FSB FINANCIAL STABILITY BOARD

5 October 2010

# G20 Framework: Regulatory Reform and Financial Sector Policies
# Note by the FSB Secretariat[1]

Since the outbreak of this crisis the G20, through the FSB and its members, has advanced a major coordinated program of financial regulatory reform. The FSB is monitoring international and national developments in advancing this program and will report to the November G20 Summit Meeting in Seoul. This program has had the following objectives:

- Strengthening capital and liquidity requirements and containing leverage in the banking system;
- The development of macro-prudential policy tools and frameworks to mitigate pro-cyclicality in the system, and to orient regulatory and supervisory policies to areas posing the greatest potential systemic risk;
- Developing a policy framework to address the moral hazard posed by 'too-big-to-fail' financial institutions through increased loss absorbency and improvements to resolution regimes and cross-border crisis management capacity;
- Strengthening risk management practices at financial institutions, especially for trading and securitisation activities;
- Enhancing supervisory intensity and international coordination through supervisory colleges;
- Establishing comprehensive central clearing and trade reporting in the OTC derivatives markets, and enhancing the robustness of core financial market infrastructure;
- Improving the consistency of regulation across sectors, and extending regulation to areas previously beyond the regulatory perimeter;
- Addressing faulty incentives of various kinds, including compensation practices in major financial institutions;
- Enhancing transparency through enhanced converged accounting and disclosure standards, and by working to close information gaps;
- Addressing the problems of credit rating agencies, and strengthening investor due diligence;
- Strengthening global adherence to international financial standards.

---

[1] The FSB Secretariat previously submitted to the G20 Framework exercise in February 2010 information on FSB member jurisdictions' implementation to date, planned next steps and schedules to implement the G20 recommendations for strengthening financial stability.

**Progress in financial reforms and the implications for the real economy**

Substantial progress has been in the global policy development to take this reform program forward[2], and will be detailed in other reports by the FSB for G20 Ministers and Governors and the Seoul Summit. Alongside the global policy development coordinated through the FSB, national and regional authorities have implemented reforms in their jurisdictions based on timetables agreed at the international level. Countries have completed or materially advanced legislation to implement the G20 reform program, to overhaul regulatory frameworks and to begin to put in place system-wide monitoring and oversight mechanisms. The measures to date have been summarised in the FSB's regular reports to the G20 and will updated reports will be provided to the Seoul Summit.

All of these efforts are central to redressing the weaknesses that produced this crisis and to shaping a financial system and policies that will support confidence and the delivery of more balanced and sustainable growth in the medium to long term. It will be a more disciplined system, better addressed to serving the needs of the real economy. Its governance and transparency will be substantially improved.

**Macroeconomic impact assessment of Basel III**

A key piece of the reform program has come into place with agreement on new bank capital and liquidity standards. Basel III will increase the minimum common equity requirement for banks from 2% to 4.5%. In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%. The strength of these cushions is reinforced by the stronger definition of capital and by higher capital requirements for trading, derivative and securitisation activities to be introduced at the end of 2011.

The quantitative impact on banks and on macroeconomy of the higher capital and liquidity requirements has been assessed and have informed the design of implementation and transition arrangements that will not put the economic recovery at risk. In its interim report published in August, the FSB-BCBS Macroeconomic Assessment Group estimated that, if new requirements are phased in over 4 years, each one percentage point increase in the ratio of banks' actual ratio of tangible common equity to risk-weighted assets would lead to a decline in the level of GDP relative to its baseline path by about 0.2% after implementation is completed. A 25% increase in liquid asset holdings was found to have an output effect less than half that associated with a one-percentage point increase in capital ratios. A companion report by the Basel Committee concluded that there are clear net long term economic benefits from increasing the minimum capital and liquidity requirements from their current levels in order to raise the safety and soundness of the global banking system. The benefits arise mainly from crisis avoidance. But by raising banking system resilience, the new standards should help to lower risk premia in financial markets and will lower fragilities in bank funding markets. At the same time, they should better align risk premia with the true underlying risks, and thereby place growth on a more sustainable path.

---

[2] The measures to date have been summarised in the FSB's regular reports to the G20 and will updated reports will be provided to the Seoul Summit.

The implementation period proposed for Basel III begins 1 January 2013, proceeds with gradual implementation over the five years and is scheduled to be completed by end-2018. The Macroeconomic Assessment Group will prepare a final report estimating the transitional costs of the new global standards by the end of the year.

