

## **To G20 Finance Ministers and Central Bank Governors**

### **Progress of Financial Regulatory Reforms**

I am pleased to report that solid progress continues to be made in the priority areas identified by the G20 Leaders at Cannes and reiterated by Leaders at Los Cabos this June. These include (i) building resilient financial institutions; (ii) ending “too big to fail”; (iii) strengthening the oversight and regulation of shadow banking activities; and (iv) creating continuous core markets by completing OTC derivatives and related reforms.

The key determinant of the effectiveness of reforms is whether they are implemented in a timely, consistent and complete manner. In this regard, progress is being made, as the detailed monitoring reports submitted to you underscore. But progress remains uneven and we still have significant work ahead.

#### ***Shadow Banking***

At the Cannes Summit, the G20 Leaders agreed to strengthen the oversight and regulation of the shadow banking system and endorsed the FSB’s work plan in this area. At Los Cabos, they asked the FSB to submit recommendations for review at the G20 Finance Ministers and Central Bank Governors meeting in November 2012.

We have sent you a note that provides an overview of the recommendations, which have been developed by the FSB, BCBS and IOSCO. The recommendations themselves, and the analyses and data underpinning them, are set out much more fully in separate reports sent to Deputies.

The FSB believes that the authorities’ approach to shadow banking should be targeted and balanced. Our objective is to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like systemic risks that emerge outside the regulated banking system, while not inhibiting sustainable and resilient non-bank financing models. The approach is designed to be proportionate to financial stability risks, focusing on those activities that are material to the system, and using as a starting point lessons drawn from the last crisis.

Hence, the recommendations seek:

- (i) to mitigate the spill-over effect between the regular banking system and the shadow banking system;
- (ii) to reduce the susceptibility of *Money Market Funds* to “runs”;

- (iii) to assess and mitigate systemic risks posed by *other shadow banking entities*;
- (iv) to assess and align the incentives associated with *securitisation* to prevent a repeat of the creation of excessive leverage in the financial system; and
- (v) to dampen risks and pro-cyclical incentives associated with *secured financing contracts such as repos, and securities lending*.

In addition, vigilant oversight of shadow banking activities will be required to respond to inevitable market mutations. In this regard, we now have well in train a monitoring process for these activities.

We will start public consultations on some of these initial recommendations shortly. These will be complemented by quantitative impact assessments of the key recommendations. Based on these iterative processes, we expect to revise the recommendations and provide a final set for the September 2013 G20 Summit in St Petersburg.

### ***Building resilient financial institutions***

The core of the Basel III agreement is the recognition that building more resilient banks requires higher and better quality capital.

Jurisdictions are making progress in developing legislation to implement Basel III, although much remains to be done. The transitional phase commences on 1 January 2013, and at this point only 8 of the 27 member jurisdictions of the Basel Committee have issued the final set of Basel III related regulations (see Annex to this letter). This means that there is a high probability that only 6 of the 28 global systemically important banks identified by the FSB will be subject to Basel III regulations from the globally agreed start date. It is crucial that all jurisdictions redouble their efforts to pass legislation that is consistent with the Basel III framework by the agreed deadline.

The Basel Committee will publish regulatory consistency assessments of the Basel III regulations of all G20 jurisdictions. Those jurisdictions that have undergone an assessment should close any identified gaps between their regulations and Basel III as quickly as practicable.

### ***Ending “too-big-to-fail”***

At Cannes, the G20 Leaders endorsed the FSB’s policy framework to address the systemic and moral hazard risks associated with SIFIs. Too often, because we have lacked adequate resolution tools and the capacity to co-ordinate resolution across borders, we have answered the threatened failure of such firms by bailing them out using taxpayer funds.

The key measures of the policy framework are:

- Reforms of national resolution regimes so that any financial institution can be resolved without disruptions to the financial system and without exposing the taxpayer to the risk of loss, using *The Key Attributes of Effective Resolution Regimes for Financial Institutions* as a point of reference.

