Modernisation of the Global Financial Architecture: Global Financial Stability

Remarks of Mario Draghi
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to the
Committee on Economic and Monetary Affairs
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Thank you very much for having invited me to take part in this important debate between European and national parliaments. International and regional cooperation and national political leadership are essential complements for achieving global financial reforms; and the debate in this Committee is really helpful for that purpose. It is ultimately national and regional legislatures, accountable to their voters, that must decide and implement reforms.

The strains in the global financial system have eased considerably in the last twelve months: the banks are once again raising funds, asset write-downs have diminished. Nevertheless, elements of fragility are still present in various parts of the financial system and risks, mainly related to the deterioration of traditional loan books, the bunching of refinancing needs in the next few years, and to new sources of risk such as sovereign risk. It is essential that we can count, in the years to come, on a fully restored ability of the banking sector to perform its essential tasks in the economy.

We have come a long way towards strengthening the financial system since this crisis began. But we have hard work ahead of us to finish up. In my remarks, I will focus mainly on these forward challenges. But let me start by taking stock of where we have gotten to.

Three things have been important in getting us to where we are now:

- First, the recognition that, in a closely integrated system, we all sit in the same boat;
- Second, the leadership of the G20 process, in which the EU has played an important role, in agreeing objectives and timelines for substantial reform; and
- Third, the establishment of mechanisms, such as the FSB, to hasten and coordinate the policy development needed to meet these objectives.

When I say we have gotten far, I am speaking to an unprecedented amount of international dialogue and co-operation on important financial system issues, and the resulting substantive changes that either have or are about to come into place. While many issues remain to be resolved, in Europe, in the US and elsewhere, we are, collectively, fundamentally reshaping the framework for systemic financial oversight:

- First, top-down, system-wide oversight arrangements are being put in place at the national, regional and international level. These include more encompassing surveillance, with broadened macro-prudential perspectives, as well as 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, as part of this, major jurisdictions and regions are overhauling their regulatory and supervisory structures to strengthen responsiveness to systemic 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 are finalizing legislation that for the first time establishes formal oversight over the OTC derivatives markets and its major dealers, hedge funds and credit rating agencies. In each of these areas, principles for what regulation should achieve have been internationally agreed;

- Fourth, we have put in place cross-border oversight and crisis management 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 we are in the process of calibrating 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, we have developed and will implement 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, we are making progress in developing a policy framework and tools to roll back the moral hazard risks posed by institutions that are systemically important;
- 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 have developed a series of supervisory tools to raise standards of governance, risk management and capital conservation at core financial institutions. In this context, let me note that:
    - we are making strong progress towards a forward looking expected loss provisioning regime for credit losses which will dampen procyclicality and align accounting and prudential objectives in this key area; and
    - we are making good headway towards establishing compensation regimes that are better aligned with risks taken in significant

financial institutions.

I have been selective in my enumeration. But the point I want to make 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 in cases 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 as we hit the homestretch in the above areas, your political leadership will determine whether we accomplish credible and robust global reforms that deliver the protections that our citizens rightly demand, yet preserve the enormous advantages of an internationally integrated financial system. We must not only reaffirm our commitment to global solutions, but demonstrate our willingness to reach agreement on the issues that stand in their way. We cannot all have it our own way.

In the process, we must guard against pressures to water down the stringency of global reforms. That such pressures originate within a financial industry concerned to preserve competitive advantages is not a surprise. But such pressures are also evident in hesitation by some countries about the impact of reforms on their own financial institutions. This hesitation is stronger where the starting point is weaker. However, it would be a very serious and unfortunate mistake to allow these different starting points to result in weaker standards than we need for the future.

Given the economic and social costs of this crisis, we simply cannot afford sub-standard outcomes. And were we to fail, the risks is that countries and regions will go their own way and that the system will fragment, with very significant global costs. Hence, we must keep our focus on achieving global standards that are credible, and as part of this, agree transition and phase-in arrangements that enable all of us to move there. I will come back to this point.

Let me speak to the key areas where we need to make headway in the months ahead.

First and foremost, we must complete the revamp of the Basel capital framework and the liquidity standard, along with the complementary changes, including provisioning, that address the problems of procyclicality that we have seen in this crisis. We made a major step forward on this issue in December, when the Basel Committee released - on schedule – the full package of reform proposals. Comprehensive impact assessments are now underway to assess the consequences of the December capital and liquidity proposals on the banking sector. This is complemented by a top down assessment to calibrate the new minimum requirements, taking account of, among other things, loss experience over this crisis, and the impact on banks' role in the financial system and the benefits and costs of the new requirements in the steady state.

