FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

24 June 2010

To G20 Leaders

Progress and issues on the global regulatory reform agenda

Since the Pittsburgh Summit, the Financial Stability Board (FSB) and its members have advanced a broad program of reforms based on clear recommendations and timetables endorsed by the G20. The progress achieved is detailed in the reports we have sent to you.

The focus of our work has been on the following core areas of reform:

- strengthening bank capital and liquidity standards;
- reducing the moral hazard posed by systemically important financial institutions;
- improving over-the-counter (OTC) derivatives markets; and
- enhancing incentive structures and transparency.

2010 will be a critical year for advancing these reforms, which are essential to creating a sounder financial system and reducing systemic risk globally. I therefore ask you to strongly signal your support and determination to implement fully and consistently reforms in these core areas at national level.

The progress we have achieved has been made possible by your support and through intense cooperation between the FSB member countries and the international bodies. However, given the global nature of our financial system, it is essential that we broaden the circle of countries engaged in our work through regional outreach, and that we strengthen the operational capacity of the FSB. We will work on this and report to you on our progress in your next meetings.

Capital and liquidity reforms

Good progress has been made in recent weeks towards new global standards to strengthen bank capital and liquidity, and limit leverage. Public comments are being incorporated and extensive impact assessments are being used to calibrate the new rules and design implementation and transition arrangements. We are confident that the Basel Committee on Banking Supervision will deliver these new standards in time for the Seoul Summit in November 2010. They will complement already agreed new trading book rules to be implemented by end of next year.

It will be important that Leaders support calibration of the new capital, liquidity and leverage standards to a level and quality that enable banks to withstand stresses of the magnitude

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experienced in this crisis, without public support. The quality and amount of capital in the banking system must be significantly higher to improve loss absorbency and resiliency. We should provide transition arrangements that enable movement to robust new standards without putting the recovery at risk, rather than allow concerns over the transition to weaken the standards.

We recommend that implementation of these new standards begins in 2012, with a transition horizon informed by the macroeconomic impact assessment now underway. Reasonable phase-in arrangements should reflect different national starting points and circumstances, with initial variance of national positions around the common new standard narrowing over time as countries converge to the steady-state position for the new global standard.

Too Big to Fail

Following your request at Pittsburgh, we are submitting to you an interim report setting out policy options to reduce the moral hazard associated with financial institutions that are too big, interconnected or complex to fail. In the report we set out key principles that national authorities should follow in developing a policy framework to reduce moral hazard risk. Over the coming months we will build on these principles in developing concrete policy recommendations for the Seoul Summit in November. These will cover:

- the attributes and tools of resolution regimes to resolve financial firms quickly, safely and without exposing the taxpayer to the risk of loss;
- supplementary prudential requirements such as capital surcharges and/or structural constraints that address the greater risks that systemically important firms pose to the financial system;
- more effective supervisory oversight for institutions which may pose systemic risk;
- robust core financial market infrastructures to reduce contagion risk from the failure of individual firms; and
- a process that provides assurance that all countries have established effective policies to reduce moral hazard risk that are consistent and mutually reinforcing.

Any effective approach to addressing the "too big to fail" problem needs to have an effective resolution regime at its base, including for cross-border firms. I urge you to commit in Toronto that your national authorities will put in place the necessary powers and tools, including if necessary through legislative reforms, to implement the principles for national resolution regimes that the FSB is currently drawing up and thus make resolution possible.

Improving over-the-counter derivatives markets

At Pittsburgh, you agreed that to increase transparency and reduce systemic risk, all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012. You also agreed that OTC derivative contracts should be reported to trade repositories. The FSB is working through its members to achieve this and will report recommendations to the November Summit. It is crucial that these reforms be consistently implemented around the world and that the proportion of the market that is standardised, and hence clearable, be increased so as to avoid regulatory arbitrage that would undermine these objectives. Separately, good progress is being made to strengthen capital requirement for OTC derivatives exposures.

Enhancing incentives structures and transparency

As you requested at Pittsburgh, we issued in March an assessment of national and industry implementation of the FSB's Compensation Principles and Standards. While significant progress has been made in incorporating the standards in domestic regulatory and supervisory frameworks, and compensation structures are becoming better aligned with prudent risk taking, we are far from full implementation of the standards. We are therefore taking additional steps to support the development of sound industry practice. To maintain the momentum, we will conduct a thorough follow-up assessment of national implementation in the second quarter of 2011.

Progress continues to be made by the International Accounting Standards Board and US Financial Accounting Standards Board toward improved, converged accounting standards as recommended by the FSB. However, in the area of financial instruments accounting, there is a potential for divergent accounting standards for lending activities, a subject of importance for financial stability. As we noted before the Pittsburgh Summit, the FSB is particularly supportive of standards that do not expand the use of fair value for lending activities.

Credit rating agencies have become more transparent about their ratings methodologies and the limitations of ratings, which is encouraging greater investor due diligence in credit markets. But the reliance on ratings in official regulation and prudential rules works against investor diligence and contributes to the "cliff" effects when credit rating downgrades occur. We are therefore assessing what additional steps can be taken to reduce the official use of ratings.

Monitoring implementation and strengthening adherence to international financial standards

FSB member jurisdictions, including all G20 countries, have committed to lead by example by implementing international financial standards, undergoing an assessment under the IMF-World Bank Financial Sector Assessment Program every five years, participating in FSB thematic and country peer reviews, and publishing the results of these assessments.

Thematic peer reviews focus on the consistent implementation across the FSB membership of standards or policies agreed within the FSB. The FSB completed its first thematic peer review, on compensation, in March 2010; later this year, we will assess financial institution disclosure practices and mortgage underwriting standards.

We are also proceeding with country peer reviews, which focus on implementation in a specific member jurisdiction. The first such review, of Mexico, will be completed next month. Reviews of Italy and Spain will follow later this year.

In response to your request, the FSB is also conducting evaluations of jurisdictions under its initiative to improve adherence to international cooperation and information exchange standards in the financial regulatory and supervisory area. All FSB member jurisdictions, as well as other jurisdictions that rank highly in financial importance globally, are having their adherence to these standards evaluated under this initiative.

To summarise, we are progressing rapidly with reforms according to the demanding but necessary timetable that has been agreed. We must ensure that we build on the gains that have been made and build public confidence in the reform process. It is crucially important that you, G20 Leaders, in Toronto renew your commitment to globally consistent rules and a level playing field, and to achieving the ambitious reforms that will lastingly increase the resilience of the financial system.

Yours sincerely,

Mario Draghi

Attachments