- Mandatory recovery and resolution plans and resolvability assessments for each global SIFI, as well as a cross-border cooperation agreement between relevant authorities.
- Requirements for globally systemically important banks (G-SIBs) to hold additional common equity capital above the Basel III minimum standards, rising from 1% to 2.5% of risk-weighted assets commensurate with the systemic impact of their failure, to be fully phased in by 2019.
- More intensive and effective supervision, including through stronger mandates, resources and powers, and higher supervisory expectations for firms' risk management and data aggregation capabilities.
- The extension of this framework to other systemic financial firms, including domestic systemic banks, insurance, non-banks and core financial market infrastructure.

Progress is being made in implementing this framework, as described below, and the FSB will ensure that implementation is peer reviewed with respect to overall consistency. Given the importance of ending TBTF, Ministers may wish to request a comprehensive assessment by the St Petersburg Summit on the extent to which it has been ended and what further steps, if any, will be required.

**Regarding reforms of resolution regimes**, a peer review of national actions taken to legislate the *Key Attributes of Effective Resolution Regimes* will be published in the first half of 2013. Getting the right legislation in place is essential to countries having the necessary powers to advance resolvability of G-SIFIs and the legal capacity for cross-border border co-operation. Finance ministers – as part of the executive branch of government – have a key role in driving through these requisite changes. Further policy development, focused on resolution of non-bank financial institutions, including investment firms, financial market infrastructures and insurers (particularly insurance groups with non-traditional non-insurance activities) that could be systemically critical if they fail, is underway in this area.

**Uneven headway is being made in G-SIFIs resolution planning.** Progress here is contingent on a clearly articulated high-level 'resolution strategy' for each G-SIFI, and this in turn depends importantly on the requisite legal frameworks being in place. In view of this, the timeline for completion of operational resolution plans for the G-SIBs has been extended by six months till mid-2013, and the start date of the FSB's peer-based resolvability assessment process delayed till the second half of 2013. To assist progress, the FSB had developed additional guidance in technical areas of recovery and resolution planning, covering (i) recovery triggers and stress scenarios; (ii) the development of resolution strategies and operational resolution plans tailored to different group structures; and (iii) the identification of firms' critical functions and critical shared services.

The FSB is **publishing this week an updated list of G-SIBs** to which the resolution and added capital requirements apply. Based on end-2011 data, the number of G-SIBs is reduced by one overall, from 29 to 28, as two banks have been added and three banks removed from the list. Starting this year, the G-SIBs are allocated to buckets corresponding to their required level of higher loss absorbency (HLA). The HLA requirements for G-SIBs will be phased in

starting from 2016, initially for those banks identified as G-SIBs in November 2014, and are to be fully met by 2019. The Basel Committee is continuing work to address remaining data quality issues and will adopt any necessary methodological refinements before the G-SIB loss absorbency requirements go into effect. The ranking and the corresponding buckets for G-SIBs are therefore provisional and will be based in the future on the best and most current available data prior to implementation.

**More intense SIFI supervision** is a key pillar of the SIFI framework. Our third progress report in this area notes that weak risk controls at G-SIBs are still a concern, and supervision needs to be strengthened to ensure that it is proactive and effective. The report recommends stepped up supervisory interaction with Boards and senior management and assessment of the effectiveness of their risk governance practices and risk culture; updated capital requirements for operational risk; and steps to increase the effectiveness of supervisory colleges. The report notes that the IMF-World Bank FSAPs continue to identify problems in the fundamental requirements for effective supervision, such as the core principles for official mandates, resources and independence. Resource constraints at supervisory authorities were identified in the 2011 FSB progress report as hampering progress toward improving the intensity and effectiveness of supervision.

Responding to the Leaders' request at Cannes, the Basel Committee and FSB have **completed the policy framework for domestically systemic important banks (D-SIBs)**. The D-SIB framework focuses on the impact that the distress or failure of banks would have on the domestic economy, while recognising also the potential for spillovers at regional or bilateral level. The framework provides for national discretion in the assessment of systemic importance and application of policy tools, including HLA and heightened supervision, recognising the different structural characteristics of national financial systems. Importantly, national implementation will be subject to peer review to preserve a level playing field and compatibility with the G-SIB framework. Given that the D-SIB framework complements the G-SIB framework, the FSB and BCBS consider it appropriate that banks identified as D-SIBs are required by their national authorities to comply with the principles in line with the phase-in arrangements for the G-SIB framework, i.e., from January 2016.

