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Statement by Mario Draghi
Governor
FINANCIAL STABILITY BOARD

Statement of Mario Draghi
Chairman of the Financial Stability Board
to the International Monetary and Financial Committee

Istanbul, 4 October 2009

The Financial Stability Board (FSB) was came into being in April 2009 as the successor to the Financial Stability Forum, with a broadened mandate to promote financial stability, expanded membership, stronger institutional basis and enhanced capacity. Since then, the FSB and its members have advanced a major program of financial reforms based on clear principles and timetables for implementation that are designed to ensure that a crisis on the scale that the global financial system experienced over the last two years never happens again.

Much has already been achieved, and much is underway, that when implemented will result in a very different financial system than the one that brought us this crisis. However, policy development is not completed, and detailed implementation of the full set of needed reforms will take time and perseverance. In a globally integrated market economy, where concerns about a level playing field and protectionist pressures are real, it is vital that national authorities strongly support the international policy development underway and signal their determination to implement these reforms fully and consistently at national levels.

In recent months, expectations have taken hold in some parts of the private financial sector that the financial and regulatory system will remain little changed from its pre-crisis contours. These expectations – that business will be able to go on just as before – need to be dispelled.

Our objective is to create a more disciplined and less procyclical financial system that better supports balanced sustainable economic growth. This system will not allow leverage to increase to the extent that it did. Nor will we allow risks to be taken where profits accrue to individual actors but ultimate losses are borne by governments and the wider public.

To these ends, our program includes substantially higher requirements for the quantity and quality of capital and liquidity at financial institutions. It also includes reforms to accounting standards and compensation regimes that improve transparency and limit incentives to excessive risk taking. We will constrain risks in trading-related activity by improving market infrastructure and by significantly raising capital charges for trading books.

Our reform plans set reasonable implementation windows to avoid aggravating the present crisis. While the financial system will continue to face challenges for some time, the faster our financial systems and economies recover, the faster we should implement finalised reforms.

This crisis has highlighted the moral hazard risks posed by institutions that have become too big to fail or that, by their interconnected nature, are too complex to resolve. We need to address the deeper-seated challenges that these institutions pose. We are committed to developing the solutions to these problems over the next twelve months.

In recent quarters, many financial institutions have returned to profitability. These profits owe much to the extraordinary official measures taken to stabilise the system, many of which remain in place. It is imperative that these profits be retained in financial institutions to rebuild capital necessary to support lending, allow official support measures to be removed and prepare institutions to meet future higher capital requirements.

The international supervisory and regulatory community is agreed that restricting dividend payments, share buybacks and compensation rates are appropriate means to these ends.

Achievements to date

Substantial progress has been made on the many measures recommended in the Financial Stability Forum's April 2008 and 2009 Reports, the G20 Washington Action Plan and the London Summit Statement, especially at the level of international policy development. Among the significant actions taken recently:

- The shortcomings in the Basel capital framework that generated incentives for off-balance sheet securitisation activity have been removed;
- The weaknesses in accounting practices and national standards that generated similar incentives for off-balance sheet activities have been addressed;
- Substantially higher capital requirements against risks in banks' trading activities have been issued;
- Strong new risk management standards for financial institutions have been issued and are being implemented;
- Banks' disclosures of their on- and off-balance sheet risk exposures have been materially improved;
- Central counterparties have been introduced to clear credit default swaps, reducing the systemic risks from this market;
- Stronger oversight regimes for credit rating agencies have been developed;
- Internationally agreed principles for the oversight of hedge funds have been issued, and national and regional legislation has been or is in the process of being introduced to implement them;
- Good practices for due diligence by asset managers when investing in structured finance products have been issued, which will reduce their reliance on credit rating agencies;
- Abusive short selling has been addressed;
- Supervisory colleges have now been established for all the large complex financial groups that the FSB has identified as needing colleges;
- Strengthened arrangements for system-wide oversight have been developed in many jurisdictions, bringing together the relevant authorities to better assess risks to financial stability and identify mitigating actions;
- Firm-by-firm contingency planning is underway to implement the FSB Principles for Cross-border Cooperation on Crisis Management;
- Core Principles for Effective Deposit Insurance Systems have been developed and an assessment methodology is under preparation.

