FINANCIAL
STABILITY
BOARD

THE CHAIRMAN

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To G20 Finance Ministers and Central Bank Governors

Financial Reforms – Progress on the Work Plan for the Antalya Summit

In February in Istanbul, we agreed the following priorities for the FSB's G20 financial regulation agenda:

- full, consistent and prompt implementation of agreed reforms;
- finalising the design of remaining post-crisis reforms; and
- addressing new risks and vulnerabilities.

Through these priorities, the FSB has been supporting the focus of the Turkish G20 Presidency on the three "I's" – Implementation, Investment and Inclusion.

This letter provides an update on our deliverables to Antalya Summit. Before reviewing them in detail, I would like to assess the FSB's progress against its overall objectives.

OBJECTIVES OF REFORM PROGRAMME

At the most recent FSB Plenary meeting, the membership stressed the importance of both grounding and assessing the progress of financial reform against the FSB's principal objectives:

- fixing the fault lines which caused the last crisis;
- building a more resilient and open global financial system; and
- deepening cooperation and building trust across our jurisdictions as we oversee and manage that system so that it can finance the investment and trade necessary to support strong, sustainable and balanced growth.

In my view, under the G20's guidance, the FSB is making considerable progress towards these objectives. Moreover, the functioning of the FSB promotes international cooperation. The FSB operates with a highly efficient, skilled but small (30 person) Secretariat. The FSB's core strength is its membership comprised of central bank governors, heads of regulatory authorities, directors of treasuries, heads of standard-setting bodies and senior leadership of international financial institutions. These individuals bring expertise and a sense of shared objectives, and they are working closely and effectively together to solve common problems. While discussions are sometimes challenging given the complex subject matter and tight timelines, the group has demonstrated a consistent ability to forge consensus and, as a consequence, to "own" the resulting reforms. This means not just a series of international standards but generally timely and comprehensive implementation of them across member jurisdictions. As a consequence, confidence in the increased resilience of the system and mutual trust and cooperation amongst authorities is building. In addition, through the peer review process as well as open and frank discussions about emerging vulnerabilities in the financial system, the membership is learning from each other and tailoring the application of these lessons to maximise effectiveness at home.

FULL, CONSISTENT AND PROMPT IMPLEMENTATION OF AGREED REFORMS

We are on track to deliver the first annual consolidated report on the implementation of the financial reforms and their effects, as we committed in Brisbane last year.

This will report both that all 24 FSB jurisdictions have Basel III risk-based capital rules in force and that final rules on liquidity (Liquidity Coverage Ratio) have been issued and are in force in almost all jurisdictions. However, consistency assessments by the Basel Committee indicate that more work is needed in some jurisdictions to align fully national implementation with the Basel framework. All large internationally active banks now meet the fully phased-in risk-based minimum capital requirements, including the global systemically important bank (G-SIB) surcharges as applicable, and 80% of these meet or exceed the fully phased-in minimum liquidity requirements.

The report will note that the G20 financial reforms have achieved a substantial strengthening of the resilience of the global banking system, and that banks have increased their capital ratios mainly through retained earnings rather than by cutting back on lending. The cost of financing, whether from banks or bond markets, has remained at generally low levels in recent years. The extended phase-in periods, coupled with exceptionally accommodative monetary policies and jurisdiction-specific circumstances, have contributed to this outcome.

International policy measures to end too-big-to-fail are also now largely complete for banks, but substantial work remains at national level to implement effective resolution regimes. And while all G-SIBs have recovery plans and cross-border crisis management groups, significant work remains to make their resolution strategies and plans fully operational. Implementation is even less advanced in the non-bank financial sectors.

Implementation of over-the-counter (OTC) derivatives reforms is underway but continues to be uneven and behind schedule. Trade reporting requirements are in place in almost all FSB jurisdictions, although authorities continue to report challenges on the quality and completeness of the reported data and their ability to access, use and aggregate it. About half of the FSB jurisdictions have central clearing frameworks in force that apply to substantially all of their market. Most jurisdictions are in the early stages of adopting margin requirements for non-centrally cleared derivatives, which will be phased-in between September 2016 and 2019.

