FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

12 February 2013

To G20 Ministers and Central Bank Governors

Progress of Financial Regulatory Reforms

Financial market conditions have improved over recent months. Nonetheless, medium-term downside risks remain, given weak growth prospects and high levels of public and private sector debt in many economies.

The recent improvement in financial market conditions owes much to central bank actions, in particular, the accommodative monetary policy aimed at stimulating the economic recovery. As a consequence, market participants' appetite for risk has increased, but this has not yet translated into a robust recovery in real investment.

The beginning of the return of risk appetite to financial markets – while intended and welcome – raises a number of issues. First, market participants and authorities need to be on guard against mispricing of risk and valuations of assets. Second, the importance of timely completion of the reforms to over-the-counter (OTC) derivatives markets and the shadow banking system has increased. Third, historically low interest rates in many countries pose challenges for institutional investors with long-dated liabilities and may leave market participants more vulnerable to unanticipated movements in the yield curve. Financial institutions and supervisors should continue to assess the resilience of the financial system through regular stress testing, notably of credit and interest rate risk, and complete the process of balance-sheet repair.

1. Reports submitted for this meeting

a. Regulatory factors affecting the availability of long-term finance

As part of the diagnostic work you requested of the international organisations, the FSB has prepared an assessment of the effect of the G20 financial reform programme on the availability of long-term investment finance. The reforms include Basel III, OTC derivatives market reforms, and changes affecting the regulatory and accounting framework for institutional investors.

The general conclusion is that, while there may be some short-term adjustment effects, the most important contribution of the financial reform programme to long-term investment finance is to rebuild confidence and resilience in the global financial system. As a result, these reforms should substantially enhance the financial system's capacity to intermediate

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investment flows through the cycle at all investment horizons. Hence, the G20 regulatory reforms are unambiguously supportive of long-term investment and economic growth.

The submissions of FSB members found little evidence that the regulatory reforms have had a notable impact on long-term financing to this point. This is not surprising given the fact that the reform process is still at an early stage. Several features of the reforms are designed to avoid major unintended consequences: the long phase-in period for reforms; the ongoing implementation monitoring; and, in certain cases, the flexibility to adjust rules during the observation period.

The financial reform programme is not specific to the regulation of long-term finance. Nevertheless, the reforms will change the incentives of some financial institutions and the costs of certain transactions, which may affect the composition of long-term finance. In particular, institutional and other long-horizon investors are expected to assume a greater role in funding long-term assets and more of this investment may be intermediated via capital markets rather than the banking system.

There are three areas for specific follow-up by the FSB. First, there should be ongoing monitoring to identify any regulatory factors that may disproportionately affect the provision of long-term finance so that they can be addressed. Second, the FSB could work with others to examine whether regulatory factors may constrain the ability of non-banks to expand their provision of long-term finance. Third, the FSB can contribute to the work of other international organisations to help promote the development of longer-term domestic savings and the capacity of domestic financial systems to intermediate them, particularly in emerging market and developing economies (EMDEs).

b. Update on accounting convergence

The Chairs of the International Accounting Standards Board and the US Financial Accounting Standards Board have written you on their work on convergence of accounting standards. The two Boards expect to make progress on the two key outstanding issues of impairment of loans, where they expect to complete their deliberations in 2013, and insurance contracts, where both Boards will be holding public consultations this year. Of these two outstanding issues, the need for convergence on a new forward-looking expected loss approach to provisioning is of most immediate concern for end-users and from a financial stability perspective. We note with concern the delays in convergence to date. We therefore recommend that the G20 ask the IASB and FASB to prepare by end-2013 a roadmap for converging to a common approach for impairment and for achieving the G20 objective of a single set of high quality accounting standards.

2. Priorities and work plans

a. Creating continuous markets

The FSB remains fully committed to the rapid completion of the G20's agreed reforms to OTC derivatives markets. As you are aware, these complex reforms are taking somewhat longer than originally planned. The FSB will submit for your April meeting its latest progress report on implementation, including a comprehensive stock-take of reforms as of end-2012, estimates of the extent to which transactions are being centrally cleared and reported to trade repositories, and an overview of the remaining issues to be resolved.

It is important that all jurisdictions promptly complete the necessary changes to legislative and regulatory frameworks to put these reforms into practice. To maintain momentum, I have asked FSB member jurisdictions to confirm before the September Summit that the legislation and regulation for reporting to trade repositories are in place, and also the steps they are taking to complete the implementation of other OTC derivatives reforms. Ministers may wish to take a particular interest in progress in their jurisdictions to ensure timely compliance with these important reforms.

