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A Narrative Progress Report on Financial Reform

Report of the Financial Stability Board to G20 Leaders

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The G20 committed in 2008 to a fundamental reform of the financial system, to correct the fault lines that led to the global financial crisis and to rebuild the financial system as a safer, more resilient source of finance that better serves the real economy. To achieve this, the G20 called on the FSB to coordinate the development of a robust and comprehensive framework for global regulation and oversight of what is now a global financial system.

Fundamental reform of financial regulation was clearly necessary. The financial boom before the crisis was fuelled by excessive and mismanaged debt. Many banks were significantly undercapitalised relative to the risks they ran. Regulators and supervisors did not adequately appreciate and address the risks building up in the financial system. When the crisis hit, many markets seized up, transmitting its effects across the globe. The loss of confidence in financial markets and institutions was only halted through authorities backstopping the system. Several institutions that were "too big to fail" passed their losses to taxpayers, while leaving a legacy of economic weakness. Despite these measures, the crisis triggered a global recession and enormous costs to government balance sheets, to economies and to citizens. Its legacy continues to pose financial stability risks to the system and is delaying economic recovery.

Over the past five years, FSB members **have agreed and are implementing a broad range of policy reforms that address the major fault lines that caused the crisis.** We are building more resilient financial institutions and markets, using substantially strengthened common international standards that have been designed to be applicable to different national circumstances. We are addressing the problem of too-big-to-fail. At the same time, we are working to prevent regulatory arbitrage - through which tightening regulation in one sector or region is simply followed by the migration of risky activity elsewhere - and have committed to ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We are building a framework for robust market-based finance that will promote continuously functioning markets.

By reducing the risk of future financial crises and the consequences of financial instability for the real economy, these reforms are an essential contribution to the G20's primary objective of strong, sustainable and balanced growth.

Our work has advanced substantially, but it is not yet complete. It is crucial that we stay the course and complete the reforms, implementing them in a rigorous, coordinated and consistent manner in order to address fully the problems that led to the crisis. To ensure that they endure, the reforms must be complemented by constant monitoring of potential vulnerabilities in our financial systems and heightened readiness to address any new fault lines that might appear. And we must continue to build the institutions and co-operative cross-border mechanisms to realise fully the benefits of an open, integrated and global financial system that supports strong, sustainable and balanced growth, including job creation.

1. Correcting the fault lines that caused the crisis

We are building more resilient financial institutions

In 2010 the G20 endorsed Basel III as a fundamental overhaul of international regulatory standards for banks, to substantially raise the quantity and quality of their capital and liquidity. Almost all FSB and G20 jurisdictions have now adopted rules to implement those new standards according to a timeline that avoids economic disruption. And they are rigorously reviewing each other's practical implementation of the standards line-by-line.

Following the crisis the capital of many banks, including globally significant ones, was severely depleted. But many are now on course to meet the new minimum requirements well ahead of the 2019 deadline for full implementation. The shortfall in equity capital today from the 2019 minimum is only half a year's profits for the largest banks. Where banks have successfully built capital, access to credit has returned, supporting economic recovery.

But there are still major challenges. The strengthening in capital has been uneven, and some banks still need significant repair of their balance sheets. Moreover, analysis of the risk models that banks use to calculate their capital needs shows large differences that cannot be explained by underlying risks, and that are driven instead by supervisory decisions and differences in bank risk models. This highlights the importance of improving the comparability across banks of the risk weights used, and having a simple leverage ratio requirement as a backstop to risk-based measures. We need to address these remaining issues if we are to rebuild fully confidence in the strength of bank balance sheets.

Some final pieces of the new international framework will be finalised very shortly: for example, the leverage ratio by early 2014. In light of the progress made, a strategic review is taking place of whether the current capital framework achieves the right balance between simplicity, risk sensitivity, and comparability across banks.

We have also made progress in correcting the compensation structures at financial institutions which created the perverse incentives for employees to focus only on short-term profits without regard to the longer-term risks they imposed on their firms.

We are increasing transparency

For markets to make their own credit and risk assessments and for authorities to oversee participants, they need good data and good processes. The FSB has been coordinating several initiatives to improve the quality of information available to the market and to authorities.

