

Mario Draghi: Financial stability in the global environment? Learning the lessons from the market crisis

Keynote speech by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at IOSCO's Annual Conference, Tel Aviv, 10 June 2009.

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I am pleased to be here today to discuss the emerging financial regulatory landscape that we are building in response to the market crisis. The last few months have been very busy ones in the international regulatory policy field. I will speak to the main thrusts of the reform agenda and the work underway and ahead of us to implement its directions. But before I do so I would like to say a few words about changes to the role that the Financial Stability Board (FSB) will play in future.

Over the last year, a broad consensus emerged towards placing the Financial Stability Forum (FSF) on stronger institutional ground, with a view to strengthening its effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. A stronger institutional set-up will make the FSB more effective in shaping the global response to the present crises and to retaining globally integrated financial markets.

To mark these changed objectives, the London Summit re-launched the FSF as the FSB, with an expanded membership and a broadened mandate to promote financial stability.

The FSB expanded membership now includes, in addition to the FSF members, the rest of the G20, Spain and the European Commission.

These changes will enhance our ability to contribute to ongoing efforts to strengthen the international financial system. New members will add broader perspectives to our deliberations, and increase buy-in and implementation of our output. All members commit to pursue the maintenance of financial stability, maintain the openness and transparency of the financial sector, and implement international financial standards. To this end, members commit to undergo periodic peer reviews – based, among other evidence, on the Financial Sector Assessment Program of the IMF and World Bank.

In terms of mandate, alongside the FSF old remit – which was to assess vulnerabilities affecting the financial system, identify and oversee action needed to address these vulnerabilities, and promote coordination and information exchange among authorities responsible for financial stability – the FSB will now also:

- monitor and advise on market developments and their implications for regulatory policy, and on best practice in meeting regulatory standards;
- we will set guidelines for and support the establishment of supervisory colleges and manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms;
- the FSB will strengthen its collaboration with the International Monetary Fund (IMF), including by conducting Early Warning Exercises;
- and importantly, we will undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities and addressing gaps. Here there is a strong consensus that the independence of standard setting is essential and must be preserved. Indeed, the value of international standard setting is indispensably linked with their independence. At the same, independent standard setting needs to be complemented with processes for coordination, accountability and governance for

standard setters, including regular consultations with stakeholders. As we have seen in the FSB in the last 18 months or so, coordination across standard setting bodies has been essential in crafting a coherent response to this crisis and to creating a more resilient financial sector going forward. The work of IOSCO has been and continues to be of great importance in this regard.

To support its functions, the FSB will establish an institutional structure commensurate with its expanded tasks. This will comprise a Steering Committee to take forward to the work of the FSB in between plenary meetings, as well as Standing Committees on Vulnerabilities Assessment, Regulatory and Supervisory Cooperation, and on Standards Implementation. And we will greatly expand its secretariat resources.

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Moving on to the regulatory reform agenda, the main value of the intense recent period of international policy making has been the broad consensus it has established on the agenda of change needed to build a stronger, less crisis-prone financial system for the future. Let me emphasize the importance of this: without this consensus, the integrated system that has been of such benefits to all of us would be at high risk of fracture. We now need consistent implementation going forward to preserve a level playing field across national financial sectors.

To summarise very broadly the thrusts of the agenda, let me begin with a key lesson: the need in future to take a system-wide approach to the assessment of financial system and economic conditions, as well to the system's regulation, rather than focus alone on the health of individual institutions, markets and products. While individual economies and financial institutions appeared sound to market participants and to us as authorities, we failed to recognise the extent to which savings-investment imbalances, the growth of complex securitised credit intermediation, changing patterns of maturity transformation, rising embedded leverage, a burgeoning shadow banking sector, and rapid credit-fuelled growth, had created large systemic vulnerabilities. In the future, we need – at national and global level – to be in a much better position to understand and address trends in credit growth, in system-wide leverage and maturity transformation, and in the inter-linkages within the financial system, to identify and constrain emerging risks. For this we require additional system-wide prudential as well as other tools.