The FSB has previously identified regulatory uncertainty as the most significant impediment to full and timely implementation of the OTC derivatives reforms. To reduce this uncertainty, regulators are working together to identify and address conflicts, duplication and gaps in the cross-border application of rules. They will provide an update in April on their progress and next steps, and a report to the Summit on how the identified cross-border issues have been resolved.

International policies in remaining important areas will also be published by the Summit. These include capital requirements for exposures to central counterparties, margining standards for non-centrally cleared transactions and guidance on resolution of central counterparties. Standard setters are undertaking an assessment of the incentives to centrally clear transactions that these standards create and will adjust them as necessary to ensure a robust system. The FSB will also report at the Summit the findings of a new macroeconomic impact assessment of the OTC derivatives regulatory reforms.

Standard setters are also developing international guidance on authorities' access to trade repository data, including in such a way that it can be aggregated across trade repositories. This guidance, which will be issued for consultation shortly and finalised by the Summit, will be important for ensuring that authorities can use information from trade repositories in their oversight of OTC derivatives markets and assessment of systemic risk. Ministers and Governors will wish to ensure there is effective cross-border access to this information, which is vital to the monitoring of emerging financial vulnerabilities.

The global Legal Entity Identifier (LEI) system will enhance the usability of the data; the Regulatory Oversight Committee as the governance body of the global LEI system was established in January 2013. Establishing the Global LEI Foundation is the key next step to launch the system in March 2013. The FSB continues to offer strong support to the LEI initiative and the FSB Secretariat will serve as ROC LEI Secretariat for the initial period.

b. Strengthening the oversight and regulation of shadow banking

As you will recall, the FSB delivered to you last November an initial set of recommendations to strengthen the oversight and regulation of shadow banking. We have received useful feedback through a public consultation on the initial recommendations. The FSB is refining the recommendations relating to securities lending and repos, and those relating to the policy measures for shadow banking entities other than money market funds.

The recommendations will address bank-like risks to financial stability emerging from outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks. The approach is designed to be proportionate to financial stability risks by focusing on those activities that are material to the system, using as a starting point those that were a source of systemic risk during the crisis. We will deliver certain recommendations to the St Petersburg Summit. These measures should be viewed as the start of a broader process since they address the specific risks that arose during the crisis and we all recognise the ability of the shadow banking sector to innovate.

c. Building resilient financial institutions

In January, agreement was reached by the Group of Governors and Heads of Supervision on the Liquidity Coverage Ratio (LCR) to be applied to banks. The agreement expands the range of high-quality liquid assets that can be included in the LCR and incorporates evidence-based assumptions about liquidity outflows in times of stress. The LCR will be introduced in 2015 as planned, with the minimum requirements beginning at 60% and reaching 100% by 2019 to allow the global banking system sufficient time to adjust.

d. Ending "too-big-to-fail"

Progress is being made by the IAIS in developing and testing a methodology for identification of global systemically important insurers (G-SIIs), and in developing appropriate policy measures. This work should be completed in the second quarter of 2013. An identification methodology for non-bank G-SIFIs will be issued for consultation in the second half of 2013.

Although implementation of the G-SIFI framework has much farther to go, we will deliver an assessment to the St. Petersburg Summit of the progress made in developing credible policies for ending too-big-to-fail (TBTF).

3. Implementation of reforms

Basel III

Consistent implementation of Basel III is fundamental to strengthening the resilience of the global banking system, maintaining market confidence in the regulatory reforms and providing a level playing field for internationally active banks. The 27 member jurisdictions of the Basel Committee on Banking Supervision (BCBS) continue to make progress toward implementation; 11 had issued final regulations by 12 February 2013 and the remaining 16 jurisdictions have tabled draft regulations (see Annex to this letter). The European Union and the United States published draft regulations in 2012 and intend to finalise them over the course of 2013. The FSB and BCBS will prepare a full update on countries' adoption of Basel III in domestic regulation for your April meeting. The countries that have missed the January 2013 start date are working to finalise their regulations and are expected to meet the 2019 timeline for full implementation.

Several more members will undergo a consistency assessment of their final regulations by the BCBS in 2013. By end-2013, all jurisdictions that are the home regulator to global systemically important banks (G-SIBs) will have been subject to an assessment of their Basel III implementation. Other jurisdictions will be subject to regulatory consistency assessments shortly thereafter.

