# Stability of the Financial System – An Introduction

## Mark Carney

Although the concept of financial stability may, at first glance, seem illusive and difficult to define, the global financial crisis of 2007-8 provided a stark and very concrete example of its antonym – financial instability. The crisis also demonstrated the importance of financial stability for economic stability as the economic fallout was horrendous: no country was left unscathed, 50 million jobs were lost and many countries have still not yet recovered to pre-crisis levels of output and employment. One positive consequence of the crisis is that the G20 assumed the leadership role as the premier global economic policy-making forum. The G20 has given the FSB an enhanced mandate to coordinate efforts to develop and consistently implement a comprehensive set of new global standards and regulations. The objective of these reforms is not to eliminate all financial crises but to lessen their likelihood and reduce their severity by increasing the resilience of the global financial system.

The breadth and scope of the chapters in this volume reflect the challenge of developing and consistently implementing a coherent set of financial reforms to promote financial stability. They make an important contribution to deepening our understanding of the many facets of financial stability. They will promote the development of financial reforms that are effective in striking the optimal balance between realising the enormous benefits that the financial sector brings in to efficient financial intermediation, capital allocation and risk management, on the one hand, and controlling systemic risks and maintaining financial stability, on the other.

Substantial progress has been made on developing and implementing the programme of financial reforms mandated by the G20. To date, the most important accomplishments are:

- Defining a new capital regime (Basel III) for banks;
- Agreeing to the core elements of a framework to end "Too-Big-To-Fail";
- Strengthening the plumbing of core financial markets;
- Placing more attention to the consistent national implementation of these reforms; and

- Putting the FSB on a firmer institutional footing.

While much has been accomplished in recent years, what is still to come is just as important, especially in four priority areas:

- Building resilient financial institutions;
- Ending Too-Big-To-Fail;
- Creating Continuously Open Core Markets; and
- Moving from Shadow Banking to Market-Based Financing.

## BUILDING RESILIENT FINANCIAL INSTITUTIONS

Achieving a stronger, more resilient banking system is an overriding priority. The full implementation of Basel 2.5/III capital and liquidity standards will significantly increase the quantity and quality of bank capital and produce more robust funding structures. Although risks to financial stability are elevated and the macro-economic environment is challenging, large parts of the system are sounder than they were before the crisis. For example, the largest banks have the capacity to meet readily the new capital adequacy targets through earnings retention over the six-year transition period from 2013 to 2019.

In addition, a simple, but effective, leverage standard has been imported from Canada to protect the system from risks that banks think are low, but, in fact, are high. Sensible liquidity measures, including the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), have also been put in place. The LCR promotes short-term resilience by ensuring a bank holds sufficient liquid assets to survive intense stress lasting for one month, while the NSFR encourages a compatible maturity structure of assets and liabilities and thus prevents significant maturity mismatches over longer-term horizons. Both measures are currently under observation with the goal of fully implementing the LCR in January 2015 and the NSFR in January 2018.

Finally, supervisory intensity is being stepped up to strengthen risk management practices and disclosure. Across FSB member jurisdictions, supervisory expectations for risk governance at financial institutions have increased.

## ENDING TOO-BIG-TO-FAIL

It is essential that large financial institutions can be resolved in the event of future failure without resorting to taxpayer support, while at the same time avoiding significant disruption to the wider financial system. Ending the problem of "too-big-to-fail" requires the full implementation of a number of agreed measures, including a marked step-up in resolution planning and cross-border cooperation. In particular, the FSB's new *Key Attributes for Effective Resolu-*

*tion Regimes* need to be fully implemented to establish effective resolution regimes in FSB member jurisdictions.

The FSB has identified a list of globally systemically important banks (G-SIBs). Cross-border crisis management groups have been established for the majority of these G-SIBs and resolution strategies and plans and cross-border co-operation agreements are being put in place to ensure their resolvability. This framework for regulating and supervising systemic global banks is being extended to domestic banks, global insurers, and key shadow banks.

## CREATING CONTINUOUSLY OPEN MARKETS

To help end the problem of "too-big-to-fail", core financial markets should be able to withstand the failure of systemic firms. Achieving such resilience requires sounder market infrastructures and practices, increased transparency, and better data for firms and supervisors to monitor exposures and emerging risks.

Over-the-counter derivatives (OTCD) markets are immense and critical to the stable and efficient functioning of the financial system. To date, much of the policy development work has been completed on OTCD market infrastructures and practices to promote increased standardisation, and greater use of central clearing, trade repositories, and trading platforms, and to specify the rules for margining and capital. An important example is a new set of safeguards (fair and open access, cross border liquidity, cooperative regulatory oversight) for a resilient and efficient global framework for clearing OTC derivatives.

Many of these OTCD market infrastructures are operational and in use for different asset classes. Their usage will increase in the future as more jurisdictions enact the necessary legislation and regulation to support the implementation of these reforms. Progress to date has been the greatest in the jurisdictions with the largest OTC derivatives markets, namely the United States, European Union and Japan.

The reform agenda for OTCD markets is a good example of the FSB's role of coordinating the work of international standard-setting bodies in areas of overlapping responsibility. The margining requirements of CCPs are set by CPSS-IOSCO and those of bilateral trades by IOSCO, and the capital standards for centrally and bilaterally cleared trades are set by the BCBS.

## MOVING FROM SHADOW BANKING TO MARKET-BASED FINANCE

Given the central role shadow banking activities played in the financial crisis, the FSB is working to strengthen the oversight and regulation of shadow banking so that it is a source of competition and diversity to the regulated sector.

The shadow banking sector needs to be converted from a source of vulnerabilities to a force for competition, efficiency and systemic resilience.

These reforms will require changes to the management of money-market funds, the terms of securitisation and, most importantly, the involvement and exposure of the regulated banking sector to shadow banking activities. These measures will aim to mitigate the spillovers between the regular banking system and the shadow banking system; reduce the susceptibility of money market funds and other shadow banking entities to runs; better align the incentives associated with securitisation; and dampen risks and pro-cyclical incentives associated with securities lending and repo activities.

## CONCLUDING REMARK: THE IMPORTANCE OF TIMELY AND CONSISTENT IMPLEMENTATION

Although the development of global standards for financial stability is important, full and consistent implementation is absolutely essential to preserving the advantages of an open and globally integrated financial system. Market participants and authorities need to have confidence in the strength of financial institutions and markets in other countries. Moreover, to realise fully the benefits of openness and competition, there must be a level playing field. Recent post-crisis experience demonstrates that when mutual confidence is lost, the retreat from an open and integrated system can occur rapidly. A return to a nationally segmented global financial system would reduce both financial capacity and systemic resilience, with major consequences for output and employment growth.

The FSB is placing more emphasis on the timely, full and consistent implementation of major reforms, with reviews of progress in implementing Basel III, compensation standards and OTC derivatives reforms. This implementation monitoring is being conducted within a coordination framework that leverages the expertise and resources of the standard setting bodies.

G20 Leaders have endorsed significant proposals to strengthen the capacity, resources and governance of the FSB. In particular, the Leaders supported proposals to put the FSB on an enduring organisational footing, with legal personality and greater financial autonomy, and increased accountability. These changes will enhance the FSB's ability to coordinate among standard setters to effectively monitor and promote timely, full and consistent implementation across FSB members.

It is important to stress that financial stability is not an end to itself. To achieve the ultimate G20 goal of strong, sustainable and balanced global growth will require coherent monetary, fiscal, and financial policy frameworks within and across G20 countries.