FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

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To G20 Leaders

Financial Reforms – Achieving and Sustaining Resilience for All

Over the past seven years, the G20 has fundamentally reformed the global financial system by working to fix the fault lines that led to the Global Financial Crisis and by building more resilient sources of finance to serve the real economy. To these ends, during the Turkish Presidency the FSB has focused on three priorities:

- Full, consistent and prompt implementation of the agreed financial reforms;
- Finalising the design of the remaining post crisis reforms; and
- Addressing new risks and vulnerabilities.

This letter reports on progress and highlights issues that demand the attention of Leaders. It makes four main points.

First, the implementation of agreed reforms has substantially strengthened the resilience of the global system. Our first Annual Report to Leaders shows that many of the key reforms have been implemented decisively and promptly. As a consequence, the financing capacity to the real economy is being rebuilt and significant retrenchment from international activity has been avoided.

Second, the FSB has now finalised the tools needed to end "Too Big To Fail" in the banking sector. As committed in Brisbane, the FSB is presenting for your endorsement the final standard on total loss absorbing capacity ("TLAC") for global systemically important banks ("G-SIBs"). Countries must now put in place the legislative and regulatory frameworks for these tools to be used, and resolution planning for individual firms must be completed so that they can be resolved in an orderly fashion.

The imperative now is to build on these successes to create a financial system that fully supports the G20's core objective of strong, sustainable and balanced growth. At a minimum, this requires the continued support of Leaders for full and consistent implementation of the agreed reforms. In addition, given the constant evolution of the financial system and global economy, new initiatives will be needed to address emerging vulnerabilities and ensure a truly global system that serves the needs of advanced, emerging and developing economies.

Third, the G20 must remain vigilant to new risks and vulnerabilities. The structure of financial markets has changed significantly since the crisis, with the growing importance of market-based finance. This has the potential to make the system more diversified and more effective, but it also brings new risks. The FSB is analysing potential vulnerabilities, including from the growth of asset management, and is working to ensure that the ability of markets to finance the real economy remains resilient in the face of major changes to market structure and liquidity dynamics. This year, during Turkey's Presidency, we also began an assessment of incentives that may distort the balance of debt and equity in corporate liability structures.

Fourth, the FSB is placing greater emphasis on the impact of reforms on emerging market and developing economies. It is conducting targeted assessments of the measures taken thus far and anticipating potential implementation challenges in new initiatives. For example, the calibration and phase-in of the TLAC standard have been informed by comprehensive impact assessments, taking account of differences in our financial systems. In addition, FSB members have developed an action plan for your endorsement to address the potential risks to some of the world's most vulnerable countries arising from the withdrawal of correspondent banking services.

The commitment of G20 Leaders has been essential to maintaining an open and global financial system. With your support, the FSB has emphasised collaboration, consensus and openness. Its strength lies in its members, who bring expertise and a sense of shared objectives, and who work together closely and effectively to find global solutions to common problems. With your support, the FSB has demonstrated a consistent ability to forge consensus, which in turn has led to common ownership and, in most cases, timely and comprehensive implementation of reforms at the national level. That progress is building both trust and effectiveness, keeping global finance open, and making it more resilient.

1. FULL, CONSISTENT AND PROMPT IMPLEMENTATION OF AGREED REFORMS

We recently published the FSB's first annual report on implementation of the financial reforms and their effects, fulfilling a commitment to Leaders in Brisbane last year. The report evaluates progress, identifies potential unintended effects, and highlights gaps and inconsistencies in implementation so that these can be addressed.

Significant Progress*: *Implementation has substantially strengthened the banking system

The report shows that all 24 FSB jurisdictions have Basel III risk-based capital rules in force. All large internationally active banks already meet the fully phased-in risk-based capital requirements, and, where applicable, surcharges for G-SIBs. Final rules on liquidity have been issued and are in force in almost all jurisdictions, and 80% of internationally active banks meet or exceed those standards.