The BCBS has concluded an initial examination of the international consistency in the application of the Basel III risk weighting scheme for trading book assets. A similar review is underway regarding the banking book. The analysis for banks' trading books indicates that supervisory decisions and variations in banks' models contribute to the substantial differences in banks' calculations of market risk. (The average risk weighting of trading assets for most banks in the study varied between 15% and 45%.) The study also shows that banks' public disclosures are insufficient for understanding how much of these variations in banks' reported risk weightings of assets are owing to differing levels of actual risk versus that owing to other factors. This situation is unacceptable, and the study highlights three policy options which are being addressed in the Basel Committee's ongoing work: (i) improving banks' public disclosures, building on the recommendations of the Enhanced Disclosure Task Force; (ii) narrowing down modelling choices for banks; and (iii) further harmonising supervisory practices over approval of models.

Resolution regimes and G-SIFI resolution plans

An effective and credible resolution regime for SIFIs is a critical component of the policy framework for ending TBTF. Full implementation of the FSB *Key Attributes of Effective Resolution Regimes* will provide authorities with the powers and tools necessary for this purpose. We will shortly conclude the first peer review of FSB members' implementation of the *Key Attributes*. The work under the review confirms that reforms are underway in many jurisdictions to align national statutory regimes with the FSB *Key Attributes*, but that significant work remains. We are developing an assessment methodology to assist countries with their implementation, and to provide a basis for future peer reviews and IMF and World Bank assessments. The methodology will be tested in pilot assessments by the IMF and World Bank later this year and published in the second half of 2013. The FSB and its members will also this year address the specific aspects of resolution of insurers and financial market infrastructures and the protection of client assets in resolution.

By June 2013, resolution strategies and plans should be in place for all G-SIFIs designated in November 2011. To assist this process the FSB has publicly consulted on specific aspects of recovery and resolution planning and is now finalising its guidance. Progress in ending TBTF is contingent on the feasibility and credibility of putting these resolution plans into operation. We will launch in the second half of 2013 a first round of assessments under the G-SIFI Resolvability Assessment Process to evaluate the progress made.

Reducing the reliance on Credit Rating Agency (CRA) ratings

The FSB has recently launched a thematic peer review to assist its members to fulfil their commitments under the roadmap for implementing the FSB principles for reducing reliance on CRA ratings. This will include a stock-take of references to CRA ratings in national authorities' laws and regulations and of actions being taken to remove or replace these references. The findings will feed into the progress report on CRAs for the Summit, while the peer review will be completed by early 2014.

Monitoring the impact of reforms on EMDEs

The FSB will organise a workshop for EMDEs in the first half of 2013 to share lessons and experiences on implementing agreed financial reforms and on undertaking ex ante assessments of their impact. FSB members with significant experience in undertaking such assessments will be asked to present their methodologies. The FSB will report the findings of the workshop and other relevant monitoring processes at the St. Petersburg Summit.

4. FSB resources, capacity and governance

Finally, I am pleased to report that the FSB has now been established with a legal personality. Alongside this, a rolling five-year agreement under which the BIS will host and provide resources for the FSB has been activated, and an institutional mechanism for the FSB's financial and resource governance established. The FSB has also adopted Procedural Guidelines for its operational and administrative activities and practices. These are important steps towards implementation of the G20 recommendations at Cannes and Los Cabos to place the FSB on an enduring organisational footing, with strengthened governance, greater autonomy in resource use and enhanced capacity to coordinate the development and implementation of financial regulatory policies, while maintaining strong links with the BIS.

The FSB will next elect new chairs for three of its Standing Committees and begin a review of the composition of their memberships. Following the St. Petersburg Summit, the FSB will set in train a review of the structure of its representation, which we envisage to be completed under the Australian Presidency of the G20.

Yours sincerely,

Mark Carney

Attachment: Status of Basel II.5 and III adoption

Annex: Status of Basel II.5 and III adoption (as of 12 February 2013)

Country	Basel II.5	Basel III
Argentina	1,4	1,4[1]
Australia	4	4
Belgium	4	(2)
Brazil	4	2
Canada	4	4
China	4	4
France	4	(2)
Germany	4	(2)
Hong Kong SAR	4	4
India	4	4
Indonesia	1	2
Italy	4	(2)
Japan	4	4
Korea	4	2
Luxembourg	4	(2)
Mexico	1	4
The Netherlands	4	(2)
Russia	1,4	2
Saudi Arabia	4	4
Singapore	4	4
South Africa	4	4
Spain	4	(2)
Sweden	4	(2)
Switzerland	4	4
Turkey	4	2
United Kingdom	4	(2)
United States	2,4	2
European Union	4	2

Number code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. Numbers in parentheses indicate countries following the EU process.

Source: Basel Committee on Banking Supervision.

[1] Pillars 1 and 2 in force. Pillar 3 expected in 2013.