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

Washington, DC, 24 April 2010

We have achieved much over the last year and a half to stabilize 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 normalize and loan growth has resumed. In other countries, policy is appropriately directed at restraining buoyant credit growth. There certainly are adjustment challenges 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. 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 regulatory reform and will largely determine whether the objectives and timelines of reform for strengthening financial stability will be met.

Capital and liquidity reforms

The key priority is to complete the revamp of the Basel capital framework and the liquidity standard. This includes introducing a leverage ratio and measures such as forward-looking provisioning and countercyclical buffers that address the problems of procyclicality that were evident in this crisis. The Basel Committee on Banking Supervision issued in December 2009 a package of proposals to strengthen global capital and liquidity regulations. Comprehensive impact assessments of these 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, transition and grandfathering arrangements should also be designed to ensure that implementation does not have an adverse macroeconomic impact. The FSB and the Basel Committee, in collaboration with the IMF, are jointly assessing the macroeconomic implications of implementing the reform proposals in order to inform the phase-in and implementation horizon.

Preliminary results on all assessment streams will be available in the summer. 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

The FSB is assessing a broad spectrum of potential reforms to reduce the moral hazard associated with systemically important financial institutions. One focus of this 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 coordination 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 are reduced to a very low level, or restrictions on the activities, size or structure that make these institutions resolvable.

One-size-fits-all solutions are unlikely to be appropriate for all "too big to fail" firms and all financial systems. However, to reduce systemic risks globally, we will need standards for such firms that set a common floor, and actions across countries that are sufficiently coordinated to avoid regulatory arbitrage. The FSB 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 should 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 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 assessment of the cumulative impact on the system of the above proposed reforms will lessen the risk of unintended consequences and help address financial industry claims that the reforms could derail the economic and financial recovery.

Over-the-counter derivatives regulation and market infrastructure

Reforms are needed 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. While legislation is advancing in major jurisdictions to establish the requisite frameworks for this, there is a need to avoid inconsistencies across jurisdictions in areas such as which derivatives products can and should be standardized and subject to a central clearing requirement, and which exemptions should be in place for end-users. An outcome where standardized contracts are centrally cleared but those contracts represent only a very small percentage of the overall marketplace must be avoided.

The FSB has therefore established a working group to report by October policy options to increase the standardization of OTC derivatives and to develop a clear process to implement consistently mandatory clearing and exchange or electronic trading requirements at the global level.

Securitization

Restarting securitization 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 securitization with genuine economic value, in part because the investor base remains slow to revive. The FSB is 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 encourage the return of a suitable, well-regulated investor base.

Compensation

The FSB issued in March 2010 a review of the steps taken by FSB member jurisdictions to implement the *FSF Principles for Sound Compensation Practices* and their *Implementation Standards*.[1] The review also covered progress to date in implementation by significant financial institutions.

The review 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 maintain the momentum of compensation reforms through 2010 and beyond. As part of the review, the FSB recommended additional measures to support the emergence of sound practice and further convergence. The FSB will undertake a more detailed follow-up review in the second quarter of 2011.

Strengthening accounting standards

Further progress has been made in some areas in improving accounting standards. The International Accounting Standards Board (IASB) has finalized a standard on classification

[1] The compensation review is available at http://www.financialstabilityboard.org/publications/r_100330a.pdf.

and measurement of financial assets that requires certain loans and investments in debt securities to be reported at amortized cost; and has proposed a forward-looking, expected loss provisioning approach. On the latter, there has been constructive cooperation between accounting standard setters and prudential authorities.

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

2010 and 2011 are critical years for the financial reform process. While much has already been achieved, policy development is not completed. Detailed implementation of the full set of needed reforms will take time and perseverance.

The FSB will continue its efforts to promote financial stability by developing strong regulatory, supervisory and other policies and fostering a level playing field through coherent implementation across sectors and jurisdictions. 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. The FSB counts on such support and determination.