Some of these aim at improving the information available about individual financial institutions:

- Improving the risk disclosures made by banks to investors and counterparties, for example through practical recommendations made last year by a private sector Enhanced Disclosure Task Force, in which the FSB brought together banks, investors and other stakeholders;
- Addressing data gaps, including in the data shared among authorities on the risk exposures and funding of global systemically important banks.
- Strengthening accounting standards, and making financial accounts more internationally comparable, by encouraging the International Accounting Standards

Board and the US Financial Accounting Standards Board to agree on high-quality converged standards;

Other initiatives will improve the information available about financial markets:

- Establishing a global legal entity identifier, for uniquely identifying counterparties to financial transactions.
- Establishing a global monitoring framework for shadow banking.
- Ensuring that all transactions in the previously lightly regulated over-the-counter derivatives market are reported to trade repositories and that all standardised contracts be traded on exchanges or electronic platforms, where appropriate.
- Reforming the processes for setting financial benchmarks, so that earlier market abuses such as occurred with LIBOR and other benchmarks are not repeated.

Initiatives such as these will enable authorities and markets to better understand the risks faced not only by individual firms but also the system as a whole, and that better understanding will itself make the system more stable. Further efforts are needed to complete some of these initiatives. We are in particular further encouraging the accounting standard-setters to complete the convergence of standards in two key areas − loan loss provisioning and insurance.

We have made substantial progress towards ending too-big-to-fail

Following the collapse of Lehman Brothers and the subsequent public rescue of many large banks, G20 Leaders called on the FSB to propose measures to address the problems associated with systemically important financial institutions (SIFIs). The "too-big-to-fail" problem arises when a SIFI's threatened failure forces public authorities to bail it out to avoid large-scale financial instability and long-lasting economic damage. The resulting public absorption of private losses distorts incentives, leading to excessive risk-taking by SIFIs, and can be ruinous for public finances.

Substantial progress has been made in developing and implementing policies to end too-big-to-fail, as detailed in a separate report for this Summit. We are identifying SIFIs in different sectors, and applying three types of measures to sharply reduce the threat that their failure poses to the wider system:

- changes to legal and operational regimes to enable all financial institutions, including those operating across borders, to be resolved safely and without taxpayer loss if they fail;
- requirements that SIFIs have higher loss absorbency to provide greater protection, given the greater economic impact of their failure compared with institutions that are smaller and less central to the system;
- more intensive and effective supervisory oversight (including sharing of risk data) to reflect the additional complexity of these institutions and the systemic risks they pose

Firms and markets are beginning to adjust to authorities' determination to end too-big-to-fail, with signs of reduced expectations of taxpayer support both in credit rating agency ratings given to SIFIs and in the market prices of their credit. However, legislative reforms to implement the Key Attributes of Effective Resolution Regimes are necessary in many countries if the SIFI framework is to be fully credible and lead to changes in firms' and markets' behaviour. Several jurisdictions have made reforms, but further actions are needed to give authorities additional resolution powers and tools We therefore urge that all G20 countries change legislation as needed to meet the Key Attributes by end-2015.

Banks must also be structured so that they are resolvable in a crisis. To that end, we are requesting your endorsement of further measures to make cross-border institutions resolvable, as detailed in the separate report on progress in ending too-big-to-fail. In particular, to strengthen confidence about the effectiveness of cross-border resolution strategies, an international approach is needed on the adequacy of loss absorption capacity in resolution, including on the nature, amount and location within the financial group's structure.

Structural reform measures at a national level can also help to address the too-big-to-fail problem by restraining excessive risk-taking and improving the resolvability of SIFIs**.** At the same time, there is a risk that diverging structural measures in different countries could impede the integration of international markets. FSB members will therefore monitor and discuss the potential cross-border spill-over effects.

Strengthened supervision of the largest financial institutions is a key element of the SIFI policy framework, but has not progressed apace with other measures. To improve supervisory effectiveness, authorities must ensure that supervisory agencies are adequately resourced (including in skills and experience), have clear mandates and have the independence and accountability they need to deliver high quality supervision.

We are filling regulatory gaps

Authorities must manage systemic risk effectively wherever it arises. And we must avoid leaving regulatory gaps, which could mean that, when regulations are tightened in one area, market participants simply move risky activities to less regulated sectors.

