Policy Note

Building financial resilience

"Financial regulation is always a work-in-progress but these reforms now need to be finalised in ways that promote confidence without eliminating risk."

Prime Minister Tony Abbott, World Economic Forum, Davos, January 2014

Financial volatility costs the global economy

Financial stability and reliable market conditions are important to strong, sustainable and balanced growth.

The global financial crisis of 2008-09 caused the worst recession in 80 years – largely through a failure in financial regulation and oversight. Many systemically important banks and financial institutions collapsed or experienced significant stress, severely undermining global growth.

While the immediate crisis has passed, building lasting confidence in the global economy means addressing the causes of the crisis and making it more resilient against future shocks.

The crisis exposed gaps, weaknesses and inconsistencies in the way the financial sector is regulated. The free flow of capital across borders exacerbated this. Banks and other financial institutions were allowed to become leveraged to a point where they were unable to absorb their losses.

Large institutions were deemed too big to fail, forcing US and European governments and central banks to bail them out. The impact on government balance sheets is still being felt in many countries.

The lack of transparency and regulation in over-the-counter derivative markets caused a build-up of risky investments in the lead-up to the crisis. When the crisis occurred, the effects of excessive risk-taking were revealed, showing how reliant the market had become on certain financial institutions, and how reliant these institutions were on each other.

The crisis also demonstrated the increasing systemic importance of financing activity outside the regulated banking sector (the "shadow-banking" sector), and the risks it can pose to the financial system if not properly regulated.

IN THE YEARS SINCE 2008 THE G20 HAS ENHANCED GLOBAL FINANCIAL STABILITY

The G20's financial regulation agenda is designed to address these past faultlines and build a system that can evolve with the global economy to support strong, sustainable and balanced growth.

Improving the regulation of the international financial system has been at the heart of the G20 agenda ever since the height of the crisis in 2008.

Over the past five years, G20 members have made considerable headway in global financial reforms aimed at preventing a repeat of the global financial crisis. Banking reforms agreed by G20 leaders in 2010 in Seoul play an important role in ensuring banks can withstand volatile market conditions. The Bank of International Settlements (BIS) supports central banks in implementing these reforms under the 'Basel III process'.

The G20 has also significantly increased the resources available to multilateral development banks, the International Monetary Fund (IMF) and export credit and investment agencies – in particular by committing $1.1 trillion in 2009 at the height of the crisis – to help restore credit, growth and jobs. But this work remains unfinished.

The G20 has mandated the Financial Stability Board (FSB) to develop and coordinate financial regulatory reforms to ensure a safer, more resilient global financial system.

Through the FSB, the G20 is seeking to deliver measurable progress on four core reform areas in 2014:

- building resilient financial institutions by implementing the remaining parts of the Basel III standards
- reducing the risks and impacts of when systemically important ('too-big-to-fail') institutions are threatened with failure
- addressing shadow banking risks by improving transparency and, where appropriate, increasing regulation
- making derivatives markets safer by improving transparency and reporting.

THE NATURE OF RISK IN THE GLOBAL FINANCIAL SYSTEM

At the heart of the global financial crisis was a distorted perception of multiple risks, which led to increased investment into unstable assets and securities in search of greater returns, and borrowing without appropriate controls. The challenge now is to maintain risk within acceptable boundaries.

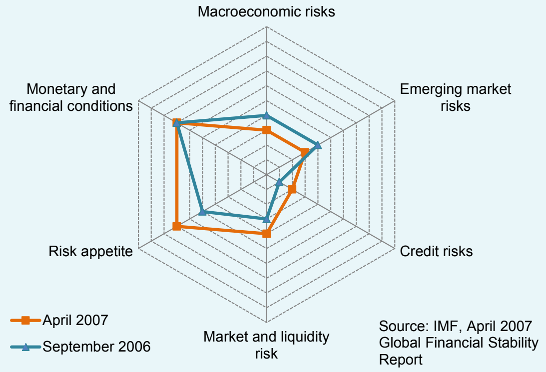
A healthy risk appetite among investors is necessary for economic activity. However, a prudent regulatory environment is needed to prevent destabilising levels of risk.

