FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

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To G20 Leaders

Building a resilient and open global financial system to support sustainable cross-border investment

The global financial system has been fundamentally strengthened by the G20 reforms to fix the fault lines that led to the global financial crisis – a crisis whose costs reached 25% of global GDP, tens of millions of lost jobs and a reduced confidence in open markets. With the Chinese Presidency, the G20 is now building on these efforts to create a resilient and open global financial system that supports sustainable cross-border investment and better serves the real economy.

This letter reports on progress and highlights the issues which demand the attention of Leaders. It makes four main points.

First, **the G20 reforms are working**. The system is providing more reliable financial services and has proven resilient in the face of recent shocks. As implementation progresses, the financial sector is increasingly absorbing shocks rather than amplifying them.

Second, **the financial system is changing to rely more on markets and less on banks**. This is a major positive development but one that also raises new vulnerabilities. As a consequence, the support of Leaders will be needed to build on the substantial progress to promote resilient market-based finance and develop robust financial market infrastructure.

Third, **the ongoing support of G20 Leaders is required to implement reforms fully, consistently and promptly**. Our second Annual Report to the Summit describes progress, the effects of reforms and areas meriting ongoing attention. In particular, it underscores that continued focus is necessary to implement critical measures to end Too Big to Fail, to make derivatives markets safer, and to transform shadow banking into resilient market-based finance.

Fourth, **developments in recent years raise the importance of new measures to support a more resilient, inclusive globalisation built on sustainable cross-border investment**. These include initiatives to address the decline in correspondent banking relationships, improve climate-related financial disclosure, address financial sector misconduct and manage the financial stability implications of new financial technologies.

THE FINANCIAL SYSTEM HAS PROVEN RESILIENT IN THE FACE OF RECENT SHOCKS

The progress of financial reform has been demonstrated by the global financial system's ability to weather two recent spikes in uncertainty and risk aversion. The first, at the start of the year, was prompted by increased concerns over medium-term growth prospects for the world economy and worries that many banks needed to adjust their business models to the stronger international regulatory framework and the continuing low growth, low interest rate environment. The second episode arose from uncertainty over the implications of the UK's vote to leave the European Union.

In both cases, the global financial system continued to function effectively, dampening aftershocks from these events rather than amplifying them. This resilience in the face of adversity demonstrates the benefits of your commitment to the G20-led financial reforms.

Large financial institutions are now considerably stronger. For the largest global banks, common equity requirements are more than ten times higher than the pre-crisis standard. The new global standards require banks to hold much higher liquid asset buffers, to strengthen the capitalisation of their trading books, and to reduce and simplify the formerly complex web of interbank exposures. In response, banks have built higher and better quality capital and liquidity buffers. Banks are still adjusting their business models to challenging conditions and low market valuations persist for some of them.

Higher capital not only delivers a more stable banking system but also provides a platform for growth. As the experience this year demonstrates, better liquidity management helps banks remain active even in stressed conditions. And recent research finds that better capitalised banks are more likely to lend.[1]

These accomplishments, while considerable, must not lead to complacency. Recent events reinforce the importance of finishing the job of implementing the post-crisis reforms. At the same time, the G20 must address decisively new challenges and seize emerging opportunities in the post-crisis world. And our collective goal should be to build an open, global financial system which supports sustainable cross-border investment that benefits all.

To support the wider G20 agenda under the Chinese Presidency, the FSB's priorities for 2016 have been:

1. Advancing a coordinated programme of reforms to deliver resilient sources of market-based finance, including addressing structural vulnerabilities associated with asset management activities;
2. Developing robust financial market infrastructures, including enhancing the resilience, recovery and resolvability of central counterparties;
3. Supporting effective macroprudential arrangements, by drawing practical lessons from national experiences of using macroprudential policy frameworks and tools, working in partnership with the IMF and the BIS;
4. Pursuing the full, timely and consistent implementation of post-crisis reforms, while addressing any material unintended consequences;
5. Addressing new and emerging vulnerabilities in the financial system, including those associated with misconduct, correspondent banking and climate-related financial risks; and

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1 BIS research, for example, shows that bank equity is an important determinant of lending growth and a 1 percentage point increase in banks' equity-to-total assets ratios is associated with a 0.6 percentage point increase in annual loan growth. See Gambacorta, L & Shin, HS (2016), "Why bank capital matters for monetary policy", BIS Working Paper No. 558.

6. Monitoring the potentially systemic implications of financial technology innovations, and the systemic risks arising from operational disruptions.

