Randal K Quarles: The Financial Stability Board at 10 years - looking back and looking ahead

Speech by Mr Randal K Quarles, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, at the European Banking Federation's Banking Summit "Building A Positive Future For Europe", Brussels, 3 October 2019.

* * *

Thank you for the opportunity to speak to you today. The European Banking Federation is often referred to as the voice of Europe's banks, and I am here in the hopes that you are the ears of those institutions as well.

This year, 2019, is the 10th anniversary of the founding of the Financial Stability Board (FSB), which means it has also been 10 years since some of the darker days of the global financial crisis. The FSB was not born on a sunny day; it was born of necessity, with storm clouds still looming.

An anniversary—particularly a 10th anniversary—is a good opportunity for reflection. Not far from here, in Antwerp, the artist Peter Paul Rubens painted the "Temple of Janus." Janus was a Roman god who could look both backward and forward in time, and when Rubens painted the work, citizens of Antwerp were at a turning point and were wondering what the future held for them. Today, I would like to take on the role of Janus. I would like to look back on the experiences of the past 10 years, what the FSB has accomplished, and also offer some perspective on just how it contributed to the construction of the post-crisis global financial architecture. As you would expect, I believe the FSB has and will continue to play an important role in our global financial system. I will discuss why that is. I would then like to look ahead to the new challenges facing the global regulatory community, such as innovations in financial technology, shifts in financial globalization and integration, and increasing nonbank financial intermediation.

Ten years ago, after the events of the fall of 2008, the G20 nations recognized that the response to the crisis had to be urgent, it had to be credible, and it had to be global. The regulatory community knew it must work to regain the confidence of financial institutions, market participants, and the broader public. They knew that then-existing arrangements for international cooperation were not up to that task.

The Financial Stability Forum (FSF), the predecessor of the FSB, had been founded by the G7 countries in 1999 after a series of financial crises in the latter part of the 1990s. The group was intended to enhance cooperation among various national and international supervisory bodies and multilateral financial institutions in order to promote stability in the international financial system. Membership was relatively narrow, with only 12 countries and few emerging markets represented.

While the group discussed matters related to financial stability, the areas it was asked to study were relatively narrow, and combined with its limited membership, it had relatively little scope to promote regulatory reform. The looseness of this arrangement represented the prevailing view in advanced nations at the time that national regulators and finance ministries were capable of monitoring and dealing with risks to global financial stability. On the one hand, these nations had long recognized that effective capital regulation of banks with a global footprint was only possible with coordination on minimal capital standards—the Basel Committee process. But there was no such consensus about financial stability, perhaps rooted in a belief, rarely expressed but widespread, that a severe global financial crisis was highly unlikely, and that traditional prudential supervision would be enough to prevent it. Major banks in Europe, Japan, and the United States had been affected by debt crises in developing countries in the 1980s and 1990s, but these crises had never seriously threatened advanced economies.

In the fall of 2008, G20 leaders recognized that the severity of the emerging global financial crisis required a response that was beyond the capabilities of the FSF. Like that Long Island police chief in the movie “Jaws,” ministers and leaders saw what was racing toward them and decided that they were going to need a bigger boat. Specifically, they recognized there was a major deficiency in the FSF that prevented it from being very effective in establishing international financial regulatory standards. The FSF was narrow—geographically, in the number of governments, and substantively, in the range of ministries, central banks, and important regulatory agencies that were not members. Some of the world’s largest economies and financial markets were not represented, in particular emerging markets like China, India, Brazil, Mexico, and South Africa. As of 2009, only 58 percent of global gross domestic product (GDP) was represented, compared to 83 percent of GDP under the FSB today. The issue of representation was crucial, because the financial crisis required a fully global response.

As a result, in April of 2009 at the G20 summit in London, the heads of state and government called for an organization “with a stronger institutional basis and enhanced capacity” that would allow them to achieve “much greater consistency and systematic cooperation between countries…that a global financial system requires.” Behind those simple words was a sea change in the willingness of advanced nations to tackle significant coordination on financial regulation. The crisis that had been raging at that point for over a year made the need for such a commitment inescapable.

