THE CHAIRMAN

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To G20 Leaders

Progress of Financial Reforms

In Washington in 2008, the G20 committed to fundamental reform of the global financial system. The objectives were to correct the fault lines that led to the global financial crisis and to build a safer, more resilient source of finance to serve better the needs of the real economy. At that and subsequent Summits, the G20 called on the FSB to develop and coordinate a comprehensive framework of reform. By reducing the risk of future financial crises and the consequences of financial instability, these reforms are an essential contribution to the G20's primary objective of strong, sustainable and balanced growth.

This letter takes stock of the progress over the past five years and outlines the major outstanding issues which demand the attention of Leaders. It makes three main points:

FSB members have made major progress correcting the fault lines that caused the crisis. We are building more resilient financial institutions and more robust markets through substantially strengthened international standards. We are addressing the problem of too-big-to-fail. We are working to prevent regulatory arbitrage, so that tightening regulation in one sector or region does not lead to risky activity migrating elsewhere. And we are building a framework for robust market-based finance so that markets will remain continuously open.

Our work is not yet completed. It is crucial that the G20 stay the course in implementing reforms in a consistent manner. More remains to be done to build the resilience of institutions. The G20 should also concentrate in particular on completion of three crucial areas of reform: ending too-big-to-fail; reforming shadow banking; and making derivatives markets safer.

The G20's response will ultimately dictate the openness of the global system and consequently the strength and sustainability of global growth. Only the G20 can decide whether the necessary institutions and co-operative cross-border mechanisms are built in order to realise fully the benefits of an open, integrated and global financial system. Strong, sustainable and balanced growth will not ultimately be achievable without such a system.

WHAT HAS BEEN ACCOMPLISHED

Achieving a stronger banking system has been the overriding priority to correct the principal fault lines that underlay the financial crisis. Only well-capitalised banks can serve the needs of the real economy to promote strong, sustainable growth.

Much progress has been made since 2010 when the G20 endorsed Basel III as a fundamental overhaul of international regulatory standards. Almost all G20 jurisdictions have now issued the final rules to implement the new Basel capital standards. From a starting point of severely depleted capital cushions, many banks, including all the globally systemic banks, are on course to meet the new minimum requirements well ahead of the 2019 implementation deadline. Core institutions are now more resilient and, where banking systems have successfully built capital, access to credit has returned, supporting the economic recovery.

Significant progress has also been made in the development of policies to end too-big-to-fail, to transform shadow banks, and make derivatives markets safer. But if we are to eliminate the fault lines that underlay the global financial crisis, renewed attention and vigour is required from the G20 in these particular areas, as well as in finishing the job of building resilient financial institutions. Under separate cover, the FSB has submitted comprehensive progress reports and work plans to your officials.

WHAT REMAINS TO BE DONE

Building resilience of financial institutions

The G20 must stay the course in implementing standards. The two remaining G20 authorities that have not yet adopted final implementing rules for Basel III – Indonesia and Turkey – should do so as soon as possible. Others will need to bring the rules fully into effect. All authorities should recognise that the strengthening in capital has been uneven and that some banks still require significant repair.

Furthermore, the risk models that banks use to calculate their capital needs show worryingly large differences. This must be addressed for depositors, investors, clients and authorities to have full confidence in the strength of bank balance sheets and their resilience during a downturn. The G20 can support supervisors in working together to do this, and in implementing the remaining parts of the Basel III framework, including the leverage ratio, which will be agreed by the Basel Committee in early 2014. The G20 can also encourage financial institutions to improve their risk disclosures, and accounting standard setters to reach agreement on a new converged standard for loan impairment.

Ending too-big-to-fail

As the G20 directed at prior summits, it is essential that systemically-important institutions can be resolved in the event of failure without the need for taxpayer support while at the same time avoiding disruption to the wider financial system. The expectation that systemic institutions can privatise gains and socialise losses encourages private sector risk-taking and can be ruinous for public finances.