With regard to the G20 shadow banking roadmap, monitoring frameworks have been adopted and progress is being made in implementing the policies agreed to address the major fault lines in shadow banking revealed by the crisis – for example, on money market funds and on incentive alignment approaches for securitisation. However, important steps remain to be taken to turn shadow banking into resilient market-based finance.

In the report, we will highlight three main areas that merit ongoing attention in terms of the effects of reforms:

- **Effects on EMDEs**. No major unintended consequences have been identified to date from the implementation of internationally agreed reforms in EMDEs. However, in some cases, EMDEs are affected by spill-overs from the implementation of reforms in the home jurisdictions of global financial institutions. The FSB with standard-setting bodies and international financial institutions will continue to monitor and report on the effects of agreed regulatory reforms on EMDEs.

- **Interaction of reforms on market liquidity.** There have been some concerns that the depth of liquidity in fixed-income markets has declined in recent years. However, the evidence of this is mixed, and the unsustainable excess liquidity which existed prior to the crisis should not be used as a baseline for comparison. The FSB and its members are analysing the causes and financial stability consequences of any shifts in market liquidity, including whether the interaction of individual regulatory measures may have unduly impacted it. The broader question is the interaction of these reforms with structural shifts in markets such as the rise of electronic and algorithmic trading, the fragmentation of trading venues, and the sharp increase in asset management.
- **Maintaining an open and integrated global financial system.** A retrenchment in international financial activity has been a common feature of past financial crises. Reforms have aimed to build a stronger and more resilient global financial system, while maintaining its open and integrated structure. While it is still too early to determine the full impact of reforms, the post-crisis evidence suggests that there has been some success in avoiding retrenchment and market fragmentation. The FSB and standard-setting bodies are working to maintain an open system by monitoring and reporting on the timely, full and consistent implementation of reforms and by developing approaches to deeper cross-border cooperation. It is critical that these efforts are supported to reach their full potential.

FINALISING THE REMAINING POST-CRISIS REFORMS

My letters in February and April set out our work this year on the international design of reforms in three areas: completion of the Basel III capital framework for banks; measures to help end too-big-to-fail; and initiatives to make derivatives markets safer. I reported in February on the actions being taken by the Basel Committee in the first of these areas, and will focus in this letter on the additional steps agreed in the second and third areas.

Ending too-big-to-fail

The FSB Plenary meeting at end-September settled the substance of changes to the term sheet that will define the new TLAC standard for G-SIBs, and agreed calibration levels and phase-in arrangements for the standard. I will outline these agreements at our meeting in Lima. This is a robust standard that has the support of the FSB members, and I am grateful for the past support and continued constructive engagement of Ministers and Governors in delivering this crucial standard for the Antalya Summit.

In addition, the International Association of Insurance Supervisors (IAIS) has published on 5 October the standard on higher loss absorbency requirements (HLA) for global systemically important insurers (G-SIIs). The HLA standard for G-SIIs will be revised before its implementation in 2019 to reflect further work by the IAIS on the assessment methodology for global systemically important insurers and insurance capital requirements.

We are progressing policy measures to extend the adoption of last year's ISDA Resolution Stay Protocol to a wider range of financial institutions as well as to broaden its scope beyond OTC derivatives to other financial contracts such as repo. Industry has been constructively engaged in work in this area, which will continue in 2016.

Work will carry on into next year on the new coordinated work plan to promote central counterparty (CCP) resilience, recovery planning and resolvability. The growing use of CCPs for standardised OTC derivatives transactions is reducing systemic risks overall – the work plan is designed to ensure that CCPs themselves are not too big to fail.

Making derivatives markets safer

As I reported in February, the G20 needs to ensure that the extensive work to date to introduce comprehensive trade reporting of OTC derivative markets is truly effective in providing authorities with an overview of systemic risks and reducing the opacity of these markets.

To that end, the FSB will shortly publish a peer review report that identifies where legal and other blockages to the reporting, sharing and aggregation of key information regarding trades need to be removed. The report will contain an agreed timeline for addressing these blockages and we will be reporting to the Summit specific jurisdictions in which action is required.