With the creation of the FSB, the G20 designed a new regulatory organization with global reach dedicated to advancing and coordinating a newly embraced priority for the global economy—far-reaching reform of financial regulation and supervision. The FSB membership spans central banks, ministries of finance, supervisors of financial institutions, international financial organizations, and market regulators. It has a broad mandate centered on financial stability and coordination of responses for those most challenging issues that cut across the traditional mandates of other global standard-setting bodies. In addition, one of the FSB’s chief responsibilities is scanning the horizon for financial vulnerabilities, making it an inherently forward-looking body.

The exigency of the crisis helped overcome longstanding deficiencies in the structure of the FSF, rooted in differences between the members or ambivalence about international standard setting itself, related to financial stability. The crisis helped bridge differences and reach consensus, so that quick initial progress was made on matters that required urgent action. In addition to those actions, the members also recognized that work must begin immediately to develop new regulatory standards for capital and liquidity, derivatives reform, and issues stemming from the nonbanking sector which would require some time for data gathering and extensive public consultation. Creation of the FSB was one of a number of steps taken at the international level in the spring of 2009 that over the subsequent months helped restore confidence in the banking system and begin the process of recovery.

Since the FSB was born with the global economy and financial markets still in turmoil, immediate attention was needed in a number of core areas: over-the-counter (OTC) derivatives, prudential bank standards, resolution, and nonbank finance. Much of the FSB’s first 10 years has been focused on these issues, and a great deal has been accomplished, resulting in a significantly strengthened and more resilient global financial system. So let me quickly review our work in these areas.

Over-the-Counter Derivatives

The elements of the FSB’s agenda for OTC derivatives fall into four categories: 1) central clearing of standardized OTC derivatives, where appropriate, 2) exchange or electronic platform trading of standardized OTC derivatives, 3) reporting to trade repositories, and 4) higher capital and margin requirements for non-centrally cleared derivatives. The most recent report on implementation progress finds that in the jurisdictions with the largest OTC derivatives markets, there is almost complete implementation of the necessary reforms. That means that today, OTC derivatives markets, which are crucial for the functioning of our financial system, are simpler, more transparent, and generally more resilient.

Prudential Bank Standards

The FSB has endorsed the work of the Basel Committee that is aimed at enhanced prudential standards for internationally active banking organizations, a process known as Basel III. The main elements of Basel III are: a stronger risk-based capital adequacy framework; a leverage ratio requirement; a capital surcharge for global systemically important banks; a liquidity coverage ratio liquidity requirement; a net stable funding ratio liquidity requirement; and a large exposures framework.

All 24 member jurisdictions of the FSB have the core elements of Basel III risk-based capital and liquidity measures in place. However, there has been uneven progress on some of the other elements. Some jurisdictions have not yet fully implemented the large exposures framework, the leverage ratio, and the net stable funding ratio. And most jurisdictions are just starting to implement the Basel III “end game” reforms agreed in December 2017. We have some work left to do but I am confident that it will be completed, and the FSB will continue to push all of its members for full completion of these important measures.

Resolution

One of the most important issues the world faced during the financial crisis was the “too-big-to-fail” dilemma. The large and unpopular bailouts that were deployed to help stem the crisis made it clear that an alternative was needed to deal with “too big to fail."

In response, the FSB established the “Key Attributes for Effective Resolution,” which identify the responsibilities, instruments, and powers that national resolution regimes should follow if they have to resolve a failing systemically important financial institution or SIFI. The FSB’s resolution work also included a new total loss absorbing capacity requirement to help ensure that authorities are able to conduct a bail-in recapitalization of a failed SIFI. Too big to fail was a defining issue of the crisis, and recognizing the importance of the work that has been done to end it, this year the FSB kicked off an evaluation of the effects of the reforms that have been put in place around the world to deal with the issue. By next year, I hope we will be able to discuss the results of that work.