Compensation practices

Most recently, the FSB issued on 25 September implementation standards for its Principles for Sound Compensation Practices that apply to significant financial institutions.[1] The standards focus on areas in which especially rapid progress is needed, including:

- independent and effective board oversight of compensation policies and practices;
- linkages of the total variable compensation pool to the overall performance of the firm and the need to maintain a sound capital base;
- compensation structure and risk alignment, including deferral, vesting and clawback arrangements;
- limitations on guaranteed bonuses;
- enhanced public disclosure and transparency of compensation; and
- enhanced supervisory oversight of compensation, including corrective measures if necessary.

Critical work underway

Beyond the areas above, a large body of critical work is underway to take forward the reform agenda. In some areas, policy development is reaching a phase in which difficult decisions will need to be made. The work underway covers the following key areas:

- *Strengthening the global capital framework for banks.* New rules will be set out by end-2009, calibrated in 2010 and phased in as financial conditions improve and recovery is assured.

- *Making global liquidity more robust.* A new minimum global liquidity standard for banks will be issued by end-2009, and measures that could mitigate cross-border liquidity problems at the national level reviewed.

- *Reducing the moral hazard posed by systemically important institutions.* Measures will be developed over the next 12 months that can be taken to reduce the systemic risks that these institutions pose.

- *Strengthening accounting standards.* Further work is encouraged to improve standards on valuation and provisioning and achieve converged high-quality global accounting standards.

- *Improving compensation practices.* The FSB will complete a review by March 2010 of the actions taken by firms and national authorities to implement our Principles and the new implementation standards.

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[1] FSB Principles for Sound Compensation Practices: Implementation Standards

- *Expanding oversight of the financial system.* Work is progressing to ensure that all systemically important activity is subjected to appropriate oversight and regulation, including relating to hedge funds and credit rating agencies.

- *Strengthening the robustness of the OTC derivatives market.* Standards will be strengthened and consistently applied to address systemic risks, including capital requirements to reflect the risks of OTC derivatives and further incentivise the move to central counterparties and, where appropriate, organised exchanges.

- *Re-launching securitisation on a sound basis.* The official sector must provide the framework that ensures discipline in the securitisation market as it revives.

- *Promoting adherence to international standards.* The framework to strengthen adherence will build upon and complement IMF and World Bank assessments through FSAPs and ROSCs. Within this framework, the FSB is developing a system of peer reviews among FSB members of regulatory and prudential standards and of policies agreed in the FSB, based among other evidence on IMF and World Bank assessments.

More details on progress to date in implementing the reform agenda and on next steps for strengthening financial stability are set out in the FSB's recent reports to the G20 Pittsburgh Summit.2 The G20 have requested that the FSB report again on progress to the G-20 Finance Ministers and Central Bank Governors in advance of the next Leaders summit.

Joint work with the IMF

The FSB continues to closely collaborate with the IMF in a variety of areas. Following the "dry run" of the joint IMF-FSB Early Warning Exercise in April 2009, the next iteration of the Exercise will be jointly presented to IMFC Ministers and Governors today. The FSB is also working jointly with the IMF on reports to be delivered to G20 Finance Ministers and Governors in November on guidelines to assess whether a financial institution, market or instrument is systemically important, and on identifying and addressing gaps in data and information revealed by the crisis. Apart from these joint projects, the FSB and IMF also collaborate in a range of other topics of common interest. I look forward to this continuing.

[2] See *Implementing Financial Regulation*, 25 September 2009, and *Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability*, 25 September 2009, available on www.financialstabilityboard.org.