Mario Draghi: The transatlantic relationship in an era of growing economic multipolarity

Keynote speech by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the Peterson Institute for International Economics – Bruegel Conference, Washington DC, 8 October 2010.

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Let me start by thanking [Fred, the IIE, Bruegel] for inviting me to this policy debate on regulatory reform and transatlantic relations. The issues on the conference agenda are highly topical and present challenges for international policy makers.

Just as is the case for tackling the problem of global climate change – another important topic on your agenda – achieving a more stable and resilient global financial system requires coordinated action at the global level. The US and Europe have strong joint interests in this and are critical to progress. But so are the growing weight of countries beyond these continents, and they have come to play an increasingly important role in shaping global outcomes.

In my remarks I will first review what we have achieved so far in terms of financial reforms. I will then turn to important challenges still ahead of us. And I will conclude with thoughts on international policy coordination and the role of the FSB.

Achievements so far

We have come a long way towards strengthening the financial system since this crisis began, reflecting an unprecedented amount of international co-ordination in achieving consistent reforms. While issues remain to be resolved, in Europe, in the US and elsewhere, we are, collectively, fundamentally reshaping the framework for systemic financial oversight. Let me note some examples:

– First, top-down, system-wide oversight arrangements are being put in place at national, regional and international levels. These arrangements are designed to deliver more encompassing surveillance, with broadened macro-prudential perspectives, and better mechanisms for triggering action on identified risks. Examples are the European Systemic Risk Board and related arrangements, the US Financial Services Oversight Council, the IMF-FSB Early Warning Exercise, and the establishment of the FSB itself.

– Second, major jurisdictions have overhaulied their regulatory and supervisory structures to strengthen responsiveness to risks, improve coordination and close gaps. The FSB is in many ways the international manifestation of these efforts;

– Third, the regulatory perimeter is being expanded. Major jurisdictions have finalized or will shortly finalize legislation that establish regulation and oversight over the OTC derivatives markets, hedge funds and credit rating agencies. In each of these areas, principles for what regulation should achieve have been internationally agreed and implementing regulation is being closely coordinated;

– Fourth, we have put in place cross-border oversight and contingency planning for the largest and most complex global financial institutions, each of which now have functioning core supervisory colleges and crisis management groups.

At the level of the essential regulatory policies to buttress financial stability, let me recall:

– that with Basel III, we have a fundamentally revised global bank capital framework which will establish stronger protection through improved risk coverage, more and higher quality capital, a counter-cyclical buffer and a constraint on the build-up of banking sector leverage;

– Second, as part of Basel III, we will for the first time have a global liquidity standard for banks that will promote higher liquidity buffers and constrain the maturity mismatching that created the condition for this crisis;

– Third, as I will describe later, we are making progress in developing a policy framework and tools to roll back the moral hazard risks posed by institutions that are TBTF;

– Fourth, we have eliminated the perverse incentives that pervaded securitization, including the scope for leverage to develop in opaque off-balance sheet vehicles through changes to accounting standards and regulatory and prudential rules;

– Fifth, we are establishing central clearing of standardised contracts in the OTC derivatives markets and a OTC global trade repository is now in operation;

– Fifth, we have developed a series of supervisory tools to raise standards of governance, risk management and capital conservation at financial institutions. In this context, let me note that:

  - we are making good progress with accounting standard setters towards expected loss provisioning regime for credit losses, which will dampen procyclicality and align accounting and prudential objectives in this key area; and

  - principles and standards have been issued to better align compensation systems with prudent risk-taking. The standards give supervisors powers to restrain compensation structures and the level of pay-out to conserve capital in the firm. As we move to raise capital levels, we will encourage supervisors to use these powers.

I have been selective in my enumeration. But the point I want to leave with you is that we should not underestimate what has been accomplished. Each of the above areas are difficult in their own right. That we have been able to progress global policy development and implementation on such a broad front, while fighting a very serious financial crisis, is something that has never happened before.

So, the direction in which we are moving internationally is encouraging. But important issues remain. And it is political resolve that will determine whether we accomplish the credible and robust reforms that our citizens rightly demand, yet preserve the enormous advantages of an internationally integrated financial system.

Addressing TBTF

Addressing the "too-big-to-fail" (TBTF) problem is perhaps the most challenging remaining legacy of the crisis. Basel III will greatly strengthen banking system resilience, but it does not address this problem.

The FSB has assessed a broad range of policy options in this area and will present its recommendations to the G20 in November.