BUILDING A RESILIENT AND OPEN GLOBAL FINANCIAL SYSTEM

1. Promoting resilient sources of market-based finance

Tackling the structural vulnerabilities of asset management activities has been a top priority for the FSB under the Chinese G20 Presidency. The financial system has changed markedly since the crisis. Funding raised through capital markets and the total assets managed by asset managers on behalf of investors have both grown significantly. This is particularly true for emerging market economies, which have tripled their net annual issuance of international bonds compared to the five years before the crisis to an annual average of almost $300 billion over the past five years.

These developments have been positive overall. The growth of asset management is creating new sources of funding and investment, promoting international flows of capital, reducing reliance on bank-based finance and adding welcome diversity to the financial system.

If, however, capital flows are to be sustained without the risks of damaging ‘sudden stops’, then structural vulnerabilities associated with asset management activities must be addressed. This is particularly important for emerging market economies which have in the past suffered when factors such as high volatility, divergent monetary policies or investors’ reassessment of economic risks have led to sudden reversals of capital flows.

A major milestone was achieved in June when the FSB published for consultation a set of proposals to address the financial stability risks posed by asset management activities. These recommendations, which address liquidity mismatches and leverage within funds, operational risks in transferring client accounts and the securities lending activities of asset managers, will help promote sustainable growth of capital flows across the entire G20, and in the process further the G20’s long-term goals for infrastructure and green investment.

- **The FSB recommendations will be finalised by the end of 2016** and reported to the German G20 Presidency. The International Organization of Securities Commissions (IOSCO) is expected to operationalise the recommendations on funds’ liquidity mismatch by end-2017 and develop simple and consistent measure(s) of leverage by end-2018.

The FSB is also working to ensure that markets can function well under pressure and not be undermined by illiquidity or fragmentation. To this end, the FSB has studied the degree and causes of changes in bond market liquidity in recent years. To date, there is limited evidence of a broad deterioration in market liquidity in normal times, although there is some evidence of reduced depth in certain sovereign and corporate bond markets. We will therefore further analyse the implications of these developments for market resilience under stressed conditions.

- **By the early part of the German G20 Presidency,** the FSB will report further findings on market depth and funding liquidity. These will include the results of a cross-jurisdiction study by the Committee on the Global Financial System of developments in repo markets, given the importance of these financing markets for overall market liquidity.

As part of the FSB's commitment under the G20 Shadow Banking roadmap, we have published a peer review on members' implementation of the FSB Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities. To support FSB risk assessments and policy discussions, the review made recommendations for further sharing of information among member authorities on policy tools and public disclosures. While progress has been made, more work is needed by the FSB and member jurisdictions to assess and respond comprehensively to potential financial stability risks associated with shadow banking.

Support from G20 Leaders is needed to complete this work to ensure market-based finance develops fully into a resilient source of finance for strong, sustainable and balanced growth.

2. Developing robust financial market infrastructures

Resilient markets that support investment and growth must be underpinned by robust financial market infrastructures, particularly central counterparties (CCPs). Under the Chinese Presidency, there have been major steps forward in policies to enhance the resilience, recovery and resolvability of CCPs.

Greater reliance on CCPs has been a central element of G20 financial reforms from the outset. This strategy has made banks less systemic and the massive OTC derivatives markets more resilient. In parallel, CCPs support the growth of more sustainable market-based finance and cross-border capital flows.

Greater use of CCPs in OTC derivative markets is already reducing risks in the financial system by replacing the complex, opaque and fragile web of ties between banks with simple, transparent and robust links between a resilient CCP and its member banks. CCPs are tightly regulated and directly overseen by authorities. Since CCPs are themselves systemic, the FSB, the Committee on Payments and Market Infrastructures (CPMI) and IOSCO are working to strengthen CCP resilience, including improving their ability to recover after shocks (such as the failure of member banks) and promoting their resolvability without the use of public funds in the event that recovery efforts fail. Underpinning these efforts is another exercise to identify and quantify interdependencies between central clearing and banking systems.

To these ends, CPMI-IOSCO have this month issued for consultation further guidance regarding CCP resilience and recovery planning, and the FSB is now consulting on essential aspects of CCP resolution planning.

- **In early 2017**, the FSB will issue for public consultation more granular guidance on CCP resolution planning, strategies and tools. These will be finalised by the time of the 2017 G20 Summit.