As I mentioned earlier, it will be critical that we do not let current strained conditions shape the standards, but instead keep our focus on the rigorous framework needed to ensure balanced, sustainable banking in the years ahead. While the banking sector has already made significant progress to raise the level and quality of its capital and liquidity, immediately implementing in full the more stringent minimum requirements could have negative effects. We will design appropriate transition and grandfathering arrangements that rule this out. We have set in train jointly with the Basel Committee, and with the IMF as a key partner, a thorough macroeconomic impact assessment to inform these phase-in and implementation arrangements. Preliminary results on all assessment streams will be available in June/July. Calibration work will continue into the fall, and the broad features of the framework, along with the transition arrangements, will be ready by the G20 Summit in November. Countries will need to pass any necessary legislation to implement the reform according to the agreed timetable, and the EU is at the forefront of this.

Second, this year we must agree on measures to credibly reduce the moral hazard and systemic risk caused by firms that are "too big to fail". TBTF is first and foremost a national problem – at worst when institutions are too big to save. But we are all affected by the moral hazard consequences of the problem going unresolved. There is no silver bullet or one-size-fits-all solution here. One focus of our work is therefore to provide supervisors with tools that enable them to take action in national contexts under existing authority – governance, intensity of supervision, structural simplification, capital surcharges, etc. Systemically important financial institutions have to be resilient even in periods of broad financial system stress events. Capital, liquidity and leverage expectations should reflect that. But we will never be able to fully eliminate the potential for failures, therefore a key requirement across all jurisdictions is the establishment of effective resolution frameworks that allow all types and size of institutions to fail, and adequate co-ordination of these frameworks across borders. This is a tall order, as we all know. However, should effective cross-border resolution prove out of reach, it will strengthen the case for alternative solutions: to place restrictions on activities/size/structure that make all institutions resolvable, or to raise capital and other requirements on systemic institutions to a point where the likelihood and impact of default is reduced to a very low level. This will come at a cost to intermediation and global financial integration.

Given the diversity of institutions and financial systems involved, a key challenge will be to avoid inconsistencies in what results. We must achieve consistent design and implementation of new measures to ensure a level playing field and to address potential concerns about market fragmentation. Our aim is to reduce systemic risks globally by having standards for TBTF firms that set a common floor, and actions across countries that are sufficiently coordinated to avoid regulatory arbitrage. We will provide an interim report on these issues to the G20 Summit in June, and final recommendations to the November Summit.

<u>Third, we must finalise reforms to regulate, make transparent and centrally clear a substantial portion of the OTC derivatives markets</u>, and so reduce their scope to act as channels of contagion. Legislation is advancing in the US and EU to establish the requisite frameworks for this. Among critical questions to resolve are:

- which derivatives products can and should be standardised, and ought to be subject to a mandatory central clearing requirement;

- whether, and if so how to define which type of, commercial end-users should be exempted from these requirements;

We must be careful to avoid inconsistencies here, because this will drive regulatory arbitrage in this global market. To accomplish meaningful systemic risk reduction, we need robust globally agreed standards of soundness for all central counterparties. And governments should ensure that the determination of which derivatives should subject be to central clearing is not left to central counterparties alone. We also need harmonised definitions of standardised derivatives, and are setting in train work across the US and EU to this effect. It is also imperative that regulators have the information available to them to police the market for potential manipulative abuses. This is why there must be mandatory trade reporting of all OTC derivatives transactions, regardless of whether they are centrally cleared or bilaterally negotiated.

<u>Fourth, we must firmly embed reforms to compensation practices at financial institutions.</u> As you know, the FSB set out Principles and Implementation Standards for Sound Compensation arrangements last year. In December, we launched a detailed assessment of implementation of these standards. This is a very important task not just because this is the FSB's first peer review, but also because of the importance and political dimension of this topic. We are on schedule to conclude this review later this month. The review points to a key message – that a lot has been done by national authorities and that change is taking place in the major firms. However, differences remain in the approach to and pace of implementation. Greater progress has been achieved in the areas of governance, supervisory oversight and disclosure of compensation, while much more work needs to be done on pay structures and risk-alignment. We will be setting out additional recommendations in this area later in March.

<u>Concluding remarks</u>

At the outset, I noted that international cooperation and national/regional political leadership are complementary drivers for achieving global financial reform.

Together, we have come a long way. But 2010 will be a critical year as we press ahead with global financial reforms. To maintain the momentum, we are critically dependent on your support. Indeed, internationally coordinated reforms cannot be agreed nor implemented without the support of national political leaders and those who are in a position to make final decisions. Your decisions, and those or your colleagues in other jurisdictions, will determine whether we are able to build a more robust and consistent global financial order necessary to preserve the advantages of an integrated financial system.

Beyond the policy development work, full and consistent implementation will take time and perseverance. As I said, we must keep our eyes on the end objective, and we will develop transition paths to take us there. As we work to improve international cooperation and to further financial reforms, I hope we can count on the political support and leadership of all of you in this room.

Thank you very much.