Further reforms, including the FSB’s Systemically Important Financial Institutions (SIFI) project, will take into account the cumulative impact of the overall reform programme in their design and phase-in arrangements.

**Future priorities for the financial reform programme**

Three priorities lie ahead:

1. Effective and consistent national implementation to deliver the strengthened resilience that the G20 Leaders have demanded and to maintain a level playing field;
2. Completing policy work on resolution frameworks and other key policies to reduce the risks and moral hazard that systemically important financial institutions (SIFI) currently pose;
3. Putting in place capable system-wide monitoring and macroprudential policy frameworks, including to assess the macroeconomic impact of reforms and the financial system responses that the implementation of regulatory reforms will inevitably bring.

Sustained action at the national and regional levels and close monitoring internationally are needed to implement already agreed reforms. The FSB will monitor implementation through ongoing workstreams, including its implementation monitoring network and through thematic and country peer reviews. Effective implementation will require continuing coordination among national authorities in key financial centres to resolve potential conflicts and to avoid discrimination and regulatory arbitrage in implementing national regulation. This will be particularly important in those global markets where business can move rapidly and are therefore vulnerable to immediate regulatory arbitrage. Examples include the regulation of the OTC derivatives markets (where recommendations for full and consistent implementation of the G20’s objectives will be delivered to the Seoul Summit); compensation practices (where the FSB will conduct ongoing monitoring of implementation of its standards), Basel III and the policy framework for SIFIs (for which peer review processes are being designed).

Policy recommendations for addressing SIFIs will be announced at the Seoul Summit. Putting in place an effective response to this problem will require national authorities to pursue in a collaborative manner a work programme whose full implementation will, for some measures, take a number of years. In the shorter term detailed measures will need to be designed to implement the recommendations to increase SIFIs’ loss absorbency, to improve the effectiveness of SIFI supervision, and to develop firm-specific recovery and resolution plans. Over a longer period, changes to legislation will be required to enable effective resolution regimes and to provide the underpinnings in law that are needed for regulators and resolution authorities to cooperate internationally. A key underlying goal of this project is to sharply reduce the likelihood and severity of the loss of economic output that a systemic crisis caused by the failure of a SIFI could currently pose.

The third priority also has many dimensions, amongst them establishing the information basis – including over the shadow banking system – needed for more effective system-wide oversight, the mechanisms to prompt action on identified risks, and coordination where a regulatory response is needed at the international or sectoral level. FSB members will be sharing modalities, tools and experiences on system-wide assessment frameworks. This work will continue to have a focus on the development, in consultation with the BIS, the standard setting bodies and the IMF, of macroprudential tools and frameworks.

An important focus of system-wide oversight in the years ahead will be to monitor carefully the interaction of regulatory reform, financial system responses and macroeconomic developments. The objectives must be to ensure that:

- financial repair is sustained and completed;
- implementation of measures to enhance resilience proceeds;
- unintended financial market dynamics or economic effects are avoided.

The importance of pursuing financial repair, more intensive supervision and regulatory reforms in the period ahead should not be underestimated. The years ahead are likely to see continued accommodative monetary conditions in the advanced economies. This environment will lessen market incentives to adjust, risks encouraging evergreening and forbearance, and carries the prospect of misjudgements of financial risks and of market participants accumulating exposures on the basis of policies that are ultimately unsustainable. Absent reforms and repair, continued fragility may require reactivation of support if shocks occur and would entrench moral hazard. More intensive supervision must exert the discipline on the system needed to continue the process of repair and to prevent the build up of new risks to stability.

Globally, substantial persistent growth differentials across the emerging and advanced economies are likely. These are already eliciting large capital flows. Many emerging market financial systems face challenges from rapid credit growth, asset price inflation, foreign currency mismatches and capital flow volatility. Regulatory policies need to respond to contain the associated risks to financial stability that these challenges present.

Governments in advanced economies must ensure that their financial policies do not add to already large debt burdens. One of the most productive means of assisting this effort is to avoid contingent liabilities to the financial sector crystallising by seeing through the key policy reforms that have now been agreed. At the same time, fiscal actions to bring down government debt burdens and actions to bolster sustainable and balanced growth will be important to reduce financial fragilities and to reduce systemic risks. More balanced growth will also reduce the risks to the financial system from unstable capital flows.

The current environments holds a continuing potential for adverse feedback loops between weak economies, fiscal strains and fragile banking systems. But is also has a counterpart – namely the potential virtuous circle of improved globally coordinated economic policies, improved government balance sheets, and a more resilient financial system able to consistently support the real economy.