Substantial progress in developing and implementing a policy framework to end too-big-to-fail is detailed in a separate report prepared for this Summit. The most important progress has been to identify systemically important firms in different sectors, impose higher capital requirements and more intensive supervision on these institutions, and to reform national resolution regimes so that failing institutions can be resolved without wider disruption.

Firms and markets are beginning to adjust to authorities' determination to end too-big-to-fail. However, the problem is not yet solved. G20 members should undertake all legislative reforms necessary to make systemic firms resolvable. G20 authorities should be encouraged to develop the necessary cross-border agreements to enable resolution plans to be put into effect. Alongside those actions, the FSB will make proposals on the total loss absorbing capacity that systemically-important banks should have in resolution – so that they are resolvable in a crisis without tax payer support.

Transforming shadow banking

One of the causes of the crisis was the rapid but opaque growth of shadow banking institutions and activities. These played roles traditionally performed by banks, such as borrowing short-term and lending long-term, and leveraging up balance sheets to provide credit. 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.

Recommendations endorsed by all G20 members have been submitted to this Summit to address the systemic risks that shadow banking can pose. These include a policy framework for strengthening oversight and regulation of shadow banking entities. Much more remains to be done. In 2014, the FSB will finalise policies to mitigate the systemic risks of the repo and securities lending market (which are key funding sources for shadow banks) and the Basel Committee will finalise proposals to address the risks from banks' interactions with shadow banks. G20 leaders can support reform by ensuring that their authorities implement these policies.

Making derivatives markets safer

A move to market based finance underscores 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 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 at times of stress. While major equity markets have these attributes, a number of other markets do not.

In particular, the crisis highlighted structural deficiencies in the lightly regulated over-the-counter derivatives market, and the systemic risk it posed for the wider market and economy. That market is now being comprehensively reformed.

While the task is substantial and complicated, progress has been made. Transparency of derivatives transactions is being enhanced through requirements to trade on organised platforms and report transactions to trade repositories. Exposures financial firms have to each other in this market are being reduced by placing central counterparties between the two participants in transactions, wherever possible, and by setting minimum capital and margining requirements.

Not all G20 jurisdictions have implemented earlier commitments. Authorities should promptly introduce requirements for reporting of all derivatives trades to trade repositories, rapidly adopt rules for central clearing and trading on organised platforms, and adopt resolution regimes for financial market infrastructures such as central counterparties.

Importantly, the G20 can follow up on their commitment to cross-border co-operation by supporting their market regulators in establishing agreements for deferring to each other's rules when these produce similar outcomes. In this global market, it is essential that consistent rules apply across jurisdictions in a non-discriminatory way.

REALISING FULLY THE BENEFITS OF AN OPEN, INTEGRATED, RESILIENT 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. The fragmentation of the international financial system would reduce growth in the global economy.

To further complicate matters, financial markets and many of the largest financial institutions are global, but – notwithstanding agreements on international standards – financial regulation remains ultimately national or regional. This underscores the importance of the support G20 members can give to their authorities to remove obstacles to information sharing and establish cross-border arrangements for resolution.

Moreover, to prevent regulatory arbitrage, regulation needs to cover comprehensively global financial markets and institutions, while avoiding conflicts, inconsistencies, unnecessary duplication and gaps between regimes. This does not necessarily mean that different jurisdictions need to have identical market regulations. What matters most is that the outcomes are essentially similar. In the context of OTC derivatives market reforms, G20 Finance Ministers and Governors agreed in July 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. The G20 should encourage the use of outcomes-based approaches to resolving such cross-border market issues.

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 with a more permanent source of funding. The FSB is coordinating a rigorous monitoring and peer review process that assesses and publicly reports on whether countries are fully and effectively implementing reforms. And it is 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.

Conclusion

All G20 members should remain focused on reforms that strengthen confidence in the resilience of national and global financial systems and should lead by example through their own implementation of the international standards.

The G20 support for completion and full, timely and consistent implementation of reforms 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, including the inevitable economic shocks. That system will best support the G20's ultimate objective of strong, sustainable and balanced economic growth and job creation.

Yours sincerely,

Mark Carney