

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

Washington, DC, 16 April 2011

The ongoing international programme of financial reforms is strengthening the robustness of the global financial system. However, pockets of weakness in the banking system remain and sovereign and banking risks are closely intertwined in some countries. The risks of sudden changes in funding conditions, credit losses and yield curves highlight the importance of credible fiscal consolidation programmes to lower financial system risks. There is a need to decisively press ahead with the repair and strengthening of weak banking systems, using the forthcoming rounds of stress tests to address expeditiously any weak points identified.

There are signs that the low interest rate environment, which has been necessary to support growth and financial sector recovery, may be leading investors to search for yield in more complex non-standard market segments that increase exposure to liquidity risks. Developments in exchange-traded funds, commodities and high-yield markets are examples that warrant closer surveillance by regulatory authorities.

In a number of emerging markets economies, rapid credit growth and portfolio inflows have raised the risks of asset price inflation and other financial imbalances. Macroprudential measures have been taken in a number of countries to reduce the resulting financial system vulnerabilities.

Addressing systemically important financial institutions

The FSB issued in October 2010 a policy framework, work processes and timelines for reducing the moral hazard posed by systemically important financial institutions. At their February 2011 meeting, the G20 Finance Ministers and Central Bank Governors asked the FSB to deliver to the November 2011 Summit the recommendations that had been scheduled for end-2011 in the October 2010 report. The FSB and its members have agreed an accelerated timetable in order to meet that request.

The Basel Committee (BCBS) has broadly agreed a methodology to assist the FSB and national authorities in assessing the systemic importance of financial institutions at a global level. This methodology incorporates revisions based on feedback from the Group of Governors and Heads of Supervision (the Committee's oversight body) and from the FSB. The revised methodology is based on quantitative indicators for five categories: global activity, size, interconnectedness, substitutability, and complexity. The BCBS's methodology will be used as input to the determination by the FSB and national authorities, in consultation with standard-setters, of the banking institutions to which the FSB global SIFI (G-SIFI) recommendations will initially apply.

SIFIs and initially in particular G-SIFIs should have higher loss absorbency capacity to reflect the greater risks that these firms pose to the global financial system. Depending on national circumstances, this greater capacity could be drawn from a menu of viable alternatives and could be achieved by a combination of a capital surcharge, a quantitative requirement for contingent capital instruments and a share of debt instruments or other liabilities represented by “bail-inable” claims.

Work towards the implementation of the recommendations on resolution set out in the October 2010 SIFI report is progressing. The FSB has established a Steering Group responsible for delivering the overall work programme on resolution and for developing the *Key Attributes of Effective Resolution Regimes* which will identify the essential features that national resolution regimes for financial institutions, including non-bank financial institutions, should have. To make resolution possible in a cross-border context, the Steering Group is also considering the essential elements for institution-specific cooperation agreements. These should serve as a benchmark and point of reference to national authorities as they negotiate these agreements (which are to be drawn up by end-2011).

National supervisors and standard setters continue to address the recommendations set out in the FSB’s November 2010 report on “Intensity and Effectiveness of SIFI Supervision”. National supervisors are to submit in June their self-assessments against the Basel Core Principles covering mandates, powers, resources and independence, which create the foundation for effective supervision. IAIS members will submit their self assessments against the revised Insurance Core Principles covering mandates, powers, resources, independence and groupwide and consolidated supervision by March 2012.

Shadow Banking

The FSB is developing, in collaboration with international standard-setting bodies, recommendations to strengthen the regulation and oversight of the “shadow banking system”. The FSB has formed a task force to develop initial recommendations for discussion that would clarify the meaning of “the shadow banking system”, set out potential approaches for monitoring the shadow banking system; and explore possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.

The FSB published this month a short background note on this project, setting out current thinking. The note proposes that monitoring and responses be guided by a two-stage approach: firstly, casting the net wide, looking at all nonbank credit intermediation to ensure that data gathering and surveillance cover all the activities within which shadow banking-related risks might arise; and second, then narrowing the focus, concentrating on the subset of non-bank credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create important risks. The FSB will consider initial draft recommendations at its July Plenary meeting and thereafter further develop the recommendations to be submitted to the G20 in the autumn.