The report notes that banks have increased their capital ratios mainly through retained earnings rather than by reduced lending. The cost of financing, whether from banks or bond markets, has remained at generally low levels in recent years. The extended phase-in periods, coupled with exceptionally accommodative monetary policies and jurisdiction-specific circumstances, have contributed to these outcomes.

Evidence of the success of the reforms can be found in the resumption of bank lending growth and during recent episodes of sharp global financial market volatility, when no major banking institution showed signs of distress.

Gaps and Inconsistencies*: *Work in other policy areas needs to accelerate

In some policy areas, implementation is less advanced. In particular, substantial work remains at the national level to implement effective resolution regimes. While all G-SIBs have crisis management groups and recovery plans, resolution plans still need further work so that the largest global banks can be resolved in an orderly fashion.

Implementation of over-the-counter ("OTC") derivative reforms, while well underway, is uneven and continues to be well behind schedule. Progress is most advanced in the largest derivatives markets.

- Half of the FSB jurisdictions have central clearing frameworks in force that apply to over 90% of their market;
- Most jurisdictions are in the early stages of adopting margin requirements for non-centrally cleared derivatives, which, having been delayed once, are to be phased-in between September 2016 and 2019;
- While trade reporting requirements are in place in almost all FSB jurisdictions, issues persist with the quality and completeness of the data which limit authorities' ability to access, use and aggregate these data, including to assess vulnerabilities and concentrations of risk; and
- Inconsistencies and gaps in requirements across jurisdictions still exist, potentially leading to fragmentation or opportunities for regulatory arbitrage.

Our implementation report identifies the jurisdictions that have fallen behind in this critical area of reform. We urge them to act, as without renewed and sustained focus on these critical issues, the vision of the 2009 Pittsburgh Summit – to make derivative markets truly safer – will not be realised.

G20 Leaders' support is needed in particular to overcome legal and other challenges to the implementation of the reform programme. These include:

- Putting in place legal powers for resolution authorities to share information across borders and to be able to give prompt effect to foreign resolution actions;
- Removing legal barriers to the reporting of OTC derivatives to trade repositories and having legal frameworks in place to permit authorities' access to data held in trade repositories by mid-2018. The FSB has sent under separate cover a peer review on implementation that details specific actions required by jurisdictions across the FSB's membership; and
- Promoting cooperation, including deference to each other when it is justified, in line with the St Petersburg Declaration, to address duplicative or overlapping requirements to cross-border OTC derivatives transactions, including between the major jurisdictions.

Reforms have been achieved without significant unintended consequences to date. Their effects will be kept under review as implementation advances.

Our first report on implementation and the effects of instituting more robust standards has not found evidence of significant unintended consequences to date. However, we have identified three aspects that we will investigate further:

- **Impact on emerging market and developing economies ("EMDEs"):** The EMDE members of the FSB strongly support implementation of the G20 reform agenda, including in their own jurisdictions, to enhance the resilience of the global financial system. No major unintended consequences have been identified to date from the implementation of the agreed reforms in EMDEs. In some cases, however, EMDEs may have been affected by spill-overs from reforms in the home jurisdictions of the largest global financial institutions. The FSB, working with international partners, will continue to monitor the effects of reforms on EMDEs and assist them in implementation.

- **Interaction of reforms on market liquidity:** There are concerns that liquidity in fixed income markets has declined in recent years. Evidence is mixed, and the baseline for comparison should not be the unsustainable excess liquidity that existed prior to the crisis. The FSB is analysing the extent and causes of any shifts in market liquidity, including the interaction between liquidity, changes in market structure and individual regulatory measures. The broader question concerns the interaction of these reforms with structural shifts in markets such as the rise of electronic and algorithmic trading, the fragmentation of trading venues, and the marked increase in asset management.