To secure the advances made under the Chinese Presidency, strong support from Leaders will be needed to provide the momentum to strengthen further CCPs' resilience, recovery and resolvability in order to achieve a lasting transformation of derivatives markets and financial markets more generally.

3. Supporting effective macroprudential frameworks and policies

One of the lessons of the crisis is the need to identify the build-up of system-wide financial vulnerabilities and develop the appropriate tools to mitigate them more effectively.

Macroprudential policy frameworks and tools aim to limit systemic risks that could otherwise disrupt the provision of financial services and thereby damage the real economy. Such risks may build up over the financial cycle or arise structurally from the interconnectedness and distribution of risk within the financial system.

Experience with macroprudential policy across advanced and emerging economies is growing. With the strong support of the Chinese Presidency, the FSB, the IMF and BIS have taken stock of the experiences that jurisdictions have gained thus far with policy tools and frameworks.

This work has shown that introducing an effective macroprudential component to the regulatory framework requires deep cooperation and coordination among domestic policymakers. There is no "one-size-fits-all" approach – institutional arrangements need to suit country-specific circumstances and institutional backgrounds. However, existing arrangements suggest that a clear mandate forms the basis of the assignment of responsibility for taking macroprudential policy decisions. Many countries have assigned the main mandate and adequate powers, matched with strong accountability, to a body able to take a broad view of the entire financial system.

The experiences set out in the FSB-IMF-BIS report can help inform all G20 jurisdictions in the development of effective macroprudential policies and provide helpful references and inputs to jurisdictions seeking to improve domestic macroprudential management.

4. Full, timely and consistent implementation of post-crisis financial reforms

Full, timely and consistent implementation of G20 agreed reforms is essential in order to deliver a financial system that better supports job creation and growth in the short, medium and long term.

The FSB's second Annual Report to G20 Leaders shows steady progress in implementing agreed reforms. The Report provides more detail on the effects of the reforms to date, including the strengthened resilience of the core banking system and resumption of credit growth.

The report also explains how the FSB is deepening our framework for evaluating the effectiveness of reforms, while remaining alert to material unintended consequences and standing ready to adjust policies when merited. In particular, work is underway to evaluate whether the reforms taken together are having their intended effects on the financial system and the broader economy. The FSB also continues to monitor carefully the effects of reforms on EMDEs and to follow up on how jurisdictions at differing stages of market development are facing and can resolve implementation challenges.

The Report calls for Leaders' continued support to address remaining gaps and inconsistencies in the core reform areas, as well as to overcome legal and operational obstacles to implementation.

With the agreements reached in recent years, including the Basel III framework and the Total Loss-Absorbing Capacity standard for global systemically important banks, the overall international regulatory and resolution framework for banks is now largely settled. The FSB, the Basel Committee and national authorities will continue to work to provide maximum clarity about the details of the framework, to instil confidence about the stability of overall requirements, and to deliver transparency about the extent to which member jurisdictions and financial institutions meet them.

- **By early 2017**, the Basel Committee will finalise the Basel III framework to ensure its coherence and maximise its effectiveness. In doing so, the Basel Committee is committed to not significantly increasing overall capital requirements across the banking sector.

Further steps have also been taken on reforms in other areas. In June, the International Association of Insurance Supervisors (IAIS) published its updated Assessment Methodology for global systemically important insurers (G-SIIs).

- **By end-2016**, the FSB will publish its annual update to the lists of global systemically important financial institutions (G-SIFIs).

Implementation of G20 reforms to over-the-counter derivatives markets is well underway, including in the largest derivatives markets, though it remains behind schedule in some jurisdictions. Implementation is most advanced for trade reporting and for higher capital requirements for non-centrally cleared derivatives. Central clearing frameworks have been or are being implemented in many jurisdictions. In addition, jurisdictions are awaiting the completion of the global CCP recovery and resolution guidance referenced above.

In contrast, platform trading frameworks that expand price transparency are relatively undeveloped in most jurisdictions. In addition, margin requirements for non-centrally cleared derivatives will be in force in only three jurisdictions by the first phase of the agreed implementation schedule in September 2016. Moreover, around half of the FSB jurisdictions do not appear on track to implement variation margin requirements in accordance with the final phase in March 2017. These are important shortcomings in a market that played a destabilising role in the financial crisis and that remains of very considerable size. We therefore call on G20 Leaders to recommit to implementing the existing agreements as soon as possible.

- **In our third Annual Report to G20 Leaders in June 2017** on implementation and effects of G20 financial reforms, the FSB will comprehensively review members' implementation of reforms to derivatives markets as well as review holistically whether the package of reforms have put the right incentives and protections in place.

