Mario Draghi: Challenges to financial stability and the proposals of the Financial Stability Board

Address by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the 12th Conference of the ECB-CFS Research Network "Learning from the Crisis: Financial Stability, Macroeconomic Policy and International Institutions", hosted by the Einaudi Institute for Economics and Finance, Rome, 12 November 2009.

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1. The crisis and the new regulation of finance

Conditions in the financial markets have been improving steadily since last spring, but neither risk premiums nor funding costs have come back to their pre-crisis level. At the onset of the crisis it became soon clear that the international community had to work together closely to find a way out of it. It was the first lesson we learnt: before the crisis, governments, regulators, and the financial services industry had for years been affected, in more than one dimension, by a sort of collective and pervasive blindness. The tremendous macroeconomic imbalances that had been accumulating for years, market developments also stemming from regulatory mistakes that had made regulators' knowledge obsolete, the new and crucial role of intermediaries' balance sheets for the transmission of monetary policy, were all phenomena that were either ignored or downplayed in their importance. Surprisingly, though it was widely recognized that risk was being priced and trade globally, this did not lead to greater international cooperation in financial regulation.

The rapid spread of this devastating financial crisis has vividly demonstrated the power and force of global integration. If banks all over the world over-extend leverage and under-price risk, a mere change in sentiment in the US housing market can be a sufficient catalyst for a widespread collapse in confidence. Market liquidity evaporates, and credit supply contracts as the global financial system comes under severe strain. After the failure of Lehman's, markets actually froze across the globe, and extraordinary intervention was needed to prevent systemic collapse. World trade slumped as demand plummeted. A "great recession" was inevitable in most advanced countries.

Then it was rapidly acknowledged that international co-operation should become an essential feature of the management of this crisis.

Financial systems were underpinned by public capital injections, massive exceptional liquidity support and funding guarantees. And there was a widespread loosening of macroeconomic policies. Authorities worked closely together to alleviate particular pressure points, such as the shortage of US dollars in foreign currency swap markets, through the introduction of temporary bilateral swap agreements. And now, as market conditions improve, there is a clear recognition of the need to co-ordinate across countries the exit from support measures, particularly where spillover risks are significant.

Clear political leadership for this has been provided by the G20, designated as the premier forum for international economic and financial co-operation.

One key objective of such co-operation is to achieve radical changes to the financial system regulation. In an integrated system, where level playing field concerns are very real, this requires international policy development and consistent implementation. In this area, the Financial Stability Board – which I have the privilege of currently chairing – plays a key role.

2. The role of the Financial Stability Board

The Board was established earlier this year by the G20 to lead, co-ordinate and monitor progress in strengthening financial regulation and to drive the development and

implementation of policies to support global financial stability. It succeeded the Financial Stability Forum, but incorporated a substantial expansion of the membership to include the large emerging economies. And at the same time, the mandate was broadened and enhanced. The strengthened mandate is now enshrined in the FSB Charter that took effect from the Pittsburgh Summit last September.

So why do we need a Financial Stability Board? What is the distinctive role the Board plays in strengthening the global financial system? How does the Board work to deliver the key objectives set by the G20 Leaders? And what are the key priorities in the coming months?

The strength of the FSB lies in its membership. It brings together in one organization senior level representatives (heads or deputies) from all the relevant actors: regulatory authorities, central banks and finance ministries from 24 jurisdictions spanning the major financial centres across the globe. Indeed, to ensure broad coverage, and thus to improve the effectiveness of policy design and execution, membership is wider than the G20. And these national representatives are joined on the Board by the heads of the key international standard setting bodies and by high-level officials from the major international financial institutions.

By harnessing the common aims and collective responsibilities of this membership, the Board is uniquely placed to promote global financial stability. A number of objectives follow.

A primary role of the Board is to undertake the *diagnosis of regulatory, supervisory and financial policy changes* needed to maintain financial stability. To deliver on this, it is our task to ensure that the work of national authorities and the international standard setting bodies is appropriately prioritized, effectively coordinated and focused on the health of the financial system as a system, that gaps in the regulatory agenda are identified and filled, and that overlaps and inconsistencies are avoided.