Nonbank Financial Intermediation

During the crisis, “shadow banking” became the term for any type of financial activity that occurred outside banks that resembled what banks did and that often wasn’t completely understood. Within the FSB, we refer to those activities as nonbank financial intermediation, or NBFI. Regardless of its name, a lot of blame for the problems that arose in the global financial crisis centered on risks that emerged from some activities in parts of this sector, and one of the FSB’s first jobs was to try to look into these activities to better understand their growing role in financial markets.

Among the important steps we took was a global monitoring exercise that results in an annual report on the size of NBFI in the global economy. That work actually goes beyond the membership of the FSB, since a number of important international financial centers also report information to us. With all of that information, we are able to track the overall size of nonbank financial intermediation, which in 2017 grew to $184 trillion, representing nearly half of financial activity in 21 countries plus the euro area. More important, we are now able to more carefully categorize activities in the nonbank sector in order to analyze potential vulnerabilities.

In addition to monitoring, we have made a number of other recommendations and are working with fellow global standard setters to implement them. For example, we are working with the International Association of Insurance Supervisors on capital standards for global insurers, and we are working with the International Organization of Securities Commissions (IOSCO) on liquidity and leverage in the funds industry. The funds sector continues to evolve, so we will focus particular attention here as we move forward.

Status of Post-Crisis Reform

The result of 10 years of policy development by the FSB and implementation at the national level has been a stronger, more resilient global financial system. Large banks are better capitalized, less levered, and more liquid. Too-big-to-fail reforms are well-advanced, particularly with the formation of effective resolution regimes for banks. OTC derivatives markets are simpler and more transparent. Nonbank financial intermediation risks are better understood, and steps are being taken to reduce and contain them. While shocks to the system, especially from unanticipated directions, can never be ruled out, these reforms go a long way to reducing the likelihood and severity of future crises.

Consequently, the FSB has started to pivot from policy development to evaluating the effectiveness of the reforms it has advocated. I just mentioned that this year the FSB began a two-year evaluation of its too-big-to-fail reform package. We are also completing an evaluation of the effects that reforms have had on infrastructure finance and lending to small- and medium-sized enterprises. Going forward, these evaluations will be critical for assessing where more work needs to be done.

Casting my gaze backward, there is much to be proud of in the last decade, success that is reflected in the strength and stability of the global financial system. So now I would like to leave the past behind and turn to the future. But while Janus was the god of beginnings, he was also the god of endings, and as such was able to look both backwards and forwards at the same time.

Assessing financial vulnerabilities is a critical part of the FSB mandate, and that is inherently a forward-looking job. The global financial system is constantly evolving, influenced in part by past experience, and by regulation. As I look ahead, I think we must consider whether the ways in which we responded to the financial crisis may not be the most appropriate ones to address the challenges and ongoing changes in the financial system that we currently face.

This year the FSB has embarked on an important project to review and update its financial stability surveillance framework. While much of the attention of the FSB in its early years was on post-crisis reforms, members also spent time thinking about new vulnerabilities to the system. As we reach our 10th anniversary, it is a good time to review the ways we monitor the ever-changing financial system. The aim of this review is to ensure that we have a framework that is comprehensive, consistent over time, and effective at identifying relevant vulnerabilities. If we are not at the cutting edge in our ability to assess the state of the financial system, we do a disservice to the public we serve, which relies on a smoothly functioning financial system. In addition, we are looking at how we communicate our understanding of the state of the financial system to the G20 and to the world. We want to be more open about our assessment, but great care has to be taken to avoid a situation where revelations about emerging concerns lead to acceleration of those concerns and becomes a self-fulfilling prophecy.

As I look forward and ponder the forces that are shaping the evolution of the global financial system, the FSB is currently grappling with two issues—financial innovation and market fragmentation—that have the potential to profoundly affect financial stability, so let me start there.