OTC derivatives reforms

The FSB published this month a progress report on implementation of OTC derivatives market reforms. The report summarises progress made toward implementation of the G20 commitments concerning standardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions to trade repositories. In particular it looks at progress against the 21 recommendations set out in the FSB's October 2010 report for implementing reforms in an internationally consistent and non-discriminatory implementation to meet the G20 commitments.

Major implementation projects are underway in the largest OTC derivatives markets, and international policy development is proceeding according to the timetable set out in the October report. Nevertheless, although implementation is still in its early stages, the FSB is concerned that many jurisdictions may not meet the G20's end-2012 deadline and believes that, in order for this target to be achieved, jurisdictions need to take substantial, concrete steps toward implementation immediately. Differences in approaches are emerging in some areas that could weaken the effectiveness of reforms in these markets, create potential opportunities for regulatory arbitrage, or subject market participants and infrastructures to conflicting regulatory requirements.

The FSB will continue to monitor developments through its OTC Derivatives Working Group as implementation progresses, and identify any further emerging inconsistencies that should be addressed. The FSB will publish a further progress report by October 2011 that should provide greater insight as to whether progress is on track, including greater detail on implementation by asset class (covering interest rate, credit, equity, commodity and foreign exchange).

Reducing reliance on CRA ratings

In October 2010, the FSB published principles for reducing reliance on credit rating agency (CRA) ratings, and requested standard setters and regulators to consider next steps that should be taken to translate the principles into more specific policy actions.

International standard setters will play an important role in stimulating and coordinating action. The BCBS, IAIS, IOSCO and OECD all have begun to consider next steps to translate the principles into more specific policy actions applicable to their sectors, including how to reflect the CRA principles within their own principles and standards. However, their work to reduce reliance is still at an early stage and in some cases has, to date, remained focused on specific market segments, notably securitisation. In addition, some national and regional regulators have already taken actions toward reducing reliance on CRAs in their jurisdictions. As work by standard-setters and regulators broadens, and also increasingly moves from setting general principles to concrete implementation measures, the FSB's future progress reports, beginning with October 2011, are anticipated to provide more detailed information

not only of the work of international standard-setters but also national and regional regulators, and the milestones for future actions.

Peer reviews

The FSB published country peer review reports on Italy and Spain in February 2011 under the FSB Framework for Strengthening Adherence to International Standards. Country peer reviews of FSB member jurisdictions examine the steps taken or planned by national authorities to address Financial Sector Assessment Program (FSAP) recommendations concerning financial regulation and supervision as well as institutional and market infrastructure. Australia, Canada and Switzerland have volunteered to undergo a peer review in 2011.

The FSB also published thematic peer review reports on mortgage underwriting and origination practices and on risk disclosure practices by financial institutions in March 2011. The follow-up thematic peer review on compensation practices in the financial institutions is in train and will assess the progress made by national authorities and significant financial institutions in implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards, as well as the impact of national policy measures on compensation practices at financial institutions.

The FSB will be launching shortly a thematic peer review on deposit insurance systems. The review will take stock of members' deposit insurance systems and of any planned changes using the Core Principles for Effective Deposit Insurance Systems, issued by the BCBS and the International Association of Deposit Insurers, as a benchmark, and will seek to draw lessons of experience on the effectiveness of reforms implemented in response to the crisis.

Regional outreach

The FSB announced in November 2010 that it will establish regional consultative groups to bring together financial authorities from FSB member and non-member countries to exchange views on vulnerabilities affecting financial systems and on initiatives to promote financial stability. These proposals were endorsed at the November 2010 Summit. The FSB has decided to set up six groups, covering the Americas, Asia, the Commonwealth of Independent States, Europe, Middle East & North Africa, and Sub-Saharan Africa.

The regional groups will bring together FSB members and over 60 jurisdictions outside the FSB's membership, providing the opportunity to discuss the vulnerabilities affecting the regional and global financial systems, policy initiatives underway and planned to promote financial stability, and the implementation of these initiatives. The operational framework for the regional groups is being finalised, invitation letters will be sent out shortly, and the first meetings of the groups will take place later this year. In addition to establishing these groups, the FSB also intends to conduct outreach as needed concerning the FSB's policy initiatives with a wider range of interested countries.