Second, as I will illustrate further below, many financial stability policy goals, such as resolving the “too big to fail” problem, span a wide range of issues that require input, expertise and action from a number of standard setting bodies and national and international agencies. The Board will *oversee these multi-dimensional work programmes*, to balance the potential solutions from individual work streams, and to offer consistent advice to political leaders on how to develop a strong policy framework.

And third, the Board will promote consistent implementation and follow through of agreed policies and standards.

3. Developing financial stability policies

A key responsibility – and a starting point for much of the FSB’s work – is to identify sources of vulnerability in the global financial system and how best to reduce them. There are conjunctural as well as structural components to this assessment and, as this crisis has amply demonstrated, these components interact.

While we regularly review trends in global financial system to identify areas where risks may be building, our primary focus is the identification of structural weaknesses: market failures, such as the misalignment of incentives, collective action and coordination problems; weaknesses in market infrastructure; and information asymmetries and shortfalls. Such “fault-lines” in the fabric of the financial system highlight the need for regulation and supervision.

It is vital that the authorities work closely together to deliver common and consistent solutions to identified system-wide vulnerabilities, given the potential for arbitrage and regulatory competition and the risks of conflicts between uncoordinated national policy objectives. A collective diagnosis is the necessary foundation for a well coordinated and effective response.

Following the onset of the financial crisis, an urgent and immediate task of the FSB's predecessor, the Financial Stability Forum, was to undertake a thorough assessment of the main sources of the crisis, the weaknesses revealed and lessons for policy. In April 2008, the FSF produced a report committing its members to a wide range of concrete actions to strengthen financial system resilience. A further set of recommendations, focusing on ways to reduce the procyclicality of the financial system, to improve co-operation in cross-border crisis management, and to strengthen compensation frameworks, was published in April 2009. Together, our 2008 and 2009 reports were major inputs into the Declarations by Leaders at the Washington and London summits on an action plan to strengthen the financial system. We have since been asked to oversee, drive forward and co-ordinate implementation of the action plan, and strengthen it where needed.

The key message is straightforward: we need major changes. We need to build a system which is less leveraged, where capital and liquidity buffers are much stronger, where all institutions or infrastructure capable of posing significant risk are subject to appropriate oversight and safeguards, and where no institution is too big to fail. And we need a systematic effort to reverse the misalignments in incentives that came to characterize part of financial system.

All this requires a regulatory and prudential framework which pays much more attention to system-wide interconnections and the health of the global financial network. We consequently need to focus much more on the difficult, but also crucially important, challenges of designing and implementing a macroprudential system of regulation. This will ensure that the financial system is a source of stability that supports the economy under stress, not a source of weakness that amplifies strains and causes major economic damage.

In undertaking this collective diagnosis and drawing up a work programme, an important element of the FSB's role has been to ensure that there is sufficient focus on key areas that cut across the responsibility of different international agencies and groupings. Two good examples, high on the policy agenda, are procyclicality and compensation.

There will be major corrective measures to mitigate the procyclical tendencies of the system. Banks will be required to build up a capital buffer during the expansionary phases of the cycle to draw on at times of generalized difficulty. It has already been proposed to mandate a significant increase in the capital charges on trading activities and exposures to securitization instruments. The FSB's proposals are being addressed within the framework for capital regulation, driven by the Basel Committee; those on provisioning, accounting and valuation issues are taken forward by the accounting standard setters with input from the regulatory community; those on margining practices in securities and OTC derivatives markets are being pursued by the Committee on Payment and Settlement Systems and the Committee on the Global Financial System.

We are now entering a critical stage in the regulatory reform process: we have to take some difficult decisions. The Basel Committee will test those affecting the capital framework through a comprehensive impact assessment in 2010, and phase them in as financial and economic conditions improve.

Principles on compensation were published in the spring. The FSB followed up with implementation standards in September, which were endorsed by G20 Leaders at the Pittsburgh Summit. The new rules apply to top management and to anyone who has the power to make decisions with a significant impact on the balance sheet of a bank. They provide that a good part of compensation should be variable, dependent on the bank's performance, but with payment deferred for at least three years and in the form of securities, and with a claw-back clause in the event of unsatisfactory performance by the bank or the executive. The aim of these rules is to counter excessive risk-taking, the pursuit of short-term gain and opacity in compensation. They emphasize disclosure and the control function of the board of directors and the shareholders. Above all, they extend regulatory jurisdiction to the sphere of executive compensation.