It is important to recognise that SIFIs vary widely in structures and activities and that the nature and degree of the risks they pose also differ. Some are large, complex highly integrated global financial institutions with activities spanning a range of sectors. Others may have a global customer base but are simpler commercial banking operations. Yet a third category is entities that are large at a domestic or regional level but nonetheless globally interconnected through wholesale funding markets.

Whatever their nature, SIFIs have two things in common: that their uncontrolled failure would cause significant systemic disruption and that we, as authorities, cannot at present resolve them in an orderly fashion without use of public funds. The framework we have agreed to address SIFIs is therefore based on four necessary pillars.

First, we must radically improve our capacity to resolve SIFIs without disruptions to the financial system and without taxpayers' support. Effective resolution regimes must advance the goals of both financial stability and market discipline. This means they need to be able to impose losses on shareholders as well as creditors while ensuring continuity of essential financial functions. All countries should have a Dodd Frank style regime in place. In addition, we need to acquire additional resolution tools. The bail-in of debt holders holds significant attractions both from the perspective of correcting creditor incentives and protecting tax payers. But the legal issues associated with the bail-in in group structures and in a cross-border context are non-trivial.

Moreover, to be effective backstops in dealing with global firms, national resolution regimes need to converge towards common standards. And these need to be supplemented by cross-border cooperation arrangements underpinned by national law that provides both mandate and capacity for resolution authorities to cooperate. Legislative changes will be needed in many countries to enable this. Lastly, "living wills" will be mandatory for major firms. These will include assessments of firm resolvability. Supervisors will have the power to require changes to a firm's structure to improve its resolvability.

Second, the loss absorption capacity of systemic firms should reflect their role in the global financial system and their potential contribution to systemic risk. Even with the best possible resolution tools, the failure of a major global firm would cause significant damage. This reinforces the importance of strengthening the resilience of major global firms. Higher loss absorption capacity for SIFIs than the minimum agreed Basel III standards, especially for the largest globally operating SIFIs, therefore are at the core of our recommendations. A credible process of peer review will be established to challenge the policy choices made within each jurisdiction and to ensure that measures applied on a country-by-country and SIFI-by-SIFI basis are consistent and mutually supportive.

The third area is strengthened oversight and supervision. Senior line supervisors have drawn a frank assessment of weakness leading up to this crisis. These weaknesses were not present in equal amounts everywhere, but there is scope for improvements all around. Our recommendations in this area have been developed with the IMF. One set is focused on the mandates, independence and resourcing of supervisors. Another is on improved methods and practices to proactively identify and address risks.

Fourth, we will be setting out higher robustness standards for core financial infrastructure. These infrastructures – including for central counterparties – are themselves sources of systemic risk were they to malfunction or fail.

This is a complex project which will unfold over a number of years. It will need to be consistently implemented in all major countries to maintain a level playing field, avoid regulatory arbitrage and effectively address the risks to the overall system. The already established FSB framework of country and thematic peer reviewing process will address improved resolution frameworks and more intensive supervision In addition for SIFIs with the potential to create damages at a global level we will establish a mutual policy review process that will review and challenge the national policies towards major global SIFIs.

Ahead of us, other issues still require attention:

– So far, most of our attention has been on strengthening the resilience of the banking system, and rightly so. Yet, the shadow banking sector remains a large part of our financial systems, less regulated, but nonetheless significant in the credit intermediation and maturity transformation, and subject to runs in damaging ways.

– We need to make frameworks for macro-prudential policies and systemwide oversight operational. We will be sharing approaches for surveillance, powers to obtain information and modalities for action on identified risks. The FSB will coordinate approaches where an international regulatory response is needed. We will be working with the BIS and the IMF to build principles for effective macro-prudential policies.

Lastly, the FSB is developing arrangements to broaden the involvement non-members in its work at early stages of policy development. We will be setting up regional arms of the FSB. Each regional group will be co-chaired by an FSB member and a regional non-member who will attend FSB Plenary meetings.

Conclusions

Let me conclude. Three things have been important in making the progress we have on reforms:

- First, the sheer seriousness of the crisis, and the recognition that, in a globally integrated system, we all sit in the same boat;
- Second, the readiness in the official community to agree objectives and timelines for substantial reform, including through the G20 process; and
- Third, the establishment of mechanisms, such as the FSB, to hasten the policy development needed to meet these objectives.

I am quite confident that, with these, we will be able to achieve globally consistent rules that will lastingly increase the resilience of the financial system and the real economy and deliver the level playing field that a global system needs.