

To G20 Leaders

Financial Regulatory Reforms – Progress and Next Steps

The FSB and its members have continued to make good progress on developing and implementing the broad programme of financial reforms mandated by the G20.

Since Cannes, the focus on timely, full and consistent implementation of major reforms has increased. Detailed reviews of progress in implementing Basel III, compensation standards and OTC derivatives reforms have been submitted for this Summit. We have formalised these reviews within a coordination framework that leverages the expertise and resources of the standard setting bodies.

Los Cabos marks the delivery of internationally agreed measures to launch a global Legal Entity Identifier System to begin operation on a self-standing basis by March 2013, and to enhance the governance and effectiveness of the FSB. We have also made substantial progress on reforming derivatives markets; extending the framework for systemically important financial institutions to domestic banks and global insurance companies; and preparing an integrated set of recommendations for more effective oversight and regulation of the shadow banking system.

While much has been accomplished, what is still to come is just as important. Ending Too-Big-To-Fail requires the full implementation of agreed measures, including legislative changes in many jurisdictions and a marked step-up in resolution planning and cooperation. Further complex reforms to derivatives markets still need to be agreed and implemented in full in order to put these massive markets on a sound footing. The shadow banking sector needs to be converted from a source of vulnerabilities to a force for competition and systemic resilience.

As previous G20 Summits have emphasised, a focus on full and consistent implementation is essential to preserve the advantages of an open and globally integrated financial system. Market participants and authorities need to have confidence in the strength of financial institutions and markets in other countries. Recent experience demonstrates that when mutual confidence is lost the retreat from an open and integrated system can occur rapidly. A return to a nationally segmented global financial system would reduce both financial capacity and systemic resilience, with major consequences for jobs and growth across our economies. We must work to avoid this.

Ultimately, implementation is the responsibility of your jurisdictions. Your continued determination to timely implementation of your commitments will be essential to building needed confidence and trust in the global financial system in order for it to function effectively and support the global recovery.

Current Macro-Financial Environment

Although risks to financial stability are elevated and the macro-economic environment is challenging, large parts of the financial system are sounder than they were before the crisis. The quantity and quality of banks' capital has improved and continues to improve; funding structures have become more robust; and the excessive leverage that built up before the crisis is being unwound. For example, since 2008, large European, Japanese and US banks have, on average, raised their common-equity-to-total-assets ratio by 25%.

But the system is still not as strong as it needs to be. The pace of repair in those economies and across institutions most affected by the financial crisis has been uneven. As a result, confidence remains fragile, creating headwinds for growth as well as reforms. Given the weakness of the global economic recovery it is understandable that the impact of financial reforms on economic growth is receiving attention. Is financial reform part of the problem? Or part of the solution?

The evidence is clear. Measures to strengthen financial stability support economic growth and create jobs rather than hold them back, even in the short term. Credit growth has resumed in those countries where financial institutions have decisively strengthened their balance sheets. Banks that have raised capital are reaping the benefits of greater access to and lower costs of market funding. This can then be passed on to customers and support economic growth. These banks are also in a stronger position to increase cross-border provision of services and to take up business opportunities that arise from the retrenchment of others. In contrast, inadequately capitalised financial institutions are contributing to increased funding costs for sovereigns and diverting scarce resources from measures to increase jobs and growth.

So there are no grounds for delays in implementing financial reforms, which would only risk prolonging market uncertainty, constraining the overall financing capacity of the system, and reducing resources for business investment and job creation.

Timely, Full and Consistent Implementation

For these reasons, the FSB will maintain a clear focus on ensuring that the financial reform commitments that have already been made are implemented in a robust and effective manner to agreed timelines. The FSB, working with the standard-setting bodies, is already closely monitoring and reporting to you on the implementation of the agreed financial reforms. We have enhanced this process, through a new Coordination Framework for Implementation Monitoring. We have sent to the Summit detailed implementation monitoring reports on Basel II.5 and III, OTC derivatives reforms, and compensation practices. These focus on adoption into national regulation of international agreements. Over time, the monitoring will focus increasingly on effectiveness of implementation.

Impact of Reforms on Emerging Market and Developing Economies

As we implement measures, it is important to monitor the impact of global financial reforms on different countries and regions. As requested by G20 Finance Ministers and Central Bank Governors, the FSB, in cooperation with the IMF and World Bank, has conducted a study of the effects of regulatory reforms on emerging market and developing economies (EMDEs),

including potential unintended consequences. While the study confirmed widespread support for international regulatory reforms underway, there are a range of views on the extent to which the reforms are having, or expected to have, an impact on some EMDE financial systems. The priority issues raised in the study are currently being addressed through the work programmes of the standard setting bodies and the FSB.

This exercise highlights the importance of monitoring cross-border spill-overs and of ongoing dialogue and cooperation between the national authorities, the standard setting bodies, and international financial institutions as reforms are implemented. Authorities need to continue to ensure that the reform package represents a mutually reinforcing, coherent whole. This coordination role is fundamental to the responsibilities of the FSB.

Building Resilient Financial Institutions

Achieving a stronger banking system is our overriding priority; hence the importance assigned to full implementation of Basel II.5 and III capital and liquidity standards. As the Basel Committee report sent to you notes, 20 of 27 BCBS member jurisdictions had issued draft or final Basel III regulations by end-May. Since then, the US has also issued draft Basel III rules. The majority of the remaining member countries believe they can issue final regulations by the implementation deadline.