Creating the prudential tools, regulatory set-ups and policy tools required to better constrain system-wide risks, including generating the transparency needed for authorities and markets to be better informed about the risks to the system, is the focus of much of the reform agenda. These changes do of course need to be implemented at national levels. But there is work internationally to generate the tools and policies needed, to promote coherence in implementation and to conduct the monitoring that is required. Let me speak to some of these.

One central lesson of this crisis is that the system entered it with too little capital, far too small liquidity buffers, and a capital and valuation regime with significant pro-cyclical consequences. Much work is underway on bank capital and liquidity that will address these issues. The Basel Committee proposed last year changes that by end 2010 will expand Basel II risk capture and very significantly increase trading book capital requirements. And the Committee's much strengthened liquidity guidelines are in the process of being implemented nationally. Further work is underway to strengthen guidance for and monitoring of liquidity management at large cross-border banks.

The FSF and its member bodies also produced a set of recommendations to mitigate pro-cyclicality. These call for (i) regulatory capital requirements to increase the quality and level of capital in the financial system during strong economic conditions so that they can be drawn down during periods of economic and financial stress; (ii) a revision of the market risk framework of Basel II to reduce the reliance on cyclical Value-at-Risk based capital

estimates; and (iii) to supplement risk-based capital requirements with a leverage ratio to contain the build up of leverage in the banking system.

Regarding provisioning, we – and now G20 Leaders – called on the IASB and FASB to reconsider the incurred loss model by analyzing alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information, including by analysing fair value, expected loss and dynamic provisioning approaches.

Policy development in these areas is underway by the IASB and FASB, as well as by the Basel Committee and detailed proposals will be set out by year-end.

On accounting more generally, the G20 asked the FSB to monitor progress by accounting standards setters in implementing the G20's accounting-related recommendations, including efforts to enhance convergence, and improve involvement of prudential regulators and other stakeholders in the IASB's standards setting process. We welcome the efforts by the IASB to accelerate its work schedule to reduce complexity in accounting for financial instruments, and reduce inconsistencies in standards, a goal that is very close to the FSB's global mission. Some authorities have raised concerns about the IASB and its approach to certain issues. The FSB has a strong interest in seeing the IASB come through this period in a manner that supports its role as a high-quality independent accounting standard setter that considers constructive input from key stakeholders. As you know, the Financial Stability Forum (FSF; now the FSB), of which the IASB, IOSCO and others are key members, has had a proven record of supporting IFRS as one of the 12 key international standards that promote financial stability, and in providing constructive recommendations that enhance transparency and related IASB standards. Good recent examples of this are the FSF's report on Enhancing Market and Institutional Resilience published in April 2008 as requested by the G7 and the FSF's procyclicality report in April 2009 which included recommendations developed by a working group co-chaired by Kathy Casey. We have had a positive role in supporting high-quality IFRS and the FSB plans to continue to do so.

A second important area in implementing a system-wide approach is to ensure that all systemically relevant institutions, markets and activities are subject to appropriate oversight, transparency requirements and, where needed, resolution mechanisms. In practice, this means that the scope of regulation will be broadened, and that prudential tools and standards, as well as the intensity of oversight, will be recalibrated to better reflect the systemic foot-print of institutions and activities. How to deal with too-big-to-fail institutions and related moral hazard concerns will be an important focus ahead. And we need to establish market infrastructure, including adequate resolution frameworks, to address the problems of interconnectedness and opaqueness in the financial system.

A lot of work is underway in these areas:

- The BIS and the IMF are setting out methodologies for quantifying systemic risk, identifying systemically relevant institutions and activities, and developing system wide tools for monitoring leverage.
- And the Joint Forum is advancing a project on gaps in the scope of regulation, and approaches to addressing them. This covers gaps both in the regulated sector (i.e. gaps such as AIG's holding company), and unregulated markets, products, and entities, where IOSCO has recently set out consultative proposals.
- In the area of OTC derivatives, work thus far has focused on establishing central counterparty clearing for the CDS market, but central clearing should be extended to standardized OTC derivatives more generally.
- On hedge funds, the US, the EU and other relevant jurisdictions are in the process of articulating registration, regulation and oversight arrangements for hedge fund managers. The FSB, relying on IOSCO, have been tasked with fostering coherent approaches in this area.