The IAIS has developed and the FSB has endorsed for public consultation **proposed policy measures for globally systemically important insurers (G-SIIs)**. These reflect the policy measures in the G-SIFI framework and comprise enhanced supervision of G-SIIs, HLA and effective resolution of G-SIIs. The initial cohort of G-SIIs will be designated and published in the first half of 2013. G-SII measures on enhanced supervision and effective resolution will begin to be implemented immediately after the list is published. HLA requirements should begin to be implemented in 2019 for the G-SIIs designated in 2017.

The CPSS and IOSCO have finalised the principles for Financial Market Infrastructures (FMIs) and will be finalising the assessment methodology, disclosure framework and resolvability of FMIs. The FSB and IOSCO are working on developing methodologies for the identification of other non-bank SIFIs and will publish a joint consultative report next year.

### *Creating continuous markets: OTC derivatives market reforms*

Our latest progress report shows that authorities have made further progress in implementing the G20 reforms to OTC derivatives markets that will improve transparency, mitigate systemic risk and protect against market abuse. In particular, the market infrastructure is now largely in place to support the reformed markets. I am pleased to report that, following the progress made in putting in place the safeguards for establishing a resilient and efficient global framework for clearing derivatives, **all FSB jurisdictions have now declared their regulatory approach to achieving the G20 commitment that all standardised derivatives be centrally cleared.** I am sending you a summary of those declared approaches. In addition, trade repositories exist in all asset classes, though some issues remain to be resolved to ensure authorities have adequate access to the data they need for regulatory and financial stability purposes.

Notwithstanding this progress, regulatory uncertainty remains the most significant impediment to full and timely implementation of the reforms to OTC derivatives markets. In particular, jurisdictions need to put in place their legislation and regulations promptly, and international coordination is needed on the cross-border scope of regulations, and cooperation over their application. The FSB is urging regulators to pursue further discussions before the end-2012 deadline to (i) identify the cross-border application of rules to infrastructure, market participants, and products; (ii) identify concrete examples of any overlaps, inconsistencies and conflicts; and (iii) develop options for addressing these issues. Senior regulators are being encouraged to coordinate on regulatory issues that are acting as impediments and find mutually acceptable solutions for providing clarity regarding how rules will apply to transactions and entities, and to keep the FSB informed of progress and remaining issues.

### *Global Legal Entity Identifier (LEI) System*

The Los Cabos Summit endorsed the FSB recommendations for development of a global legal entity identifier (LEI) system for parties to financial transactions, with a global governance framework representing the public interest. The Summit Declaration noted that the LEI system will be launched by March 2013, and asked the FSB to report on progress in November 2012.

This initiative is on track. As a key first step in the implementation, the FSB has prepared a draft Charter for the Regulatory Oversight Committee (ROC) of the global LEI System. **Endorsement by the G20 of the draft Charter is sought to initiate the process to form the ROC.** In turn, establishment of the ROC as the permanent governance arrangement is a prerequisite for the creation of the proposed global LEI foundation and the operational structure of the global LEI system. Good progress is being made collaboratively with private sector experts on preparatory work covering legal and governance arrangements, operational planning and the enhancement of relationship data.

### *Addressing data gaps revealed by the financial crisis*

As part of the FSB and IMF effort on closing information gaps, the FSB is leading work to improve the collection and sharing of data on interlinkages between SIFIs and their exposures

to countries, sectors and markets. An important milestone will be reached in March 2013, when national supervisory authorities will start pooling bank-level data based on a common data template in a secure data hub located at the BIS, and sharing information under effective governance protocols defined in a multilateral framework agreement between authorities. Over time, it is expected that the data gaps framework will develop to enable more informed micro and macroprudential assessments, support crisis management, and contribute to a better monitoring of the risks posed by SIFIs.

### ***Enhancing the risk disclosure of major banking institutions***

The FSB encourages the G20 to recognise the recent publication of the Report of the private-sector Enhanced Disclosure Task Force (EDTF). The EDTF was formed in May this year at the initiative of the FSB. It brought together senior officials from financial institutions, investors and audit firms to develop recommendations for enhancing ongoing risk disclosure practices by major banks, starting with end-year 2012 annual risk disclosures. As requested by the FSB, the EDTF has maintained extensive outreach with regulatory and standard setting bodies and with industry groups at key stages as it developed its report.

