Mario Draghi: The Turner Review rollout

Remarks by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board (previously Financial Stability Forum (FSF)), at the Turner Review Conference, Financial Services Authority (FSA), London, 27 March 2009.

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The past eighteen months of crisis have been a learning experience for all of us. Many had expressed forebodings about the build-up of risks and leverage ahead of the crisis – and I would count both the FSF, BIS and the FSA in that number – but the weaknesses of risk management at major banks were so serious and pervasive as to defy even the more pessimists. Authorities have had to re-examine their fundamental assumptions about how the financial system works, and draw conclusions for how to reshape regulation. Lord Turner's review does an excellent job at both of these tasks.

As we seek solutions to these immediate challenges, from a longer-term perspective we are revising our ideas about what regulation can do, what it cannot do, and what it needs to do. Some say that we should avoid detailing how we will move to a more transparent, better capitalised, less leveraged system in the future and that to do so now would increase the burdens and uncertainties faced by banks in the present. I, and I think Lord Turner as well, would reject this view. To the contrary, as policymakers, while being fully aware about the time scale of implementation of these measures, we need to be as clear as possible right now about how we see the system evolving as we emerge from this crisis, if we are to rebuild confidence in the system among financial institutions, investors and the public at large.

Lord Turner's review lays out a sound, well argued case for revising our approach to financial regulation and placing such revision in an international context. Many of these changes are fully in line with discussions and recommendations that have taken place in the FSF. This shouldn't come as a surprise, since Lord Turner and Callum McCarthy before him, and more broadly the whole of the FSA have made important contributions to these recommendations. I would especially emphasise:

- improving the quantity and quality of bank capital, especially for the trading book;
- improved regulation and risk management of liquidity risk;
- a risk-based approach to compensation in the financial industry;
- counter-cyclical capital buffers; and
- incorporating cyclical factors in published accounts.

I also applaud Lord Turner's proposals for enhancing macroprudential analysis – that is, assessing the implications of macroeconomic trends for financial stability, the ability of the financial system to absorb or propagate macroeconomic shocks, and the interlinkages among financial firms. Indeed, it is precisely in this area that we have the most to learn from the experience of this crisis. We need to think hard and carefully about how to put these lessons into practice in formulating policies that incorporate financial stability concerns into traditional macroeconomic policy levers as well as regulatory rules and approaches.

Many of these areas for action have an important international dimension. As we implement these new approaches, it is critical to maintain a level playing field internationally as far as possible. We must avoid a situation where national authorities are reluctant to impose tighter regulation for fear that this gives an advantage to banks in other countries. We need internationally consistent rules and standards to support sound international financial activity and mechanisms for supervisors to share information and coordinate supervision of large cross-border institutions. And we must better understand the systemic risks that never respect national borders, as we have repeatedly seen during the past 18 months.

This means that we need more effective international cooperation. The FSF contributes to this cooperation by regularly bringing together senior officials responsible for setting financial policy at the national level along with international financial institutions and standard setters. Our dialogue facilitates a common diagnosis of problems, a better understanding of how key policy responsibilities and fields of operation interact, and a more coherent and consistent approach to maintaining a stable and efficient financial system.

FSF members share a determination to address the systemic problems that have been at the heart of the crisis and have engaged in an active collaborative effort over the past year and a half to develop and implement measures to strengthen the underpinnings of the financial system. A year ago we published our *Report on Enhancing Market and Institutional Resilience,* which set out a plan of action for strengthening the system in such areas as prudential regulation, transparency, the role of credit rating agencies, and international cooperation in the supervision of large complex groups. We are also about to issue recommendations and principles in important additional areas:

- On procyclicality, the FSF recommends actions that will dampen procyclicality in bank capital, establish more forward-looking loan loss provisions, and mitigate the adverse interaction between the build-up of leverage, maturity mismatching and fair value accounting;
- The FSF has also endorsed Principles for Sound Compensation Practices that will better align compensation arrangements in financial firms with prudent risk taking, and make these arrangement subject to supervisory oversight;
- Finally, we have endorsed Principles for Cross-border Cooperation on Crisis Management that commit our members to cooperate in preparing for and dealing with financial crises.

A significant amount of this work delivers on the G20 Action Plan and will be published as part of the London Summit in the next few days.

To be effective and retain legitimacy, the FSF's international coordination activities need to involve the leading advanced and emerging economies. For this reason, we have recently announced the expansion of our national membership to encompass all of the G20 countries, as well as Spain and the European Commission. The expansion of the FSF's membership will enhance the FSF's ability to contribute to ongoing reforms of the international financial system. Countries that are members of the FSF commit to co-operate in promoting financial stability, maintain the openness of the financial sector, endorse and implement international financial standards and to undergo periodic peer reviews of their financial, supervisory and regulatory arrangements.

Looking forward, the FSF needs to remain engaged with the most important issues and questions that have been raised by the present crisis. For example, as the Turner Review recognises, regulation needs to focus on the economic substance of financial activities, rather than the legal form assumed by institutions. We have learned that the activities of large, highly leveraged institutions of all kinds have significant systemic impacts and potentially pose critical systemic risks. For this reason, the FSF has initiated work to assess the proper perimeter of regulation – to evaluate which institutions, markets, instruments and activities need to be supervised directly with an eye to their systemic relevance, regardless of their legal form, and what regulatory tools are appropriate.

Finally, as authorities we need to improve our ability to recognise, assess and respond effectively to mitigate nascent systemic risks at the global level. This is by no means an easy task – as we have learned from the experience of the present crisis, many critical risks are hidden on and off the balance sheets of large, complex institutions, or in the exposures to complex financial instruments, or in the idiosyncratic characteristics of national markets. No single authority can realistically obtain a complete picture. Yet, looking back on what was said by the FSF, the FSA and others in the leadup to the crisis, it is clear that there was a growing unease with the overall degree of risk-taking, financial institutions' management of the risks of complex credit products, and with the expectation of many institutions and markets that high, stable levels of market and funding liquidity would continue indefinitely. What the official sector lacked previously was the willingness to dig deeper into these concerns, develop timely strategies to mitigate these risks, and track the effectiveness of our responses over time.

For this reason, it is critical that we better pool the analysis and assessments of supervisors and central bankers across the major economies and financial centres and that of the international financial institutions that undertake surveillance of the global financial system. The FSF and the IMF have begun a process to do just this. Second, we need to be more proactive and persistent in how we respond to the risks that we identify. While we will never be able to precisely anticipate the nature and timing of the next financial crisis, there is a great deal we can do to ensure the follow up on the actions of policy-makers to mitigate macrofinancial risks before they become threats to systemic stability, and thereby to ensure that future episodes of financial turbulence remain contained.

So let me conclude by once again commending Lord Turner for his timely and well thought report. I hope it will spur all of us, at both the national and international levels, to rethink how and why we regulate, and to make the tough decisions that will be necessary if our financial systems are to resume their primary function in supporting stable economic growth.