- The FSB has published member jurisdictions' plans to meet their commitments to remove legal and regulatory barriers to the reporting of OTC derivatives to trade repositories and to authorities' access to data by mid-2018.

Leaders' continued support will be important to ensure that the needed legal changes are made to achieve the goal of transparent trade reporting, and to undertake the comprehensive review of the implementation and effects of derivatives market reforms to ensure that the G20's objectives are achieved.

OTHER FSB PRIORITIES

5. Addressing new and emerging vulnerabilities

Misconduct risks

In recent years, the incidence of financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets.

In response, the FSB, with other standard-setters, is pursuing a major work programme to address these risks. The work includes:

- Studying financial institutions' governance frameworks for addressing misconduct and then potentially developing a supervisory toolkit or guidance to strengthen these;
- Examining the effectiveness of firms' compensation structures in discouraging misconduct;
- Examining whether steps are needed to improve standards of conduct in fixed income, currency and commodity markets in order to increase individual accountability and support enforcement actions; and
- Coordinating reforms to major financial benchmarks to reduce opportunities for market manipulation. In May, the BIS released the first phase of a Global Code of Conduct for the Foreign Exchange Market.

- **In the first half of 2017**, the FSB will issue a report drawing together actions taken and recommendations to reduce misconduct in the financial sector.

Correspondent banking

Consistent with the Chinese G20 Presidency's emphasis on financial inclusion, G20 Leaders can reinforce the FSB's coordinated Action Plan to address the decline in correspondent banking.

The FSB's Action Plan focuses on:

- Developing a more accurate understanding of where declines may be occurring and a focused policy response is needed;
- Clarifying regulatory expectations of correspondent banks, particularly through upcoming Financial Action Task Force and Basel Committee on Banking Supervision guidance;
- Building capacity for stronger domestic regulatory frameworks that support the prevention of financial crime, including encouraging sufficient resources for technical assistance by the International Financial Institutions; and
- Developing stronger tools for client due diligence, including recommendations published by the CPMI in July.

Taken together, these steps should help address the current trends in withdrawal of correspondent banking relationships, which, if left unchecked, may result in some countries or classes of customers becoming excluded from the global financial system. Joint action by the public and private sectors is needed to preserve inclusion, trade and openness.

- **By end-2016,** the FSB will report in detail on progress made under its coordinated Action Plan and recommended next steps.

Task Force on Climate-related Financial Disclosures

Access to higher quality information on climate-related financial risks will allow market participants to understand and manage these risks better through time. Early understanding will promote a smooth, rather than abrupt, market re-pricing of those risks, while providing a timely perspective on the effectiveness of climate-related policies.

In response to Leaders' request to engage with the private sector on these issues, the FSB convened in January an industry-led Task Force chaired by Michael Bloomberg on Climate-related Financial Disclosure to develop voluntary, consistent climate-related financial disclosures for use by companies. In April the Task Force issued its Phase 1 report, setting out fundamental principles of effective, relevant disclosure in this area and defining the scope and objectives of the next phase of the Task Force's work. Our work in this area has benefited greatly from the support and encouragement of the Chinese Presidency.

- **By end-2016**, the Task Force will publish for public consultation specific recommendations and leading practices for climate-related financial risk disclosures.

6. Financial stability implications of financial technology

Rapid technological innovation has the potential to transform the financial system. The regulatory framework must keep pace to manage any systemic risks that may arise without stifling innovation. The FSB has agreed a framework for categorising the innovations and their potential financial stability implications, and we are now analysing specific applications together with the standard-setting bodies.

- **By early 2017**, the FSB and the standard-setting bodies will report on the financial technology case studies underway and highlight regulatory issues that merit policy attention.

CONCLUSION

Events this year have shown that the work to fix the fault lines that led to the Financial Crisis is paying off and is now helping to support strong, sustainable and balanced growth. Thanks to your commitment to rigorous implementation of G20 reforms, the financial sector is now more likely to dampen shocks rather than amplify them.

Under the Chinese Presidency, substantial progress has been made towards promoting resilient market-based finance, developing robust financial market infrastructure and enhancing our understanding of effective macroprudential frameworks.

Our collective priorities must be to implement our past agreements in a full, timely and consistent manner; to address new risks and vulnerabilities; and to continue to build an open global financial system that benefits all.

We welcome your direction and look forward to building on this progress under the German Presidency.

Yours sincerely,

Mark Carney