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

Washington, DC, 9 October 2010

While considerable progress has been made in strengthening the financial resilience worldwide, financial systems in advanced economies remain vulnerable to risks of fiscal strains in national and local governments, of renewed fragilities in bank funding markets and of weakening economic conditions. The potential for adverse feedback loops between weak economies, fragile banking systems, and fiscal strains remains significant. Further financial stability challenges arise from the continued reliance of some banks on support mechanisms, and from potential market pressures and risks of disorderly unwinding of large capital inflows to faster growing emerging markets.

Financial system repair needs to be accelerated by identifying and resolving weak banks in an orderly way, through a clear and systematic process which avoids forbearance. Intensified supervisory scrutiny in targeted areas is needed as well to stem undesirable side-effects of low interest rates and low market incentives for banks to adjust. Finally, authorities should continue to foster transparency through targeted consistent disclosures by financial institutions of risk factors that are most relevant to the market conditions at the time (e.g. sovereign risk during times of fiscal strains).

Against this background, the need to complete the financial sector reform programme remains pressing. Much has already been achieved to strengthen the financial system since the crisis began, reflecting an unprecedented amount of international co-ordination in achieving consistent reforms. However, more work is needed, both to complete work in important policy areas and to implement reforms.

The FSB is coordinating the global programme of regulatory reforms and will be presenting key recommendations to the November G20 Leaders summit in Seoul. It will follow up by monitoring national implementation closely, in 2011 and beyond.

Basel III

The Basel Committee’s governing body in September reached a landmark agreement on the new bank capital and liquidity standards. The new standards will markedly increase the resilience of the banking system, by reducing the likelihood and severity of future financial crises and creating a less procyclical banking system that is better able to support long-term economic growth.

The FSB, with the Basel Committee, have assessed the macroeconomic impact of the transition to the stronger capital and liquidity standards. They concluded that the transition to stronger capital and liquidity standards is likely to have a modest impact on aggregate output, to set against the clear net long-term economic benefits from raising standards. The final report of the Macroeconomic Assessment Group will be published later this year.

Addressing systemically important financial institutions

The FSB is developing policy approaches for addressing the "too big to fail" problems associated with systemically important financial institutions (SIFIs). The policy framework to reduce the moral hazard from SIFIs will include the following elements:

- improved capacity to resolve SIFIs without disruption to the financial system and without taxpayer support.
- additional loss absorption capacity for global SIFIs beyond the Basel II minimum standards, which could include combinations of capital surcharges, contingent capital and bail-in debt.
- increased intensity of SIFI supervision.
- higher robustness standards for core financial infrastructure, including central counterparties to reduce contagion risk in the OTC derivatives market.
- a mutual policy review process to promote consistent national policies.

The FSB will publish recommendations in November.

Implementing central clearing and trade reporting of OTC derivatives

An FSB Working Group is developing recommendations to achieve the G20's commitments to improve transparency, mitigate systemic risk and protect against market abuse in the over-the-counter (OTC) derivatives market. The recommendations will promote consistent implementation across jurisdictions of measures to increase standardisation, central clearing and, where appropriate, exchange or electronic platform trading, and to have all OTC derivatives contracts reported to trade repositories. The report and recommendations will be published in November.

Reducing reliance on CRA ratings

The FSB is developing principles to reduce authorities' and financial institutions' reliance on credit rating agency (CRA) ratings. The goal of the principles is to reduce the cliff effects from CRA ratings that can amplify procyclicality and cause systemic disruption.

The principles, to be issued later this month, will call on authorities to reduce reliance on CRA ratings in rules and regulations, in order to reduce mechanistic market reliance on those ratings. Accordingly, authorities should assess references to CRA ratings in laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness. The principles will set out the direction of change needed and ask standard-setters and regulators to follow up by defining the more specific actions that will be needed to implement the changes.

Peer reviews

The FSB has published its peer review on Mexico—the first country peer review report to be completed under the *FSB Framework for Strengthening Adherence to International Standards.*

FSB peer reviews are intended to complement and support the IMF-World Bank Financial Sector Assessment Program (FSAPs). FSB members have committed to undergo periodic country and thematic peer reviews focused on the implementation of financial sector standards and policies agreed within the FSB. The next two country peer reviews, for Italy and Spain, are underway and will be completed in early 2011. The first FSB thematic review, on compensation practices, was completed in March 2010. Two further thematic reviews are currently underway – on risk disclosures and on mortgage underwriting practices – and a follow-up review of compensation practices will take place in the second quarter of 2011.

Regional outreach

The FSB will establish outreach arrangements with non-member authorities, through the establishment of regional groups comprising member and non-member authorities. It is designing the potential operational arrangements for these groups, including the information sharing and consultative roles that they could play. A detailed proposal on those arrangements will be further discussed at the next FSB Plenary meeting, to take place on 20 October in Seoul. The regional groups' first meetings will take place in 2011.