- **Maintaining an open and integrated global financial system:** Sharp retrenchment in international financial activity has been a common feature of past financial crises. Implementation of the reforms has delivered a stronger and more resilient financial system, and has helped to avoid significant fragmentation or retrenchment. This progress will be supported by continuing to monitor the consistency of implementation and by deepening cross-border cooperation.

2. FINALISING REMAINING POST CRISIS REFORMS

We have created the tools needed to end Too Big To Fail for banks

Last year in Brisbane, we committed to finalise by this Summit a robust international standard for the total loss absorbing capacity (TLAC) that global systemically important banks need for orderly resolution without risks to public funds. We are presenting to this Summit the final standard for your endorsement. This is a landmark achievement, which means the tools are now agreed for authorities to end Too Big To Fail in the banking system. These agreements must be followed by rigorous national implementation.

The series of G20 reforms including TLAC seek to:

- Remove the implicit public subsidy enjoyed by systemic banks and re-instil private market discipline;

- Ensure that creditors and shareholders, who enjoy the rewards of profits in the usual course of business, will bear the costs when banks fail;

- Promote a level playing field for globally systemic banks while taking into account differences in national resolution regimes; and

- Give confidence to host nations, particularly emerging economies, that they will not be side-swiped by the failure of a large advanced-economy bank.

It is important to recognise that success in ending Too Big To Fail may never be absolute because all financial institutions cannot be insulated fully from all external shocks. But these proposals will help change the system so that individual banks as well as their investors and creditors bear the costs of their own actions, and the consequences of the risks they take.

The delivery of a robust final TLAC standard is testimony to the collaborative, consensual approach of the FSB membership and the spirit of international co-operation that is the foundation of how the FSB works.

Further progress is being made this year to strengthen the ability of authorities to resolve G-SIBs through the extension of the International Swaps and Derivatives Association Resolution Stay Protocol to cover securities financing agreements in addition to existing coverage for OTC bilateral derivatives and to cover additional G-SIBs. It is expected that non-G-SIB counterparties will adhere over the course of 2016.

Ending Too Big To Fail outside the banking sector

Good progress is also being made ending Too Big To Fail outside the banking sector. The International Association of Insurance Supervisors has completed a first version of its Higher Loss Absorbency ("HLA") requirements for global systemically important insurers ("G-SIIs"). The HLA standard will be revised before its implementation in 2019 to take account of developments in the methodology for identifying G-SIIs.

In July 2015, the FSB announced its decision to wait to finalise the assessment methodologies for non-bank non-insurer global systemically important financial institutions. The FSB is currently assessing the financial stability risks of asset management activities which will inform the assessment methodology and will develop activities-based policy recommendations as necessary in the first half of 2016.

Use of central counterparties ("CCPs") to clear standardised OTC derivatives transactions is an essential element of achieving the G20's reform objective of reducing systemic risks. The work programme of the major standard setting bodies and the FSB on CCPs' resilience, recovery and resolvability is designed to ensure that CCPs and authorities have the right tools, powers and financial resources available so that these crucial parts of the financial architecture are not themselves Too Big To Fail.

3. ADDRESSING NEW RISKS AND VULNERABILITIES

Risks stemming from market-based finance, and changes in market structure and liquidity

Market-based finance has grown in importance and has a crucial role to play in a diverse and open system able to finance investment, trade and growth. That makes it all the more important that any risks and vulnerabilities in this sector are understood and addressed.

We have worked, in conjunction with the International Organization of Securities Commissions, to identify risks associated with market liquidity and asset management activities. In September we called markets' attention to elevated near-term risks and encouraged funds to use stress testing to assess their ability individually and collectively to meet redemptions under difficult market liquidity conditions. Through 2016, longer-term work will continue on potential structural vulnerabilities and policy options to mitigate them.

Consistent with the growing importance of market-based finance and the evolving nature of financial markets, the FSB will remain vigilant to, and take full account of, the financial stability implications of changes in market structure and liquidity.

Misconduct risks

It is clear that the extent of misconduct in some financial institutions has the potential to create systemic risks by undermining trust in financial institutions and markets.