The reform programme is aimed at ensuring comprehensive regulation and oversight of the system. Policy measures should be appropriate to the systemic risks posed, whichever type of institution or market in which they arise. For this reason, the framework to end too-big-to-fail described above covers all types of financial institutions that are identified as being systemically important. Another example of our work to fill regulatory gaps is our initiative to strengthen oversight and regulation of shadow banking.

We are addressing the systemic risks from shadow banking

Non-bank financial intermediation provides a valuable alternative to banks in providing credit in support of economic activity. The crisis however revealed systemic risks from important fault lines in the shadow banking system that had lain mostly unrecognised during its rapid expansion. Key amongst these were a heavy reliance on short-term wholesale funding, a variety of incentives problems in securitisation that weakened lending standards, and a general lack of transparency that hid growing amounts of leverage, maturity and liquidity transformation. When risks manifested, these factors caused credit intermediation through the shadow banking system to come to a dramatic halt.

At the Cannes Summit in 2011, G20 leaders agreed to strengthen the regulation and oversight of the shadow banking system. We have developed a set of policies to address the systemic risks that shadow banking can pose. They focus on the types of shadow banking that led to concerns during the crisis, but also set out an overall policy framework for authorities to identify and address shadow banking risks wherever they may arise in future. Our aim is for shadow banking to deliver transparent and resilient market-based financing, thus diversifying the sources of financing of our economies in a sustainable way.

2. Promoting continuously-functioning financial markets

A move to market-based finance emphasises the importance of having continuously-functioning markets. The crisis highlighted how the interconnectedness of the major firms and markets in the financial system can lead to rapid contagion when markets and liquidity suddenly dry up. The G20 and the FSB are implementing several policy initiatives to reduce the systemic risks arising from the exposures of the largest financial institutions to each other and to create more continuously functioning markets. The goal is to ensure that markets remain liquid and their participants well protected against default by one of their number, so that markets can be sources of strength rather than weakness, even at times of stress.

We are making the derivatives markets safer

The global financial crisis of 2008 highlighted structural deficiencies in the lightly regulated over-the-counter derivatives market, and the systemic risk it posed for the wider market and economy. Regulators did not have sufficient information on derivatives positions held by market participants to be able to assess the build-up of risky exposures.

The over-the-counter derivatives market is now being comprehensively reformed. We are increasing transparency through requirements to trade on organised platforms and report transactions to trade repositories. We are also reducing and more systematically controlling the exposures financial firms have to each other in this market, by ensuring that central counterparties are placed between the two participants in standardised transactions, by setting minimum capital and margining requirements.

In this global market, it is essential that consistent rules apply across jurisdictions in a non-discriminatory way. We are reporting separately on the understandings among regulators on how they will regulate the cross-border market. Regulators should continue to cooperate in the application of regulations in cross-border contexts, to enable them to defer to each other's rules where these achieve similar outcomes.

We are strengthening market infrastructure

Authorities are requiring greater use of market infrastructure, such as central counterparties, in order to reduce the interconnectedness between firms that can lead to contagion in a crisis. Robust financial market infrastructures make an essential contribution to financial stability by reducing what could otherwise be a major source of systemic risk. At the same time, authorities must take steps to ensure that a core financial infrastructure does not itself become a source of systemic risk. New and more demanding international principles have been developed for the safety and soundness of all systemically important financial market infrastructures, including central counterparties, payment systems, central securities depositories, securities settlement systems and trade repositories. We have provided guidance on the application of the Key Attributes of Effective Resolution Regimes to infrastructures.

This is being supported by a formal process to monitor consistent national implementation of the principles.

We are reforming credit rating agencies and reducing reliance on them

Other steps are being taken to make markets less prone to boom-bust cycles and to reduce herd behaviour. Credit rating agencies are now subject to stronger oversight, regulation and transparency requirements about their underlying processes, following the agencies' conflicts of interest and the failures in rating practices for structured products that contributed to the crisis. However, authorities and standard-setting bodies need to accelerate work to end market participants' mechanistic reliance on external ratings, which can lead to herd behaviour and cliff effects in market prices when downgrades occur. Firms must take responsibility for their investments by performing their own credit assessment and due diligence instead. Authorities in most G20 countries have made only slow progress to reduce reliance across the different financial sectors, and they have agreed to develop action plans to accelerate efforts.