APRIL 2007: PRE-CRISIS — EASY MONETARY AND FINANCIAL CONDITIONS COUPLED WITH LOW RISKS GENERATED A LARGE RISK APPETITE AMONG INVESTORS.

Prior to the global financial crisis, when the implications of the endemic problems in the US mortgage market were only beginning to be realised, the International Monetary Fund and other economic institutions believed that the levels of risk in the global economy were relatively low.

At the time, macroeconomic risks were seen to be diminishing, emerging market risks were improving, credit risks were rising due to the high volume of borrowing – but still comparatively low – while market risks were considered quite low, perhaps due to a perception that low risk had become a permanent feature of the financial market landscape.

April 2007: Global Financial Stability Map*

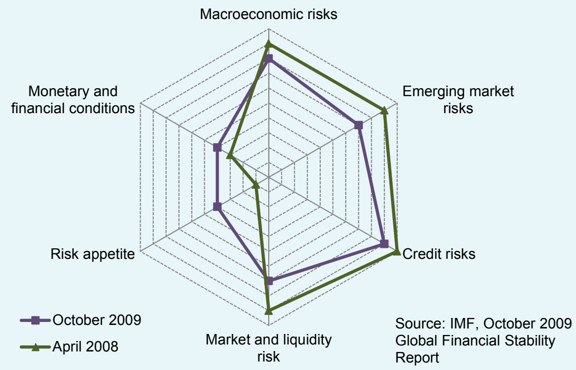


OCTOBER 2009: THE CRISIS DRAMATICALLY REVEALED THE TRUE NATURE OF RISK IN THE GLOBAL FINANCIAL SYSTEM.

Risk assessments peaked in early 2009, when several multinational banks and financial institutions were amid or threatening to collapse, demonstrating the seriousness of the systemic risks. As a consequence, investors had a particularly low risk appetite, slowing economic activity globally.

Towards the final period of the crisis, macroeconomic, emerging market, credit and market and liquidity risks all improved, but remained much higher than prior to the crisis.

October 2009: Global Financial Stability Map*

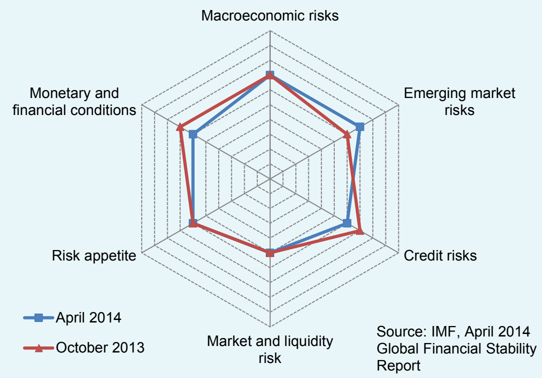


APRIL 2014: RISKS IN THE GLOBAL FINANCIAL SYSTEM HAVE IMPROVED SINCE THE CRISIS, BUT ARE STILL HIGHER THAN THE PRE-CRISIS PERIOD.

Investor confidence has improved with greater transparency and ongoing reform efforts, but systemic risks remain that impede conditions needed for growth.

Specifically, macroeconomic risks remain balanced as growth improves in advanced economies and weakens in emerging markets. Emerging market risks have increased, reflecting tighter external conditions and market turbulence. Market and liquidity risks remain steady. Monetary and financial conditions have tightened, as real interest rates have increased in response to the US tapering. Credit risks have declined, led by improvements in bank funding conditions.