To address this issue we have agreed on an action plan that examines current conduct practices and whether additional measures might be needed. That work includes: considering whether post crisis reforms to incentives are having sufficient effect on reducing misconduct risks, including by holding individuals accountable; whether steps are needed to improve global standards of conduct in the fixed income, commodities and currency markets; and implementing reforms to benchmarks to prevent opportunities for market manipulation.

Correspondent banking and the potential risk of financial exclusion

Over the past year, a withdrawal by international banks of correspondent banking services from some regions has come to light. The potential consequence for the affected local banks and economies in these regions is the loss of access to the global financial system. In January, the FSB undertook to coordinate work to examine the extent and causes of banks' withdrawal from correspondent banking services, the implications for financial exclusion and potential policy measures in response.

World Bank research shows that fully half of EMDEs have experienced some withdrawal of these services, and, if unchecked, this process could extend further. While this is not yet a globally systemic risk, there are potentially significant consequences in the affected regions and jurisdictions. This dynamic runs counter to the general process of integration of global trade and finance. The FSB has agreed a four-point action plan working in partnership with the World Bank, the Committee on Payments and Market Infrastructure and the Financial Action Task Force ("FATF"), comprising:

- Further examining the dimensions and implications of the issue, through collection of information by the World Bank, other international organisations and national authorities;
- Clarifying regulatory expectations to give additional certainty and confidence to those engaged in correspondent banking, including more guidance by the FATF next year on how to identify properly and to manage money laundering and terrorist financing risks ("AML/CFT") in the context of correspondent banking and remittances. This guidance will help money remitters identify and manage their risks, and help banks evaluate and manage the risks of providing financial services to money remitters;
- Domestic capacity-building to strengthen customer due diligence and other AML/CFT controls in jurisdictions that are home to affected respondent banks, utilising technical assistance from the international financial institutions and building upon assessments by the FATF, and the sharing of best practices within the financial industry; and
- Harnessing technology to improve the efficiency and effectiveness of customer due diligence by correspondent and respondent banks.

Climate change and risks to financial stability

In April, G20 Finance Ministers and Central Bank Governors requested that the FSB convene the public and private sector to consider how the financial sector can take account of climate-related issues.

The potential risks to the financial sector from climate change are complex, and the understanding of them is still at an early stage. Following a successful public-private sector dialogue, we identified three climate change risks that could impact the financial sector: **physical** risks (the impacts on insurance liabilities and the value of financial assets that may arise from climate- and weather-related events such as floods and storms that damage property or disrupt trade), **liability** risks (which could arise if parties that have suffered damage from the effects of climate change seek compensation from those they hold responsible) and **transition** risks (financial risks which could result from the process of adjustment to a lower-carbon economy). It is likely that all of these risks will grow with time.

Access to better quality information will allow market participants to understand and manage these risks better. Importantly, better information could reduce the dangers to financial stability of abrupt shifts. Therefore, we recommend to Leaders the establishment of an industry-led disclosure task force to develop recommendations for voluntary disclosures that effectively and efficiently meet the needs of investors and creditors. If the G20 agrees, the FSB stands ready to facilitate the establishment of this task force, which will be led by the private sector, following the successful example of the Enhanced Disclosure Task Force to improve post-crisis risk reporting by banks.

CONCLUSION

The G20 has worked intensively over the past seven years to fix the fault lines that led to the Global Financial Crisis. Under the leadership of the Turkish Presidency further landmark progress has been made, and the focus on building a more diversified, resilient and truly global system has been increased.

Durable success will require sustained efforts to implement fully the G20’s agreed reforms; to monitor their effects on sustainable growth; to maintain constant vigilance to new and evolving risks, and to deepen the FSB’s open and cooperative approach.

In these ways, the FSB can fully support the G20’s efforts to build a resilient, open and trusted financial system that will support strong, sustainable and balanced growth for all countries.

Yours sincerely,

Mark Carney