Statement of Mario Draghi
Chairman of the Financial Stability Board
to the International Monetary and Financial Committee

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In the last several weeks we have witnessed a modest revival in market confidence. It appears that the worst scenarios regarding prospects for the global economy and financial system are no longer quite so prominent in the minds of market participants. This offers us a unique window of opportunity both for short-term actions to stabilise institutions and promote credit extension, and for implementing measures to strengthen the system for the longer term.

Our main challenge is to break the negative feedback loop between the financial system and the real economy. Repairing the balance sheets of financial institutions is a key part of this, and authorities have taken a range of actions to inject capital into banks, guarantee their liabilities and reduce or remove their exposures to bad assets. The ultimate objective of these measures should be to create an environment in which banks are able to repair their balance sheets through sustainable earnings growth and raise the capital they need from private markets at a relatively low cost. This also means providing enough transparency about risk exposures to allow the market to confidently distinguish strong from weak banks, and reducing market uncertainties on the future treatment of different classes of claimants. Regulatory stress tests are a central part of this process, as are efforts to improve disclosure.

Another important part of breaking the feedback loop is to take steps to maintain credit extension to creditworthy borrowers. This has involved, and will continue to involve, a role for public sector balance sheets, including central bank lending and a variety of programmes by fiscal authorities. Steps to restart securitisation markets, with improved transparency and incentive structures building on the lessons of the crisis, can also help to restore credit flows, while enabling banks to clear their warehoused assets. Governments can help here by supporting transparency and standardisation initiatives in the private sector. In the short term, another useful step might be providing guarantees or wraps for the senior tranches of new securitisation issues that conform to strengthened standards of transparency.

As we take steps to revive credit markets, we should be especially mindful of the need to maintain an integrated global financial system. Cross-border financial flows have fallen dramatically, among both advanced and emerging economies. This would not be a concern to the extent that it merely reflected a broader process of deleveraging and reduced risk-taking. But we should guard against actions that unnecessarily reinforce this trend and reverse the long-term progress towards global financial integration. For example, actions to support banking systems should not distinguish between domestic and foreign-owned institutions, nor should credit be diverted to domestic borrowers through subsidies or inappropriate regulatory incentives.

Stabilising the financial sector also includes establishing greater clarity on what the regulatory framework will look like in the longer term. Even as we implement measures to build a stronger, better capitalised financial system, banks and their investors need to be reassured as to their prospects for pursuing profitable business models going forward. This means allowing room for innovation and flexibility, without short-changing fundamental policy goals such as controlling leverage and enhancing consumer protection.

Thanks to the work of the Financial Stability Board (FSB) and others, the broad outlines of this future regulatory environment are now much clearer than they were a year ago. The Financial Stability Forum (FSF) – predecessor to the FSB – and its member bodies made several recommendations for strengthening the system over the past year. This represents an enormous effort in terms of international policy development and the priority now must be on national implementation.

This work has encompassed actions to:

- Strengthen **prudential oversight of capital, liquidity and risk management**, with key proposals and work underway to strengthen the Basel II framework and enhance supervisory guidance.

- Strengthen the **operational infrastructure for over-the-counter (OTC) derivatives**, with central counterparty clearing for OTC credit derivatives now launched in the United States and in Europe.

- Enhance **transparency and valuation**, with consistent guidance now issued by accounting standards setters in a number of areas.

- Improve the **role and use of credit ratings**, with a revised *Code of Conduct Fundamentals for Credit Rating Agencies* issued by the International Organization of Securities Commissions (IOSCO) last year and substantial implementation by the rating agencies.

- Strengthen **information exchange** among authorities, with supervisory colleges now established for most global banks.

- And finally, actions to strengthen **arrangements to deal with financial stress**, including through the *FSF Principles for Cross-border Cooperation on Crisis Management* (published this month), and the new *Core Principles for Effective Deposit Insurance Systems*, now out for public comment.