ADDRESSING NEW RISKS AND VULNERABILITIES

Following our meeting in Istanbul, the FSB has developed work programmes to address two specific emerging vulnerabilities: the growing importance of market-based finance and sharp rise in misconduct. We have also taken forward the G20's request in April that the FSB convene public- and private-sector participants to review how the financial sector can take account of climate-related issues.

Risks stemming from market-based finance

I reported in April and September on our work, in coordination with IOSCO, to identify risks associated with market liquidity and asset management activities in the current market conditions, as well as potential structural sources of vulnerability associated with asset management activities.

At the September FSB Plenary, we reviewed this work and called markets' attention to elevated near-term risks. In particular, the FSB encouraged the appropriate use of stress testing by funds to assess their ability individually and collectively to meet redemptions under difficult market liquidity conditions.

We also agreed to extend the FSB's regulatory framework for minimum securities financing haircuts to nonbank to nonbank transactions in order to provide a level playing field with bank to nonbank transactions and thereby close a potential future channel of regulatory arbitrage.

With regard to the longer-term work on asset management structural vulnerabilities, we are prioritising the following areas for further analysis and policy recommendations, as necessary, to be concluded in the first half of 2016:

- mismatch between liquidity of fund investments and redemption terms and conditions for fund units;
- leverage within investment funds;
- operational risk and challenges in transferring investment mandates in a stressed condition;
- securities lending activities of asset managers and funds; and
- potential vulnerabilities of pension funds and sovereign wealth funds.

Misconduct risks

As discussed in Istanbul, the scale of misconduct in some financial institutions has risen to a level that has the potential to create systemic risks.

To address misconduct risks, the FSB has agreed an action plan that is:

- examining whether the **reforms to incentives**, for instance to risk governance and compensation structures, are having sufficient effect on reducing misconduct and whether additional measures are needed;
- **reforming benchmarks** to reduce opportunities for market manipulation – for example, we have published reviews of progress in reforming benchmark-setting for interest rate and foreign exchange benchmarks, which identify further steps needed;
- assessing whether steps are needed to improve **global standards of conduct** in the fixed income, commodities and currency markets in order to increase individual accountability and support enforcement actions; work has also been taking place at national level to address these issues, including in the UK through its Fair and Effective Markets Review published in July; and
- working to assess the extent of **potential withdrawal from correspondent banking** and its implications for financial exclusion, and developing possible steps to address this issue; ahead of the Summit, the World Bank will publish the findings from its surveys of the reported decline in availability of correspondent banking and remittances services, and the Committee on Payments and Market Infrastructures will propose technical measures that might alleviate some of the concerns related to correspondent banking.

Climate change and the financial sector

In response to the request of G20 Finance Ministers and Central Bank Governors at their April meeting, the FSB held a public-private sector meeting in September to consider the implications of climate-related issues for the financial sector. The meeting provided an opportunity to exchange views on the existing work of the financial sector, authorities and standard setters in this area; the challenges they face; areas for possible further work; and the possible roles the FSB or others could play in taking that work forward.

The potential risks to the financial sector from climate change are complex, and the understanding of them is still at an early stage. The discussion identified three types of financial stability risks: **physical** risks (direct impacts on property or trade disruption), **liability** risks (which could arise if parties that have suffered damage seek compensation in the future from those they hold responsible) and **transition** risks (financial risks arising from the transition to a lower carbon economy). It is expected that all of these risks will grow with time. The discussions at the meeting frequently concentrated on the need for better information to improve understanding and analysis as well as to avoid an abrupt transition in financial markets.

Following this meeting, I have asked the FSB to consider whether to recommend that more be done to develop consistent, comparable, reliable, clear and efficient disclosures so as to better enable investors and the financial industry to assess the risks to asset values arising from climate events or the transition to a low carbon economy. One possible approach could be to establish an *industry-led* **disclosure task force**, to design and deliver voluntary standards for effective disclosures that meet the needs of investors and creditors. This would draw on the FSB's successful experience in catalysing a private sector initiative, the Enhanced Disclosure

Task Force, to improve substantially the relevance and effectiveness of the disclosure of major banking institutions.

CONCLUSION

Under Turkey's G20 leadership, the G20 will have taken further important steps to build a resilient, open, and trusted global financial system that supports the G20's ultimate objective of strong, sustainable and balanced growth for all countries.

Yours sincerely,

Mark Carney