- The FSF also recently published *Principles for Cross-border Cooperation on Crisis Management*, to strengthen arrangements for dealing with financial stress at cross-border institutions, and better prepare authorities to manage crisis situations. Another group under the Basel Committee is looking into legal differences across countries and how they can hinder orderly resolution of financial firms.

I would like to highlight here the very important work of securities market regulators, working through IOSCO, to restore transparency, market quality and integrity in the securitisation process. The checks and balance within the market failed to address significant moral hazard problems within this chain. For securitization to recover and to play a role consistent with financial stability objectives, these problems need to be addressed. There is balance to be drawn here as to how far regulation should go and how far we can trust market discipline to reassert itself. But one issue we must not lose sight of is that much securitisation product, whether complex or not, whether with their knowledge or not, ultimately ends up in retail investor portfolios. IOSCO is formulating recommendations to address these incentives problems, through conduct and disclosure requirements, retention by issuers of economic exposure to transactions, strengthened due diligence requirements on asset managers, strengthened investor suitability requirements, and not least, reduction of conflicts of interest at credit rating agencies. We look forward to receiving your conclusions at our forthcoming FSB meeting.

The above complements other important efforts to strengthen risk management practices and governance at banks and other financial institutions. The lessons of failures in these areas have been set out in reports and guidance by the Senior Supervisors Group (SSG), the Basel Committee, by the IIF and the Counterparty Risk Management Policy Group.

One area that politicians, the broad public and supervisory authorities will pay significant attention to is changes to compensation practices at financial institutions. The Principles we have developed cover Effective Governance of Compensation Systems, Effective Alignment of Compensation with prudent risk taking, and Effective Supervisory Oversight and disclosure to and engagement by shareholders. They will be reinforced through supervisory examination and intervention at the national level, as well as by disclosure requirements (on which IOSCO is working). We expect national authorities and firms to implement material parts of the Principles by end of 2009.

There is a clear need for supervisors, regulators and other authorities to raise their own game, nationally and internationally. At both levels, authorities need to become more responsive to and more nimble and effective in mitigating emerging risks. Information exchange and co-operation across authorities both nationally and internationally needs to improve. Most countries are reviewing their national arrangements for collaboration amongst relevant national authorities. And at the international level, supervisory colleges have now been established for most global banks.

The priority ahead is implementation. This is largely in national hands, but we need coherent approaches across countries and regions. Indeed, the G20 leaders have placed a renewed emphasis on this. The FSB, the standard setting bodies and the IMF/WB have been tasked with assessing implementation to serve three complementary aims: first, to foster greater adherence to international standards; second, to help identify jurisdictions that lag behind in terms of their implementation of selected standards; and third, to support peer review processes, such as those FSB members have committed to as an obligation of membership.

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I'd like to conclude with a number of principles that guide our actions as we pursue our reform agenda:

- First, the guiding principles behind our work is to recreate a financial system that operates with less leverage, is more immune to the set of misaligned incentives at the root of this crisis, where transparency allows better identification and

management of risks, where prudential and regulatory oversight is strengthened, and the system is able to let mismanaged institutions fail.

- Second, clarity. We are committed to establishing clear expectations about what the future regulatory environment will look like. Establishing stable expectations regarding the future regulatory environment will allow market participants to make forward strategic decisions with a greater degree of confidence.
- Third, while the direction is clear, changes will in cases be gradual. Some elements of the reformed system (such as higher capital) will need to be phased in as conditions improve.
- Fourth, we must preserve the advantages of open and integrated global financial markets. Given global markets and institutions but national regulatory rules and practices, we must strive for international consistency in standards of regulation to support a level playing field across jurisdictions. At the same time, if open global markets are to be preserved, these standards need to be strengthened to give adequate protections to “innocent bystanders” affected by the indiscriminate risk taking and retrenchment we have observed.
- Last, as we develop and apply more assertive regulation and supervision to contain excessive leverage and address market failures, we must resist imposing excessive, stifling levels of regulation. Regulation must not prevent innovation, which is necessary if we are to improve product choices for consumers and an expanded access to credit. But we need to ensure that innovation does not compromise other clearly stated goals, including systemic stability and consumer protection. The challenge for regulators and market participants alike is, as always, to strike the right balance.