Work has been also underway to **mitigate procyclicality** in the financial system, with recommendations issued by the FSF earlier this month covering the bank capital framework, loan loss provisioning practices, and ways of dampening the adverse interaction between leverage and valuation. And the *FSF Principles for Sound **Compensation Practices***, also published this month, will align compensation-related incentives with the long-term profitability of firms.

These efforts will help us to avoid similar crises in the future. But the policy agenda is not complete and we must sustain momentum to continue to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.

Indeed, work has not stopped since the London Summit. For instance, there is a substantial work programme underway in the Basel Committee on Banking Supervision on capital and procyclicality, and we are setting in train work with the Bank for International Settlements (BIS) on macroprudential tools. In addition, three areas in which critical work is taking place are (i) accounting and valuation, (ii) hedge funds, and (iii) other systemically relevant entities and products.

On **accounting issues**, the London Summit welcomed the recommendations of the FSF's procyclicality report, and G20 Leaders called for "accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards." In this respect,

- The International Accounting Standards Board (IASB) decided this week to adopt approaches consistent with the recent guidance on fair value for illiquid markets and fair value disclosure from the US Financial Accounting Standards Board (FASB). While the IASB decided not to implement the FASB staff's approach to credit loss impairment for available-for-sale debt securities, it did decide to work with the FASB to issue this year a converged proposal to dramatically simplify their standards for financial instruments, which is expected to include a common credit loss impairment approach for loans and debt securities.

- The IASB-FASB Financial Crisis Advisory Group has called on both standard setters to work with the FSB and the Basel Committee to address the provisioning and valuation recommendations of the FSB and the G20. A working group to be run by the Basel Committee is being established to develop positions.

On **hedge funds**, the FSB has been tasked with working with national authorities to develop and implement coherent approaches to regulation and oversight of hedge fund managers. We will also be working with IOSCO to develop mechanisms for cooperation and information sharing between relevant authorities on hedge fund exposures.

- IOSCO, along with a number of national authorities, is reviewing its approach to oversight of hedge funds. IOSCO released a consultative document on this issue in late March and has held consultative meetings recently. Final policy recommendations are expected in the summer.

- The FSB is working to have the hedge fund industry bodies bring forward proposals for high quality global best practice standards for hedge fund managers. These are now expected in May. The various interested bodies will assess their adequacy and report in the fall.

Three distinct efforts are underway internationally on **other systemically relevant entities and products:**

- The Joint Forum is advancing its project on the differentiated nature and scope of regulation. It covers four areas: (i) consolidation and group-wide approach, which deals with non-regulated entities within groups; (ii) hedge funds (other funds, such as money market funds, will be considered at a later stage); (iii) mortgage originators and brokers and other intermediaries; and (iv) risk transfer mechanisms, focusing on credit risk transfer instruments and associated markets.

- This group is drawing on IOSCO's work on unregulated markets and products, focused on securitised products and credit derivatives markets – a consultative document in this area will be put out in the next days.

- The IMF and the BIS are advancing their work on methodologies to quantify systemic risk and identify systemically relevant institutions and activities. There will be discussion in the weeks ahead on the expectations for joint delivery for the fall.

All the above address a few of the areas for actions highlighted during the London Summit. In addition,

- On supervisory colleges, the FSB is reviewing progress in the establishment and operation of the colleges. It is expected that colleges for all selected large and complex groups will have been established by June.

- On cross-border crisis management, firm-by-firm groups will be established shortly to review contingency planning for the institutions that have FSB supervisory colleges.

- The G20 also called on the FSB and standard setters to assess and raise supervisory and regulatory standards and codes, drawing efficiently on existing processes – including the joint IMF/World Bank Financial Sector Assessment Program (FSAP). Three related objectives under this headings include (i) fostering greater adherence to international standards; (ii) helping to identify jurisdictions that lag behind in terms of their implementation of these standards; and (iv) supporting a peer review process among FSB members.

The FSB, with its expanded mandate and membership, is well placed to carry through and build on these various initiatives. In all of these areas, the FSB will work to promote better coordination among national authorities, international institutions and standard setting bodies.