Owing to our forward-looking orientation, the FSB has been actively engaged in monitoring financial innovation for some time. Starting a little over five years ago, there was an explosion of financial innovation that had a technological component, which we now call fintech. This encompasses peer-to-peer lending, cryptocurrencies like Bitcoin, and the use of new techniques like artificial intelligence and machine learning. In 2017, the FSB issued a report on the implications of fintech for financial stability. The report was careful to note the potential benefits of many of these innovations, including the possibility of greater financial inclusion and increased speed of financial transactions. However, the report also drew attention to several supervisory and regulatory issues, including three priorities where international collaboration is critical: managing operational risk from third-party service providers, mitigating cyber risks, and monitoring macrofinancial risks that could emerge as fintech activities increase.[1]

More recently, one particular area of fintech has received a lot of attention—stablecoins. These are a type of crypto-asset that attempts to address the volatility of some crypto-assets by tying their value to conventional assets, such as the value of the U.S. dollar or a basket of currencies. While it hasn't been created yet, it is Facebook's proposal for a new stablecoin that significantly increased the public's attention to stablecoins. At the FSB, we undertake regular monitoring of the financial stability implications of crypto-assets, and we have had discussions about the regulatory and supervisory approaches to crypto-assets and potential gaps in regulation. The introduction of stablecoins, however, brings a potentially new scale and scope that the financial regulatory community must carefully consider. Although there is a small risk to financial stability today, there is no doubt the potential scale of stablecoins and other crypto-assets yet to emerge may pose regulatory challenges. At present, the G7 is finishing a preliminary assessment of stablecoins, and the G20 has asked the FSB to lead the work going forward, which we are actively undertaking. This is an issue that can potentially affect every country in the world. We have already begun work to identify which regulations exist that apply to stablecoins in our jurisdictions, and once that assessment is complete, we will report to the G20 on any appropriate actions that need to be taken to ensure that financial stability is not negatively affected by their introduction.

The FSB is grappling with other challenges beyond fintech. As time has passed since the financial crisis, there is concern about fragmentation of financial markets—a sense that globalization of financial markets may be slowing and differences in the regulatory requirements at the national level may be on the rise. Some forms of market fragmentation may have financial stability benefits, such as reasonable loss absorbency requirements imposed on subsidiaries of global banks, but market fragmentation may also bring about unintended negative consequences, such as increased opportunities for regulatory arbitrage and cumulatively higher regulatory burdens for firms.

Over the past year, at the request of the G20, the FSB has been examining the different forms in which market fragmentation is manifest. Following up on that, we recently held a workshop where FSB members met with representatives from the private sector and from academia to discuss the internal allocation of capital and liquidity by global financial institutions.[2] We are also following up in other areas, such as working with IOSCO on issues related to deference and examining improved ways for regulatory and supervisory information sharing. Market fragmentation is an issue that will never disappear, and we will remain vigilant to ensure that it does not pose a threat to financial stability.

At the outset today, I said I was going to take the mantle of Janus, who could look backward and forward in time. Janus was also the god of transitions, which makes him doubly appropriate for the FSB at this time, because we find ourselves in transition from a time when we were largely focused on addressing the effects and the lessons of the financial crisis. We now find ourselves with increasingly focused energy on looking forward, with both a strong organization that has been tested through an intense period of policy formulation and implementation and a strong global financial system resulting from those efforts. I hope that 10 years from now, a successor of mine as FSB Chair can point to 10 more years of success in flexibly and adeptly responding to all that the global financial system throws at us. Speaking on behalf of the members of the FSB, we stand ready.

---

[1] Consumer protection is a major concern in relation to fintech and cyber risk, but it is outside the FSB's mandate and is being handled by member governments.

[2] Randal K. Quarles, "Government of Union: Achieving Certainty in Cross-Border Finance" (speech at the Financial Stability Board Workshop, Philadelphia, PA, September 26, 2019).