governors is needed to remove legal barriers that block the reporting of counterparty information on derivatives trades, including by changing laws where necessary, and to support authorities in sharing information, analysis and policy choices, most notably on shadow banking.

Looking across the financial system as a whole, the reforms and the strengthened global framework for cooperation mean that we will be in a better position to face new and evolving risks. Moving forward, we must continue to 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,

A handwritten signature in black ink, appearing to read 'M. Carney', with a large, sweeping flourish underneath.

Mark Carney