3. Realising fully the benefits of an open, integrated and resilient global financial system

Strengthening confidence in an open, global financial system

Short-term incentives to protect domestic economies and taxpayers can sometimes appear to outweigh the longer-term benefits of a global system. The depth of the crisis and the accompanying dislocation of cross-border activities reinforce that bias. Fragmentation of the international financial system could reduce growth by putting up barriers to the efficient allocation of capital and liquidity in the real economy. Reforms that strengthen confidence in the resilience of national and global financial systems, including the prospects for economic growth, and that prevent regulatory arbitrage, will reduce the risk of contagion between jurisdictions in our integrated global financial system and help to mitigate incentives to protect and ring-fence national systems. It is vital therefore that we continue to demonstrate our common commitment to complete the financial reforms. To this end, the FSB coordinates regular public reporting by authorities of progress in developing and implementing global policy reforms, including through this progress report to the Summit.

Ensuring timely, consistent implementation of new regulatory standards

The package of reforms can only be effective in truly addressing risks and rebuilding confidence if it is fully and consistently implemented, and seen to be so. For this reason, the FSB is coordinating with the standard setting bodies a rigorous monitoring and peer review process that assesses and publicly reports on whether countries are fully and effectively implementing reforms, with a particularly intense monitoring of six priority areas for reform - the Basel capital and liquidity framework; derivatives market reforms; compensation practices; policy measures for global SIFIs; resolution frameworks; and shadow banking. We are also monitoring the effects of reforms on the real economy and on the financial system's ability to play its role as a source of financing for long-term investment. Where unintended consequences or improved methods of achieving the desired outcome are identified, the regulatory community is prepared to respond.

Deferring to each other's rules where these deliver similar outcomes

Financial markets and many of the largest financial institutions are global, but – notwithstanding agreements on international standards – financial regulation remains ultimately national or regional. To prevent regulatory arbitrage, regulation needs to cover comprehensively global financial markets and institutions, while avoiding conflicts, inconsistencies and unnecessary duplication between regimes. This does not necessarily mean that different jurisdictions need to have identical regulations, as long as they have similar outcomes.

Recent progress in regulatory cross-border cooperation on OTC derivatives provides an example of the type of approach needed. In July 2013 G20 Finance Ministers and Governors agreed that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identical outcomes, in a non-discriminatory way, paying due respect to home country regulations.

More generally across the reform agenda, the FSB promotes outcomes-based approaches to assessing the consistency of implementation of agreed reforms, enabling jurisdictions to defer to each other's rules where they deliver similar outcomes, thus avoiding one-size-fits-all solutions.

Enhancing co-operation and information sharing

Proper oversight of cross-border financial institutions and markets requires cooperation between financial authorities.

We need to enhance the operations of colleges through which supervisory cooperation takes place, through sharing of good practices, and strengthen channels for supervisors to share data and other information. The FSB will develop recommendations by end-2014 for strengthening supervisory colleges.

The home and key host authorities for each global SIFI have set up a cross-border crisis management group so as to cooperate in the preparation for, and management of, a crisis in such firms. We must improve cooperation within these groups. We will also develop recommendations by early 2014 on cooperation and information sharing with authorities where a global SIFI is systemic in their jurisdiction but they are not on the crisis management group.

The G20 should continue to encourage adherence to the international standards for effective cooperation and information exchange between financial sector supervisors and regulators in different countries. All G20 countries should lead by example through their own implementation of the standards and demonstrate their readiness to handle the case of non-cooperative jurisdictions.

Continuing to cooperate

Mechanisms such as the G20 and FSB enable the cooperation in policy development, oversight and crisis management that a global financial system requires. At the G20's request, the FSB has been placed on a firmer international footing by becoming a separate legal entity in early 2013, while continuing to be hosted and funded by the Bank for International Settlements.

We are also reaching out to a broader community through a variety of fora – including Regional Consultative Groups that bring an additional 70 countries into the policy discussion, workshops involving a wide range of stakeholders and public consultations on policy proposals.

4. Conclusion: Towards a financial system that supports strong, sustainable and balanced economic growth

G20 support to complete the set of international reforms and implement them in a full, timely and consistent way will not only build more resilient national systems but also, by building confidence in each other's commitments, support a more effective and open system. The result will be a resilient global financial system that serves an increasingly global real economy throughout the economic cycle, despite inevitable economic shocks. That system will best support the G20's ultimate objective of strong, sustainable and balanced economic growth and will help create jobs.