As noted, banks are strengthening their capital base. Using the new more stringent definition of capital, the average common equity Tier 1 capital ratio (CET1) of large internationally active banks was 7.1% in 2011. For smaller banks, the average CET1 ratio stood at 8.3%. For all large banks to reach by January 2019 the 7% target for CET1 and the surcharge for global systemically important banks (G-SIBs), they need to raise over the six-year implementation horizon capital in an amount equal to 1.5 times their aggregate profits last year, after tax and before distributions. Thus, although there is considerable variation across banks, the industry in aggregate has the capacity to meet the new capital adequacy targets through earnings retention over the transition period.

Work is continuing to strengthen risk management practices through increased supervisory enhancements to risk disclosures. Across the FSB member jurisdictions, supervisory expectations for risk governance at financial institutions have increased, particularly for SIFIs. The capital treatment of banks' trading books is also under fundamental review to reduce materially the scope for regulatory arbitrage between the banking and trading books and to replace value-at-risk with an exposure measure that better captures tail risk.

Ending Too-Big-To-Fail

As you have directed at prior Summits, it is essential that G-SIBs can be resolved in the event of future failure without the need for taxpayer support while at the same time avoiding disruption to the wider financial system. To this end, encouraging progress has been made by major jurisdictions to put in place or propose legislation to establish effective resolution regimes. In addition, cross-border crisis management groups have been established for 24 of the 29 G-SIBs identified in November 2011. However, much work is needed to develop by end-2012 the resolution strategies and plans, and cross-border co-operation agreements, to ensure the resolvability of these G-SIBs. Attention to these issues at the top level is required.

The framework for systemic institutions is now being extended to domestic banks, global insurers, and key shadow banks. When implemented, robust resolution regimes, greater supervisory intensity and higher loss absorbency will ensure that the system is not beholden to the fate of one firm or group of firms.

Last month, the IAIS issued proposals for public consultation on extending the framework for systemically important financial institutions to cover global insurers, and the Basel Committee will issue this summer for consultation a common minimum framework for the identification and regulation of domestic systemically important banks. Such a principles-based framework would allow for an appropriate degree of national discretion in identification and in the application of policy tools, recognising the different structural characteristics of national financial systems.

This crisis has underscored the importance of effective contingency planning and open cross-border dialogue between authorities. Lack of information can quickly lead to uncoordinated measures to the detriment of all. Under the auspices of the FSB, central banks, supervisors and treasuries are maintaining close dialogue and cooperation during this period of heightened uncertainty.

Strengthening the Oversight and Regulation of Shadow Banking

We must ensure that shadow banking does not pose systemic risks but instead is a source of resilience and diversification. In April, the FSB presented to finance ministers and central bank governors a detailed progress report on the work underway to achieve this goal. Our focus is two-fold: to put in place a monitoring framework to better understand and trace risks in this part of the financial system, and to develop regulatory measures to reduce the systemic risks. These measures will aim to mitigate the spill-overs between the regular banking system and the shadow banking system; reduce the susceptibility of money market funds and other shadow banking entities to runs; better align the incentives associated with securitisation; and dampen risks and pro-cyclical incentives associated with securities lending and repo activities. We will need to assess the overall impact of all of these measures on collateral markets and the functioning of the system, but remain on-track for an initial integrated set of recommendations by year-end.

Creating Continuous Core Markets

Our financial systems depend on the continuous functioning of core financial markets. Delivering this requires substantial changes to infrastructure, supervision and regulation. The principal focus here is reforms to OTC derivatives markets, where the G20 has established clear objectives for implementation by end-2012.

Good progress in advancing national legislation and regulation and practical implementation of reforms to market infrastructures has been made by the jurisdictions with the largest OTC derivatives markets, including the US, EU and Japan. Encouraging progress has also been made in agreeing international policies that are keys to advancing OTC derivatives reform implementation across jurisdictions. These include important safeguards to help establish a resilient and efficient global framework for clearing derivatives. As a consequence, all jurisdictions now have sufficient information about international standards and policies to put

in place the needed domestic legislation and regulation, and will need to aggressively push ahead to achieve full implementation by end-2012 to meet the G20 commitments in as many reform areas as possible.

In response to your request at Cannes, we have developed for your endorsement at Los Cabos recommendations for the establishment of a global Legal Entity Identifier (LEI) system that will provide unique identifiers for all entities participating in financial markets. Such a system will materially enhance the management of counterparty risk and collateral at financial institutions and authorities' ability to trace risk in the system. The proposals set out the objectives of the LEI, the global governance arrangements to protect the public interest, as well as the steps to implement and begin operating the system on a self-standing basis by March 2013.

Strengthening the Capacity, Resources and Governance of the FSB

Finally, in response to your requests at the Cannes Summit, the FSB has taken major steps to strengthen its capacity, resources and governance. First, the membership of the Steering Committee has been broadened and made more representative. Second, the FSB is pleased to deliver substantial, detailed proposals that will put it on an enduring organisational footing, with legal personality and greater financial autonomy, while maintaining the existing strong links with the Bank for International Settlements. The close nexus between the FSB and the G20 has been essential to our ability to drive forward the reform agenda. This nexus is reinforced in the revised FSB Charter which is now presented to you as part of the proposals for endorsement.

Yours sincerely,

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

Mark Carney

Attachments:

- Recommendations for the establishment of a global [Legal Entity Identifier](#) system for financial markets
- Recommendations for strengthening [FSB Capacity, Resources and Governance](#), and revised Charter of the FSB