Action is now urgently required by national authorities and by the standard setters for the banking, securities and insurance industries to implement these principles consistently. A first check on their application is scheduled for March 2010.

4. Rolling back moral hazard risk

At the top of our current agenda is the need to resolve the "too big (or too complex/too interconnected) to fail" problem. The problem has been around for years, it has not been addressed and, by objective measures, our actions to save the financial system this time have expanded the problem. The FSB have committed to propose measures to reduce the risks posed by systemically important institutions by October 2010.

Work will progress under three broad, complementary approaches.

The first is to reduce the probability and impact of failure of a systemically important institution. Options under consideration include strengthening the resilience of the institution through higher prudential requirements, contingent capital, or limitations on higher risk activities, and policies that lessen the impact of failure and the associated contagion risks through constraints on size and/or connectedness.

The second approach is to improve the capability of the financial system to deal with failure, through ex ante contingency planning to develop individual de-risking, and through further steps to improve national and international crisis resolution frameworks.

The third approach is to strengthen the core financial infrastructure to withstand failure, including through arrangements for central counterparties, OTC contract design and collateralization practices.

Given significant differences in financial structures and systems, there is unlikely to be a one size fits all answer to the moral hazard problem. But the underlying challenges and the necessary approaches to them are broadly similar across jurisdictions. Many of the policy approaches discussed have level playing field implications for the structure of international banking and financial activity.

We need therefore to ensure that the policies adopted to meet these challenges are consistent and coordinated, do not promote arbitrage that undermines their effectiveness, and do not impose unnecessary constraints that lead to fragmentation of the global financial system.

5. Strengthening policy implementation

The FSB have been successful in formulating a common agenda that has gained widespread political endorsement. But that is not enough. Effective, timely and consistent implementation of agreed policies and standards at national level is essential: first, to resolve collective action and coordination problems; second, to prevent harmful arbitrage, spillovers and regulatory competition; and third, to preserve the benefits of a level playing field across the global financial system.

It is ultimately up to the national supervisors and regulators to implement the measures they agreed upon within the FSB. Responsibility for the surveillance on the actual implementation belongs to the IMF.

However, one should also underline that all 24 member authorities have committed in the FSB Charter to implement international financial standards, and to undergo periodic peer reviews of their adherence. These peer reviews will be of two kinds – country on country reviews, and thematic reviews which examine implementation of agreed policies in a given area across the membership.

We will begin conducting peer reviews in January, starting with a review of the implementation of the FSB's Principles for Compensation that I spoke about earlier. More generally, to further bolster international consistency in rulemaking, our members will participate in an information network to monitor the national implementation of all new measures agreed by the FSB and G20 to strengthen global financial stability. That network will be drawn on in future thematic reviews.

The FSB aims to lead by example to strengthen observance of international financial standards across the globe. Independent, published, peer reviews of implementation of standards within member jurisdictions will encourage a "race to the top" in terms of adherence. They will also reinforce the credibility of the FSB.

6. Concluding remarks

International cooperation has limited the economic impact of the crisis, avoiding the worst scenarios. Still, difficult challenges lie ahead of us: how to recover a balanced, sustainable growth path; how to build a new financial regulatory framework that reflects the lessons drawn from the crisis.

The FSB has been created to improve the design and implementation of financial policies across the globe. The current framework has been shown to be seriously wanting and has posed enormous economic costs. It is consequently vital that authorities diagnose the current problems thoroughly and take bold and radical action to remedy the current deficiencies. The need to strengthen the resilience and robustness of the global financial system is clear and paramount.

There is a major work programme ahead for international regulatory bodies, for national authorities, for the IMF and for the Financial Stability Board itself. In many areas, such as the "too big to fail" problem, there will be no easy answers. In others, such as introducing a macro-prudential or systemic approach to financial regulation, both academic and policy thinking is still at an early stage. And as the situation improves, the power of vested interests contrary to any substantive reform gets stronger. Nevertheless, we must take action in the near term in all areas.

Can we prevent the next crisis? Almost by definition of the word "crisis" the response to this question is bound to be negative, but what we can and should do is to make our financial system more resilient when the next crisis will hit it. After all we have shown that we are able to learn from experience. This crisis had all the potential to generate the same devastation as in 1929, but this time both the structure of the real economies was more robust, and the policy reaction was more perceptive and eventually successful.