April 2014: Global Financial Stability Map*



* *Away from centre signifies higher risks, easier monetary and financial conditions, or higher risk appetite.*

BUILDING THE RESILIENCE OF BANKS (BASEL III)

- During the global financial crisis, many banks lacked sufficient capital and liquidity and faced insolvency. Banks had not appropriately assessed risk and underestimated the amount of capital needed to manage losses
- G20-driven reforms (implemented under the 'Basel III' process) include specific recommendations due for completion by the end of 2014 to ensure banks can withstand volatility in the market, such as sharp adjustments in interest and exchange rates

REDUCING THE RISKS AND IMPACTS OF WHEN LARGE INSTITUTIONS FAIL

- When 'too-big-to-fail' institutions take on too much risk and are threatened with failure, the impacts threaten to destabilise the financial system
- Reforms enable governments to resolve financially distressed and systemically-important institutions without disrupting the financial system and exposing the taxpayer to the risk of loss
- G20-driven reforms include lifting capital requirements so institutions can absorb greater losses, greater oversight, and legal and operational changes to protect taxpayers

TRANSFORMING THE SHADOW BANKING SECTOR

- Shadow banking, or non-bank financial services, can provide access to credit to support economic activity
- Shadow banking does not have the same regulation as the formal banking sector, which can diminish transparency and increase risk. Funds can be drawn into the sector as investors avoid the burden of regulation on banks
- G20-driven reforms include increasing oversight and regulation of areas at risk

MAKING DERIVATIVES MARKETS SAFER

- Over-the-counter derivatives are stocks (also known as 'unlisted stocks') traded via a dealer network rather than on a centralised exchange. This means they are not subject to the same scrutiny as other stocks
- G20-driven reforms aim to improve transparency, reporting, address gaps between jurisdictions, and reduce the exposure firms have to each other in the derivatives market

IN 2014, G20 MEMBERS WILL DELIVER KEY REFORMS TO BUILD THE RESILIENCE OF THE GLOBAL ECONOMY AND FINANCIAL SYSTEMS

2014 is the right time to begin moving the G20 financial regulation agenda from one of 'crisis response' towards work with a longer-term focus.

For the Brisbane summit, G20 members are progressing key aspects of the core reform areas to address the vulnerabilities revealed by the financial crisis.

BANK OF INTERNATIONAL SETTLEMENTS

First established in 1930, the BIS aims to assist central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.

The BIS has a central role in supporting implementation of the Basel III reforms aimed at building the resilience of banks. The BIS is represented in the G20 at meetings of Finance Ministers and Central Bank Governors.

Substantially completing key aspects of these reforms will improve financial regulation and supervision of the global financial system. G20 members aim to build mutual confidence and trust to support a return to stronger, more sustainable growth.

REFORMING GLOBAL FINANCIAL INSTITUTIONS TO ENSURE THEY ARE EFFECTIVE AND REFLECT ECONOMIC REALITIES OF THE 21ST CENTURY

Institutions like the IMF and the World Bank are crucial in supporting global economic and financial stability. They assist economies facing difficulties in times of crisis through financial support, targeted policy advice and co-ordination of international responses.

The G20 is working to help global financial institutions – including the IMF and the World Bank – adapt to the changing global economy, to help ensure that they can continue to provide crucial assistance to troubled economies.

The G20 wants to ensure these institutions remain effective, legitimate and credible.

The IMF is the central institution of the global financial safety net. IMF quota and governance reforms agreed in 2010 were designed to double the IMF's permanent resources. The reforms will also bolster the IMF's credibility by giving emerging market economies a bigger voice in the Fund, reflecting their growing share of the global economy and the increased importance of their role in protecting it against shocks. The G20 continues to push to implement these reforms.

Also, in 2014, the FSB is reviewing its structure to ensure a balance between its representation and effectiveness and will recommend changes to leaders for the Brisbane summit.

FINANCIAL STABILITY BOARD

G20 leaders established the FSB in 2009 to coordinate the work of national financial authorities (including G20 countries) and international standard-setting bodies to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

Its key tasks include assessing vulnerabilities of the global economy and promoting coordination among authorities responsible for financial stability.

HOW IT HAPPENS

Under Australia's Presidency, Finance Ministers and Central Bank Governors will meet five times over the year to advance work on the resilience agenda.

Finance and Central Bank Deputies meet several times a year to progress decisions made at G20 meetings of Finance Ministers and Central Bank Governors.

The Financial Stability Board supports this process by coordinating work on regulatory, supervisory and other financial sector policies in consultation with senior government officials.

- prepared by the Australian Presidency

Further information

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