The EDTF's principles and recommendations for improved bank risk disclosures practices are designed to provide timely and useful information for investors and other users, which will contribute, over time, to improved market confidence in financial institutions and financial market functioning, complementing regulatory developments by the public sector. The report has been transmitted to the accounting setters and the Basel Committee as an input into their respective work on disclosure frameworks.

### ***Accounting convergence***

At previous summits, the G20 Leaders emphasised the importance of achieving a single set of high quality, improved global accounting standards. Completing the convergence programme on a timely basis is an important step in that process. The FSB has reviewed recent developments in the effort between the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to converge accounting standards. While the two boards have made progress in certain areas, including most recently with respect to plans to more closely align their approaches to classification and measurement of financial instruments, they are beginning to diverge in the important area of impairment of financial assets ("provisioning").

Sound expected loss provisioning for financial institutions is critically important to financial stability. Final IASB and FASB standards should result in improved provisioning practices that incorporate a broader range of available credit information than current practices, so as to recognise credit losses in loan portfolios at an earlier stage. The FSB is concerned that the two boards have not developed a common model in this important area, and encourages them to renew their efforts to converge.

The FSB reiterates the benefits of a timely completion of convergence and considers it important that the convergence programme not lose momentum in other areas. The FSB will

request by no later than end-June 2013 a joint IASB-FASB report on all outstanding items with a specific timetable for completion.

***Reducing reliance on credit rating agency ratings***

It is important to end mechanistic reliance by market participants on CRA ratings, which can amplify procyclicality and contribute to systemic disruption. In Los Cabos, G20 Leaders asked for accelerated progress to achieve this. In response, the FSB has agreed a roadmap, with timetable, to take this forward.

***Monitoring the effects of reforms on emerging market and developing economies (EMDEs)***

The FSB submitted to the Los Cabos Summit a study on the extent to which the agreed regulatory reforms may have unintended consequences for EMDEs. We have developed, in consultation with standard-setting bodies and international financial institutions, a follow-up process for continued monitoring, analysis and reporting of material unintended consequences and measures taken to address them, as requested in Los Cabos.

***FSB resources, capacity and governance***

Following the Leaders' endorsement of the recommendations and the revised FSB Charter at the Los Cabos Summit, action is underway to ensure expeditious implementation of reforms to place the FSB on a more enduring organisational footing. The Articles of Association needed for vesting the FSB with legal personality are being finalised, as are the procedures for guiding the FSB's internal governance. In line with Leaders' call to maintain strong links with the BIS, necessary documentation governing immunities and resource availability is ready for execution, while a Standing Committee on Budget and Resources has been created as an institutional mechanism for assessing the resource needs of the FSB that are commensurate with its assigned mandate. We are looking to conclude these reforms by the St Petersburg Summit.

**Conclusion**

While much progress has been made since we last met, the tasks ahead remain considerable. Your continued engagement, direction and support will be essential to ensuring that we build a more resilient, efficient financial system.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'M. Carney', with a long horizontal flourish underneath.

Mark Carney

Attachment

**Annex: Status of Basel II.5 and III adoption (as of October 2012)**

<b>Country</b>	<b>Basel II.5</b>	<b>Basel III</b>
Argentina	1	1
Australia	4	3, 2
Belgium	4	(2)
Brazil	4	2
Canada	4	2
China	4	3
France	4	(2)
Germany	4	(2)
Hong Kong SAR	4	3
India	4	3
Indonesia	1	2
Italy	4	(2)
Japan	4	3
Korea	4	2
Luxembourg	4	(2)
Mexico	1	2
The Netherlands	4	(2)
Russia	1,2	2
Saudi Arabia	3	3
Singapore	4	3
South Africa	4	2
Spain	4	(2)
Sweden	4	(2)
Switzerland	4	3
Turkey	4	1
United Kingdom	4	(2)
United States	2,3	2
European Union	4	2

Number code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. Numbers in parentheses indicate countries following the EU process.

Source: BCBS Report to G20 Finance Ministers and Central Bank Governors, October 2012.