19 April 2010

To G20 Ministers and Governors

Progress on the global regulatory reform agenda

I am pleased to attach the following reports for the meeting on 23 April:

- A report on progress in implementing the G20 regulatory reform objectives, covering international policy development and national implementation;
- A peer review assessment of implementation of the FSB compensation principles and standards;
- A joint FSB-IMF-BCBS comparative note on capital and liquidity surcharges, and systemic levies and taxes.

Also attached is a note on competitive conditions in the financial sector, requested at St Andrews.

The G20 have achieved much over the last year and a half to stabilise the financial system. Exit from exceptional support is underway, and completed in some cases. Credit conditions in the countries at the heart of the crisis have begun to normalise and loan growth has resumed. In other G20 countries, policy is appropriately directed at restraining buoyant credit growth. There are, to be sure, challenges of adjustment ahead, but on the whole the financial system is on the mend.

Good progress continues to be made on regulatory reform. International policy development is proceeding to agreed timelines. Where policies have been completed, implementation at national level is taking place across a broad front, as the attached reports show. Legislative changes necessary to implement new regulatory objectives are advancing in the major jurisdictions.

Yet, 2010 and 2011 will be critical years for the most important pieces of global reform and will largely determine whether we meet the reform objectives and timelines agreed by G20 Leaders.

Capital and liquidity reforms

First and foremost, we must complete the revamp of the Basel capital framework and the liquidity standard, including the introduction of a leverage ratio and measures such as forward looking provisioning and countercyclical buffers that address the problems of procyclicality that we have seen in this crisis. Comprehensive impact assessments of the

December capital and liquidity proposals are now underway to calibrate the new framework. It will be essential that the calibration is focused not on current strained conditions but on the long-term required minimum standards for capital and liquidity buffers to ensure balanced, sustainable banking in the future.

Alongside this, we will design transition and grandfathering arrangements that ensure that implementation does not have an adverse macroeconomic impact. The FSB and the Basel Committee on Banking Supervision (BCBS), in collaboration with the IMF, are jointly assessing the macroeconomic implications of the implementation of the reform proposals in order to inform the phase-in and implementation horizon.

Preliminary results on all assessment streams will be available in June/July. Calibration work will continue into the fall, and the key features of the calibrated framework, along with the transition arrangements, will be ready by the G20 Summit in November.

Too Big to Fail

We are assessing a broad spectrum of potential reforms to reduce the moral hazard associated with systemically important financial institutions. One focus of our work is to provide supervisors with tools to reduce the probability and impact of failure of a systemically important financial institution. Two essential complements are the establishment of effective resolution frameworks nationally, together with adequate co-ordination of these frameworks across borders, and improvements to financial infrastructure that reduce contagion risks, notably in the over-the-counter (OTC) derivatives market. Where systemically important institutions are not effectively resolvable, it will strengthen the case for measures such as raising capital surcharges or other requirements to a point where the likelihood and impact of default is reduced to a very low level, or restrictions on activities/size/structure that make them resolvable.

One-size-fits-all solutions are unlikely to be appropriate for all "too big to fail" (TBTF) firms and all financial systems. However, to reduce systemic risks globally, we will need standards for TBTF firms that set a common floor, and actions across countries that are sufficiently coordinated to avoid regulatory arbitrage. We will present a shortlist of likely policy options to the G20 Summit in June and a final package of recommendations to the November Summit.

Cumulative impact of reforms

It will be important to consider how possible capital or liquidity surcharges on the one hand, and financial levies or taxes on the other, might interact, bearing in mind that these measures should not be regarded as alternatives. They can act as complements, with surcharges reducing the probability and impact of failures, and levies helping to recoup the resolution costs to the government when failures occur. Neither surcharges nor levies substitute for the key priority of strengthening capital and liquidity requirements in the wider banking system through implementation of the Basel proposals. Their contribution to the cumulative impact of reforms should therefore be assessed on the basis that they will be additional to the necessary Basel capital and liquidity reforms. In the case of cross-border firms, the different implications of such measures for home and host jurisdictions need to be carefully considered. The attached report from the FSB, IMF and BCBS addresses this issue in more detail. Impact assessments will be important for the correct calibration of these additional measures.

The cumulative impact on the system of the above proposed reforms will need to be carefully considered, in order to lessen the risk of unintended consequences and to counter financial industry claims that the reforms could derail the economic and financial recovery.

Over-the-Counter Derivatives Regulation and Market Infrastructure

We must substantially advance reforms this year to regulate, make transparent and centrally clear a substantial portion of the OTC derivatives markets, and so reduce their scope to act as channels of contagion. Legislation is advancing in the US, EU and Japan to establish the requisite frameworks for this. We need to avoid inconsistencies across jurisdictions in areas such as which derivatives products can and should be standardised and subject to a central clearing requirement, and in exemptions for end-users. At the same time, we must work to avoid an outcome where standardised contracts are cleared but the cleared contracts represent only a very small percentage of the overall marketplace. We have therefore established a broad-based working group to report by October policy options to increase the standardisation of OTC derivatives and to develop a clear process to implement consistently mandatory clearing and exchange or electronic trading requirements at the global level.

Securitisation

Restarting securitisation on a sound basis remains a priority to facilitate the supply of credit to the real economy while strengthening banks' funding sources. Regulatory and legislative actions have been taken to address deficiencies in the market. But these have yet to encourage resumption of securitisation with genuine economic value, in part because the investor base remains decimated. The FSB will be examining what further actions could be taken in areas such as transparency, disclosure and the alignment of incentives, and also whether there are any steps that could help to encourage the return of a suitable, well-regulated investor base.

Compensation

The FSB's peer review report shows that significant progress has been made in incorporating the FSB Principles and Standards into domestic regulatory and supervisory frameworks. There is evidence that compensation structures in the major financial firms are changing in response. But full national implementation is far from complete, and authorities will need to exert pressure on firms to maintain the momentum of compensation reforms through 2010 and beyond. We recommend additional measures in our report and supervisors must make sure that these additional measures are put in place.

When later this year the new targets for capital requirements are established, supervisors will be in a better position to use their powers to restrain compensation to enable capital to be built up. We will undertake a more detailed follow-up review in the second quarter of 2011.

Strengthening accounting standards

We have seen further progress in some areas in improving accounting standards. The International Accounting Standards Board (IASB) has finalised a standard on classification and measurement of financial assets that requires certain loans and investments in debt securities to be reported at amortised cost; and has proposed a forward-looking, expected loss provisioning approach. On the latter, there has been constructive co-operation between accounting standard setters and prudential authorities.

Adoption of the IASB's International Financial Reporting Standards (IFRS) is widening globally. And the IASB and the US Financial Accounting Standards Board (FASB) have greatly intensified their convergence efforts. However, there is a very material risk that the two standard setters may end up with large divergences in accounting for financial instruments. We will continue our dialogue with standard setters to achieve the G20 objectives of improved, converged standards that will enhance the quality of financial reporting while diminishing procyclicality.

The detailed report on progress that I have attached provides further information on these, as well as other, important areas for reform, including improving adherence to international cooperation and information exchange standards in the financial regulatory and supervisory area.

In closing, let me reiterate that 2010 and 2011 are critical years for the reform process. The G20's support will be vital for the difficult decisions to be made and for timely implementation. I look forward to discussing the challenges ahead at our meeting on Friday 23 April.

Yours sincerely,

Mario Draghi